5 T.C. 1251 (1945)

A grantor is taxable on the income of trusts they create for family members when they retain substantial control over the trust assets and income.

Summary

V.U. Young created trusts for his children and grandchildren, retaining broad powers over the assets. The Gary Theatre Co., controlled by Young, sold stock to these trusts at below-market value. The Tax Court held that the trust income was taxable to Young because he retained substantial control. The Court also held that the below-market sale constituted a constructive dividend from Gary Theatre Co. to Young-Wolf Corporation (Young's holding company), and then from Young-Wolf to Young himself, to the extent of available earnings and profits. This case illustrates the application of grantor trust rules and the concept of constructive dividends in closely held corporations.

Facts

Gary Theatre Co. was a wholly-owned subsidiary of Young-Wolf Corporation. V.U. Young and Charles Wolf controlled Young-Wolf Corporation. Young created four trusts for his children and grandchildren, naming himself as trustee and retaining broad powers of administration and control, including investment decisions and distributions. Shortly thereafter, Gary Theatre Co. sold stock in Theatrical Managers, Inc. to these trusts (and similar trusts created by Wolf) for significantly less than its fair market value. Young-Wolf Corporation had a deficit at the end of the tax year. The trusts generated substantial income, some of which was distributed to beneficiaries.

Procedural History

The Commissioner of Internal Revenue determined deficiencies against Gary Theatre Corporation, V.U. Young, and Gary Theatre Corporation as transferee of Young-Wolf Corporation. Young challenged the inclusion of trust income in his personal income and the dividend assessment. The Tax Court consolidated the cases for review.

Issue(s)

1. Whether the income from the trusts created by Young is taxable to him under Section 22(a) of the Revenue Act of 1936, given his retained powers and control?
2. Whether the sale of stock by Gary Theatre Co. to the trusts at below-market value constitutes a constructive dividend to Young-Wolf Corporation and then to Young?

Holding

1. Yes, because Young retained substantial control over the trusts, making him the

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de facto owner for tax purposes.
2. Yes, because the below-market sale was effectively a distribution of corporate earnings to the benefit of Young, the controlling shareholder.

Court's Reasoning

1. The court relied on *Helvering v. Clifford*, finding that Young's broad administrative powers, combined with the beneficiaries being members of his immediate family, justified treating him as the owner of the trusts under Section 22(a). The court stated Young retained "such rights, power and authority in respect to the management, control and distribution of said trust estate for the use and benefit of the beneficiary, as I have with respect to property absolutely owned by me." Thus, the trust lacked economic substance separate from Young.
2. The court applied the principle that a sale of property by a corporation to a shareholder for less than its fair market value results in a taxable dividend to the shareholder, citing *Timberlake v. Commissioner* and *Palmer v. Commissioner*. The court reasoned that Gary Theatre Co.'s transfer of stock at below market value ultimately benefited Young, the controlling shareholder of Young-Wolf Corporation. The Court noted, "Clearly, the effect of the sales here in question was to distribute the accumulated earnings and profits of Gary Theatre Co. to persons chosen by or on behalf of its stockholder, and such must have been the intent of Young and Wolf who brought it about."

Practical Implications

This case illustrates the importance of carefully structuring family trusts to avoid grantor trust status. Grantors must relinquish sufficient control to avoid being taxed on the trust's income. It also clarifies the concept of constructive dividends in the context of closely held corporations. A below-market sale can be recharacterized as a dividend, even if it is not formally declared as such. Later cases applying this ruling focus on the degree of control retained by the grantor and the economic benefit conferred upon the shareholder. Attorneys advising on trust creation and corporate transactions must be aware of these principles to avoid adverse tax consequences for their clients. The decision emphasizes that the substance of a transaction, not its form, controls for tax purposes, especially in situations involving related parties and closely held entities.

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