5 T.C. 1089 (1945)

A grantor is taxable on trust income under Section 22(a) of the Internal Revenue Code when they retain substantial control over the trust, especially when the trust assets consist of stock in a closely held family corporation.

Summary

Samuel and Anna Morgan created trusts for their children, funding them with stock in their family-owned corporation. As trustees, they retained broad powers to manage the trusts and accumulate income. The Tax Court held that the Morgans were taxable on the trust income because they maintained significant control over the trust assets and the beneficiaries were members of their immediate family. This control, combined with the family relationship, triggered the application of Section 22(a) of the Internal Revenue Code, attributing the trust income back to the grantors.

Facts

Samuel and Anna Morgan established four irrevocable trusts, one for each of their children. The trusts were funded primarily with preferred stock of Local Finance Co., a corporation controlled by the Morgans. The trust indentures granted the Morgans, as trustees, extensive powers, including the ability to accumulate income, invest in various assets, and even control the operations of corporations in which the trusts held stock. The trustees could also use trust corpus for the beneficiaries' maintenance if the grantors were unable to provide support. The beneficiaries were their children, some of whom were married and living independently during the tax years in question (1940 and 1941).

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Samuel and Anna Morgan, arguing that the income from the trusts should be included in their individual taxable income. The Morgans petitioned the Tax Court for a redetermination of these deficiencies. The Tax Court upheld the Commissioner's determination, finding that the Morgans retained sufficient control over the trusts to warrant taxing them on the trust income.

Issue(s)

Whether the income from trusts established by the petitioners is taxable to them under Section 22(a) of the Internal Revenue Code, given their retained powers as trustees and the nature of the trust assets.

Holding

Yes, because the grantors retained substantial control over the trusts, and the beneficiaries were members of their immediate family, the trust income is taxable to the grantors under Section 22(a) of the Internal Revenue Code.

Court’s Reasoning

The court relied on the principle established in *Helvering v. Clifford, 309 U.S. 331 (1940)*, which held that a grantor may be treated as the owner of a trust for tax purposes if they retain substantial dominion and control over the trust property. The court emphasized the broad powers retained by the Morgans as trustees, including the power to accumulate income, invest in various assets, and control corporations in which the trusts held stock. The court also noted that the trust assets consisted primarily of stock in a family-owned corporation, further solidifying the Morgans’ control. The court distinguished this case from those where the grantor did not retain significant control or where the trust did not alter the grantor’s voting potential in a related company. The court stated that even though some beneficiaries were adults, the grantors retained control until the beneficiaries reached the age of 30. The court found a continuing family solidarity aspect of the *Clifford* rule.

Practical Implications

This case reinforces the principle that grantors cannot avoid income tax by creating trusts if they retain substantial control over the trust assets, especially when dealing with family-owned businesses. It highlights the importance of carefully drafting trust agreements to avoid the grantor being treated as the owner of the trust for tax purposes. Attorneys must advise clients that retaining significant control over trust investments, particularly in closely held businesses, may result in the trust income being taxed to the grantor. The case serves as a reminder that the IRS and courts will scrutinize family trusts where grantors act as trustees and retain broad discretionary powers, particularly concerning investments in entities where the grantors have significant influence.

