Alexander v. Commissioner, 7 T.C. 960 (1946)

A grantor who retains substantial control over a trust, including the power to control income distribution and the reversion of the trust corpus upon the beneficiary's death, may be taxed on the trust income under Section 22(a) of the Internal Revenue Code, and a husband-wife partnership is valid for tax purposes when the wife independently purchases her partnership interest with her own capital and manages her own finances.

Summary

The Tax Court addressed whether trust income was taxable to the grantor under Section 22(a) of the Internal Revenue Code due to retained control and whether a husband-wife partnership was valid for tax purposes. The grantor established a trust for his wife, retaining significant control over its assets. Later, the wife purchased a partnership interest. The court held the grantor taxable on the trust income because of his retained control, but it validated the wife's partnership interest because she independently purchased it and managed her finances. This case illustrates the importance of relinquishing control in trusts and genuine economic activity in family partnerships to avoid taxation to the grantor or controlling spouse.

Facts

The petitioner, Alexander, owned a 75% interest in a baking company. On January 1, 1938, he created a trust for his wife, Helen, designating a 25% interest in the business as the trust corpus. The trust instrument granted Alexander broad powers, including control over income distribution and reversion of the trust corpus to him upon his wife's death. Helen had no power to assign or pledge the trust income. Later, on January 2, 1940, Helen purchased a 25% partnership interest from Alexander's uncle for $35,000, funding the purchase through a bank loan co-signed by Alexander and withdrawals from the business.

Procedural History

The Commissioner determined deficiencies in Alexander's income tax for 1939-1941, arguing that the trust income was taxable to him under Section 22(a) or Sections 166 and 167 of the Internal Revenue Code. The Commissioner also argued that the income from the purchased partnership interest should be attributed to Alexander. The Tax Court reviewed the Commissioner's determination.

Issue(s)

1. Whether the income from the trust established for Helen Alexander is taxable to the petitioner, Alexander, under Section 22(a) of the Internal Revenue Code, given the control he retained over the trust.
2. Whether the income from the 25% partnership interest purchased by Helen Alexander from Samuel Alexander is taxable to the petitioner, Alexander.

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Holding

1. Yes, because Alexander retained substantial control over the trust, including income distribution and reversion of the corpus.
2. No, because Helen Alexander independently purchased the partnership interest with her own capital and managed her own finances.

Court's Reasoning

The court reasoned that Alexander's control over the trust was so extensive that he retained dominion substantially equivalent to full ownership, citing *Helvering v. Clifford*, 309 U.S. 331 (1940). The trust indenture did not substantially change the investment, management, or control of the business. Regarding the partnership interest, the court found that Helen independently purchased the interest from Alexander's uncle, contributing her own capital and managing her own bank account. The court distinguished this from cases where the husband creates the right to receive and enjoy the benefit of the income. The court noted that, "Did the husband, despite the claimed partnership, actually create the right to receive and enjoy the benefit of the income, so as to make it taxable to him?" (Commissioner v. Tower, supra.) was not the case here.

Practical Implications

This case demonstrates the importance of relinquishing control when establishing trusts to shift income for tax purposes. Retaining significant control can result in the grantor being taxed on the trust income, even if the income is nominally distributed to a beneficiary. For husband-wife partnerships to be recognized for tax purposes, each spouse must make real contributions of capital or services and exercise control over their respective interests. The Alexander case shows that a wife's independent purchase of a business interest, even with some financial assistance from her husband, can be recognized as a legitimate partnership for tax purposes, provided she actively manages her finances and the husband does not retain control over her share of the business. Later cases will analyze the totality of circumstances to determine whether the partnership is bona fide or merely a sham to reallocate income within a family.

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