14 T.C. 1241 (1950)

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Trust income can be taxed to the beneficiaries rather than the trust itself when the beneficiaries exert significant control over the distribution of income, effectively acting as the real owners of the assets.

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Summary

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Edwin and Winnifred Flato created six trusts, ostensibly for their three sons, to transfer their business interests. However, the sons exerted considerable control over the trusts' income distribution, leading the Commissioner to argue the trust structure was a tax avoidance scheme. The Tax Court agreed, holding that the trust income was taxable to the beneficiaries because they effectively controlled the income. Additionally, the court addressed whether the sale of breeding cattle qualified for capital gains treatment, finding that it did since the cattle were not held primarily for sale to customers in the ordinary course of business.

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Facts

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Edwin and Winnifred Flato owned a 75% interest in three partnerships; their son, Franklin, owned the remaining 25%. To facilitate his sons' involvement and mitigate potential spousal interference, Edwin and Winnifred created six irrevocable trusts, two for each son, with $1,000 initial funding. Simultaneously, each parent gifted $4,000 directly to each son. The trusts then purchased the parents' interests in two of the partnerships, financed partly by notes. The trustees were the sons themselves, acting for each other's trusts. Distributions of trust income were at the trustees' discretion.

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Procedural History

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The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax liabilities, arguing that the trust income should be taxed to the beneficiaries, not the trusts. The cases were consolidated in the Tax Court, which ruled in favor of the Commissioner regarding the trust income, but in favor of the taxpayers regarding the capital gains treatment of the cattle sales.

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Issue(s)

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1. Whether the income of the six trusts is taxable to the beneficiaries Franklin, Robert H., and Frederick W. Flato.

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2. Whether the gain realized by Franklin Flato in 1943 and 1944 on the sale of cattle used for breeding purposes is taxable as ordinary income or as capital gain under the provisions of section 117(j) of the Internal Revenue Code.

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Holding

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1. Yes, because the beneficiaries effectively controlled the trust income distributions, making them the true recipients for tax purposes.

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2. Capital gain, because the breeding cattle were not held primarily for sale to customers in the ordinary course of business.

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Court's Reasoning

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Regarding the trust income, the court emphasized that "technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue," quoting *Helvering v. Clifford*, <span normalizedcite="309 U.S.

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331“>309 U.S. 331. The court found the beneficiaries’ control over income distribution rendered the trusts a sham for tax purposes. Despite the

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