7 T.C. 54 (1946)

A grantor who retains substantial control over trust property, including the power to accumulate income and manage investments in family-controlled corporations, may be taxed on the trust's income under Section 22(a) of the Internal Revenue Code.

Summary

Maurice Friedman created trusts for his children, funding them with stock in his family's corporations and real estate used by those businesses. As trustee, Friedman had broad management powers, including discretion over income distribution and the power to accumulate income. The Tax Court held that Friedman was taxable on the trust income under Section 22(a) because he retained substantial control and economic benefit from the trust assets, particularly through his continued control over the corporations whose stock the trusts held. This case highlights the importance of relinquishing control when establishing trusts to shift the tax burden.

Facts

Maurice Friedman, president of M. Friedman Paint Co. and California Painting & Decorating Co., created three trusts for his children, naming himself as the sole trustee of each. The trusts were funded with Class C stock of the paint company, stock in the decorating company, and the land and building where the paint company's wholesale and retail store was located. The trust agreements granted Friedman broad powers, including the discretion to distribute or accumulate income, and to invade the principal for the beneficiaries' welfare. No income was distributed to the beneficiaries during the tax years in question (1940 and 1941), except to pay the trusts' income taxes.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Friedman's income tax liability for 1940 and 1941, arguing that the income from the trusts should be included in Friedman's personal income under Section 22(a). Friedman contested this determination in the Tax Court.

Issue(s)

Whether the income of trusts, where the grantor is also the trustee with broad discretionary powers over income distribution and trust management, is taxable to the grantor under Section 22(a) of the Internal Revenue Code.

Holding

Yes, because the grantor retained substantial control and economic benefits over the trust property, particularly through his management of the family corporations whose stock the trusts held, making the trust income taxable to him under Section

22(a).

Court’s Reasoning

The Tax Court relied heavily on the precedent set by *Helvering v. Clifford*, finding that Friedman’s control over the trust property and the family corporations was so substantial that he effectively remained the owner for tax purposes. The court emphasized the following factors: Friedman’s broad discretionary powers as trustee to distribute or accumulate income, his power to manage and control the trust assets, including voting stock in his own companies, and the fact that the trusts held assets vital to the operation of Friedman’s businesses. The court noted, “Trustee shall have the right and power, in his discretion, to vote said stock in favor of himself as director and/or officer of the corporation or corporations of which he holds shares of stock as trustee of this trust.” The court concluded that the trusts were primarily a means of retaining control over the family businesses while attempting to shift the tax burden, a strategy disallowed under Section 22(a).

Practical Implications

The *Friedman* case serves as a cautionary tale for grantors attempting to use trusts to minimize their tax liabilities. To avoid grantor trust status and ensure that trust income is taxed to the beneficiaries, grantors must relinquish substantial control over the trust assets. This includes limiting the grantor’s power to control income distributions, restricting the grantor’s involvement in the management of trust assets, and avoiding situations where the trust assets primarily benefit the grantor’s personal or business interests. Subsequent cases have further refined the factors used to determine whether a grantor has retained sufficient control to be taxed on trust income, making it critical for attorneys to carefully structure trusts to comply with these requirements.

