Markosian v. Commissioner, 73 T. C. 1235 (1980)

A trust lacking economic reality will not be recognized as a separate entity for federal income tax purposes.

Summary

Louis Markosian, a dentist, and his wife Joan established a family trust, transferring all their assets and Louis' future dental income to it. They continued using these assets as before, paying 80% of the dental practice's gross income to the trust as a 'management fee. ' The U. S. Tax Court ruled that the trust was an economic nullity and should not be recognized for tax purposes, as the Markosians retained full control and economic benefit of the assets, using the trust merely as a tax avoidance scheme.

Facts

In January 1975, Louis and Joan Markosian created the 'Louis R. Markosian Equity Trust,' transferring their home, personal assets, dental equipment, and Louis' future dental income into it. They named themselves and a neighbor, Martha Zeigler, as trustees, though Zeigler resigned shortly after. The trust document allowed for broad trustee powers, including managing the trust's assets and distributing income at their discretion. Despite the transfer, the Markosians continued to use their home and personal assets, and Louis used his dental office and equipment as before. All income from Louis' dental practice was initially deposited into his personal account, from which they paid an 80% 'management fee' to the trust.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Markosians' 1975 income tax, disregarding the trust and attributing its income to the Markosians. The Markosians petitioned the U. S. Tax Court, which heard the case and ruled on March 31, 1980, affirming the Commissioner's determination.

Issue(s)

1. Whether the trust created by the Markosians should be recognized as a separate entity for federal income tax purposes?
2. If not, whether the Markosians should be treated as owners of the trust under sections 671 through 677 of the Internal Revenue Code?
3. Whether the management fee paid by the Markosians to the trust is deductible under section 162 of the Internal Revenue Code?

Holding

1. No, because the trust lacked economic reality and was merely a tax avoidance scheme.

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2. The court did not need to address this issue due to the ruling on the first issue.
3. No, because payments to an economic nullity are not deductible under section 162.

Court’s Reasoning

The court applied the economic substance doctrine, looking beyond the trust’s legal form to its substance. It found that the Markosians retained full control and economic benefit of the transferred assets, using them as before without any real change in their financial situation. The court cited *Gregory v. Helvering* and *Furman v. Commissioner* to support the principle that a transaction lacking economic substance should not be recognized for tax purposes. The trust’s broad powers allowed the Markosians to deal with the assets freely, undermining any separation between legal title and beneficial enjoyment. The court also noted the lack of fiduciary responsibility exercised by the Markosians as trustees and their disregard for the trust’s terms, further evidencing the trust’s lack of substance. The court concluded that the trust was an economic nullity and should not be recognized for tax purposes, making the management fee non-deductible.

Practical Implications

This decision reinforces the importance of economic substance in tax planning. It warns taxpayers against using trusts or similar entities as mere tax avoidance schemes without altering their economic situation. Practitioners should advise clients that the IRS and courts will look beyond legal formalities to the economic reality of transactions. The ruling impacts how trusts are analyzed for tax purposes, emphasizing the need for real economic separation between the grantor and the trust’s assets. It may deter the use of similar ‘pure trusts’ for tax avoidance and has been cited in subsequent cases to deny recognition of trusts lacking economic substance.

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