6 T.C. 804 (1946)

A grantor who retains substantial control over a trust, including the power to manage the trust property and distribute income at his discretion, may be taxed on the trust's income under Section 22(a) of the Internal Revenue Code, even if the trust is nominally for the benefit of another.

Summary

S. Kenneth Alexander, owner of a baking business, created a trust for his wife, naming himself as trustee. The trust held a one-fourth interest in the business, but Alexander retained broad control over its management and income distribution. The Commissioner of Internal Revenue assessed deficiencies against Alexander, arguing that the trust income was taxable to him. Alexander challenged the assessment, while the Commissioner sought an increased deficiency based on income from another one-fourth interest in the business purportedly purchased by Alexander's wife. The Tax Court held that Alexander was taxable on the trust income due to his retained control, but denied the increased deficiency, finding the wife genuinely purchased the other interest.

Facts

Alexander owned a three-fourths interest in Alexander Brothers Baking Co. He created a trust, naming himself trustee, with his wife as beneficiary, holding a one-fourth interest in the business. The trust instrument restricted the wife's ability to assign or pledge trust assets. Alexander retained broad powers to manage the trust property, control the business, and distribute income to his wife at his discretion. Upon the wife's death, the trust assets would revert to Alexander. The wife did not contribute any services to the business.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Alexander's income taxes for 1939, 1940, and 1941, based on the inclusion of the trust income. Alexander petitioned the Tax Court for review. The Commissioner amended the answer, seeking increased deficiencies for 1940 and 1941, arguing that income from an additional one-fourth interest purportedly purchased by Alexander's wife should also be taxed to him. The Tax Court upheld the original deficiencies but denied the increased deficiencies.

Issue(s)

1. Whether the income from the one-fourth interest in the baking business held in trust for Alexander's wife is taxable to Alexander under Section 22(a) of the Internal Revenue Code.
2. Whether the income from the one-fourth interest in the baking business purportedly purchased by Alexander's wife is taxable to Alexander under

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Section 22(a) of the Internal Revenue Code.

Holding

1. Yes, because Alexander retained substantial control over the trust and its income, making him the de facto owner for tax purposes.
2. No, because the evidence showed that Alexander's wife genuinely purchased the interest from Alexander's uncle, using her own funds and credit, and controlled the income generated from that interest.

Court's Reasoning

Regarding the trust income, the court relied on *Helvering v. Clifford, 309 U.S. 331 (1940)*, which held that a grantor could be taxed on trust income if he retained substantial control over the trust. The court noted that Alexander retained broad powers to manage the trust property, control the business, and distribute income to his wife at his discretion. The court stated: "Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position." These retained powers gave Alexander "dominion over the trust corpus substantially equivalent to full ownership."

Regarding the purportedly purchased interest, the court found that Alexander's wife genuinely purchased the interest from his uncle. Although Alexander endorsed his wife's loan to finance the purchase, the court emphasized that the wife used her own funds and credit, and the income from the purchased interest was used to repay the loan. The court also noted that the wife maintained her own bank account and Alexander had no authority to draw on it. Thus, the court concluded that Alexander did not create the right to receive and enjoy the benefit of the income from that interest.

Practical Implications

This case illustrates the importance of relinquishing control when establishing a trust to shift income for tax purposes. Grantors who retain significant management powers, control over income distribution, and the possibility of reversion risk being taxed on the trust's income. It also highlights the importance of demonstrating genuine economic substance in transactions between family members. To avoid having income attributed to them, taxpayers must demonstrate that the other party truly owns and controls the asset or business interest, not just in form but in substance. Later cases applying *Clifford* and its progeny continue to scrutinize the degree of control retained by grantors over trusts, and the economic realities of transactions between family members.

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