T.C. Memo. 1948-248

Income from a business is taxable to the individual who earns it, even if they attempt to transfer interests in the business to a trust, if the transfer lacks economic substance and the individual retains control.

Summary

W.H. Easley, owner of a Seven-Up bottling franchise, attempted to shift income to trusts established for his children by transferring partial ownership of the business assets to the trusts. The Tax Court held that the income was still taxable to Easley because the transfers lacked economic substance. Easley retained control over the business operations and the core asset, the franchise agreement, was not transferred to the trusts. The court emphasized that income is taxed to the one who earns it, and the trust structure was merely an attempt to reallocate income within the family.

Facts

Easley owned and operated the Seven-Up Bottling Company of San Francisco as a sole proprietorship. The core of the business was an exclusive sales territory granted by the Seven-Up St. Louis company. Easley created two trusts for his minor sons, purportedly transferring a one-fourth interest in the business to each trust. The assets listed in the trust agreements included real estate, plant equipment, and some receivables, but crucially omitted the franchise agreement and a substantial cash balance. Easley remained the trustee and maintained full control over the business operations and its income. The trust agreements did not restrict his ability to withdraw earnings, and distributions to the beneficiaries were discretionary and could be delayed for many years.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Easley, arguing that the income from the bottling business was taxable to him, not the trusts. Easley petitioned the Tax Court for a redetermination. The Tax Court upheld the Commissioner’s determination.

Issue(s)

Whether the income from the Seven-Up bottling business was taxable to Easley, the original owner, or to the trusts he established for his children, given his purported transfer of interests in the business assets to the trusts.

Holding

No, the income is taxable to Easley because the transfers to the trusts lacked economic substance and Easley retained control over the business and its income.

Court's Reasoning

The court relied on the principle established in *Lucas v. Earl*, 281 U.S. 111, that income is taxable to the one who earns it. The court found that Easley's attempt to transfer income to the trusts was an ineffective assignment of income because he retained control over the business and its earnings. The court noted that the key asset of the business was the franchise agreement, which was not transferred to the trusts. The court stated, "The income of his business was not attributable in substantial part to property in which Easley could assign undivided interests in trust to his children." The trust agreements also lacked any restrictions on Easley's control over the income, allowing him to withdraw earnings at will. The court concluded that the trust structure was merely an attempt to reallocate income within the family without any genuine economic impact.

Practical Implications

This case reinforces the principle that taxpayers cannot avoid income tax by merely shifting income to family members through artificial structures. The IRS and courts will scrutinize such arrangements, focusing on whether the transfer has economic substance and whether the original owner retains control over the income-producing asset. The case highlights the importance of transferring control of key assets and imposing meaningful restrictions on the trustee's power when establishing trusts for income-shifting purposes. Later cases cite *Easley* as an example of an ineffective attempt to assign income, emphasizing the need for genuine economic impact and relinquished control for such transfers to be respected for tax purposes. The Tax Court emphasized that, despite the filing of gift tax returns, income tax liability remained with the earner of the income.