Flato v. Commissioner, 14 T.C. 1241 (1950)

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When beneficiaries of a trust have significant control over trust income distributions, the income may be taxed to them directly, regardless of discretionary clauses in the trust agreement.

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Summary

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The Tax Court addressed whether trust income should be taxed to the beneficiaries or the trusts themselves. Six trusts were created for the benefit of three brothers and their wives. The trusts acquired partnership interests from the parents of the brothers. The court found that despite the trusts being nominally discretionary, the beneficiaries effectively controlled the distribution of income. Therefore, the income was taxable to the beneficiaries. The court also addressed whether the gain from the sale of breeding cattle should be taxed as ordinary income or capital gain, holding it was capital gain.

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Facts

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A mother and father owned a 3/4 interest in three partnerships. Their son, Franklin, owned the remaining 1/4 interest. The parents desired to transfer their partnership interests into trusts for their three sons. They created six trusts (two for each son), funding each with $1,000. They also gave each son $4,000 directly. The sons acted as trustees for each other's trusts. The trusts then purchased the parents' partnership interests for $5,000 cash and a note for $9,716.52. The partnership profits were divided with 3/4 going to the trusts and 1/4 to Franklin. The trustees distributed trust income to the beneficiaries upon their request.

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Procedural History

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The Commissioner of Internal Revenue assessed deficiencies against the Flato family, arguing that the trust structure was a sham and the partnership income should be taxed directly to the brothers. The Tax Court reviewed the Commissioner's determination.

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Issue(s)

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1. Whether the income of the six trusts is taxable to the beneficiaries of those trusts under Section 22(a) of the Internal Revenue Code.

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2. Whether the gain realized by Franklin Flato on the sale of cattle used for breeding purposes is taxable as ordinary income or as capital gain under 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 despite the "discretionary" language in the trust agreements.

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2. Capital gain, because the sale of breeding cattle was not part of the ordinary business and met the requirements of Section 117(j).

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Court’s Reasoning

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The court relied on the principles established in *Helvering v. Clifford*, 309 U.S. 331, stating that

