Grandfather created a trust for the benefit of a grandchild and funded it with stock of Z corporation. A bank was appointed trustee and authorized in its sole discretion to determine the needs of the beneficiary and to pay out so much of the income or corpus as necessary to provide for such needs.

One month later the grantor "sold" to the trust stock in Y corporation having a fair market value of 700x dollars in exchange for the trust's contractual obligation to pay him 40x dollars each year for the rest of his life. The current income yield of the entire property held in trust (that is, both the Y and Z stock) is 40x dollars per year. The only funds available for making the annual payment to the grantor are those received as income of the trust, unless stock of the trust is converted into cash.

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor, or a nonadverse party, or both, may be (1) distributed to the grantor, or (2) held or accumulated for future distribution to the grantor.

The ruling held that while, in form, the transaction purports to be a sale of Y stock to the trust by the grantor, in substance it is a contribution of Y stock to the trust with a reservation by the grantor of annual payments of a fixed amount for life. Since all of the income of the trust is, or may be, used to make the payments to the grantor, he is treated as the owner of the trust under section 677(a) and taxed on all the income therefrom under section 671.