Krause v. Commissioner, 57 T. C. 890 (1972)

A trust will not be recognized as the true owner of a partnership interest for tax purposes if the grantor retains significant control over the trust's assets.

Summary

In Krause v. Commissioner, the Tax Court ruled that the Krauses could not shift income from a limited partnership to trusts they established for their children and grandchildren because they retained too much control over the trusts. The Krauses had formed A. K. Co. , a limited partnership, and subsequently transferred their 60% interest to six trusts in exchange for cash and future income distributions. The court found that the Krauses' control over the trusts' assets, including the power to remove trustees and reacquire the partnership interest, meant the trusts were not the true owners of the partnership interest for tax purposes. Additionally, the court applied the reciprocal trust doctrine, taxing the Krauses on income from trust-held assets due to the interrelated nature of the trusts they created for each other.

Facts

On February 5, 1959, Adolph and Janet Krause formed A. K. Co. , a limited partnership, and concurrently established six trusts for their children and grandchildren. Adolph transferred his 60% limited partnership interest in A. K. Co. to these trusts in exchange for $100 cash per trust and 80% of the income the trusts received from A. K. Co. over 16 years. Each trust was funded with cash and shares of Wolverine Shoe & Tanning Corp. The trusts were required to distribute 80% of their income from A. K. Co. to Adolph annually. The Krauses retained the power to remove trustees, control partnership distributions, and potentially reacquire the partnership interest if payments were late.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Krauses' federal income tax for the years 1964, 1965, and 1966, asserting that the income from A. K. Co. was taxable to the Krauses rather than the trusts. The Krauses petitioned the U. S. Tax Court to contest these deficiencies. The Tax Court upheld the Commissioner's determination, finding that the trusts were not the true owners of the partnership interest and that the Krauses were taxable on the income under the reciprocal trust doctrine.

Issue(s)

1. Whether the six trusts created by the Krauses are bona fide partners in A. K. Co. under Section 704(e) of the Internal Revenue Code.
2. Whether the trusts are controlled by the grantor trust provisions, thereby causing the trusts' income to be taxable to the Krauses.

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Holding

1. No, because the Krauses retained too many incidents of ownership over the partnership interest transferred to the trusts, indicating that the trusts were not the true owners.
2. Yes, because the trusts were subject to the reciprocal trust doctrine and the grantor trust provisions, making the Krauses taxable on the income produced by the trusts.

Court’s Reasoning

The court applied Section 704(e) of the IRC, which requires a complete transfer of a partnership interest to a trust for the trust to be recognized as a partner. The court found that the Krauses retained significant control over the trusts, including the power to remove trustees, control partnership distributions, and potentially reacquire the partnership interest. These factors indicated that the Krauses did not fully divest themselves of ownership, as required by the regulations. The court also applied the reciprocal trust doctrine, treating each spouse as the grantor of the trust created by the other due to the interrelated nature of the trusts and the mutual economic position maintained by the Krauses. The court determined that the trusts were subject to Section 677(a)(2) of the IRC, as the trustees could accumulate income and distribute it back to the Krauses, making the Krauses taxable on the trusts’ income.

Practical Implications

This decision underscores the importance of ensuring a complete transfer of ownership when attempting to shift income to trusts. Practitioners should advise clients that retaining significant control over trust assets can result in the trust not being recognized as the true owner for tax purposes. The case also highlights the application of the reciprocal trust doctrine in income tax cases, cautioning against creating interrelated trusts with similar provisions for tax avoidance. Subsequent cases have cited Krause when analyzing the validity of trust arrangements and the application of the grantor trust provisions. This ruling impacts estate planning by demonstrating the tax consequences of retaining control over transferred assets, even if indirectly through trust provisions.

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