1 T.C. 921 (1943)

A grantor is not taxable on trust income under Sections 166 or 167 of the Internal Revenue Code if the power to revest the trust corpus or income is held by a person with a substantial adverse interest, such as a remainderman, and the trust income is not used to discharge the grantor's legal obligations.

Summary

Lillian Newman created two trusts for her children, with her husband, Sydney, as trustee and remainderman. Sydney had the power to alter or revoke the trusts. The Commissioner of Internal Revenue argued that the trust income was taxable to Lillian under Sections 22(a), 166, and 167 of the Internal Revenue Code. The Tax Court held that the trust income was not taxable to Lillian, except for dividends declared before the trust's creation, because Sydney had a substantial adverse interest as remainderman, and the trust income wasn't used to fulfill Lillian's support obligations. The court rejected the idea that family solidarity negated Sydney's adverse interest.

Facts

Lillian Newman created two trusts on June 28, 1940, one for her 15-year-old daughter, Janice, and one for her 12-year-old son, Robert.
Her husband, Sydney R. Newman, was the trustee of both trusts.
The corpus of each trust consisted of stock worth approximately $10,000.
The trust instruments were identical, except for the beneficiary.
Sydney, as trustee, had the power to sell investments, collect income, and pay the income annually to the respective child.
Upon each child's death, the remainder was to be paid to Sydney; if Sydney predeceased the child, he had the power to appoint the remainder via his will.
Sydney also held the power to revoke, alter, or amend the trust agreements.
The securities were endorsed over to Sydney as trustee but were not transferred out of Lillian's name on the corporate books to maintain easy marketability.
Dividends were initially paid to Lillian, who then endorsed them over to Sydney as trustee.
Separate bank accounts were opened for each trust.
Sydney paid for the household expenses and the support and education of the children.
Lillian did not file a gift tax return for either trust.

Procedural History

The Commissioner determined a deficiency in Lillian's 1940 income tax.
Lillian petitioned the Tax Court for a redetermination.
The Tax Court reviewed the Commissioner's determination.

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Issue(s)

Whether the income of the trusts is taxable to Lillian Newman as the grantor under Sections 22(a), 166, or 167 of the Internal Revenue Code.

Holding

No, except for dividends declared before the trust's creation, because Sydney Newman, as remainderman, had a substantial adverse interest, and the trust income was not used to discharge Lillian's support obligations.

Court's Reasoning

The court analyzed each of the Commissioner's arguments under Sections 166, 167, and 22(a).
Regarding Section 166 (Revocable Trusts), the court found that Sydney's power to revest the corpus was subject to his substantial adverse interest as remainderman. The court rejected the Commissioner's argument that family solidarity negated this adverse interest, citing previous cases like *Estate of Frederick S. Fish, 45 B.T.A. 120*.
Regarding Section 167 (Income for Benefit of Grantor), the court questioned whether Sydney could amend the trust to give income to Lillian. Even if he could, he could also amend it in his own favor, creating an adverse interest. The court cited *Laura E. Huffman, 39 B.T.A. 880* and *Stuart v. Commissioner, 124 F.2d 772* to support this.
Regarding Section 22(a), the court found that Lillian did not retain substantial ownership or control over the trust funds. The court noted that merely naming her husband as trustee did not necessitate taxing her on the income, citing *Robert S. Bradley, 1 T.C. 566*.
The court also rejected the argument that the trust income was used to discharge Lillian's support obligations. The trust instruments did not specify that the income was to be used for support, and under New York law, the primary duty to support the children rested on the father. The court referenced *Laumeier v. Laumeier, 237 N.Y. 357*.
The court found that valid gifts were made and trusts created despite the lack of transfer of securities on the corporate books and the failure to file gift tax returns. The court accepted the explanation that the securities were kept in Lillian's name for ease of marketability.
Finally, the court held that dividends declared before the trusts were established were taxable to Lillian, citing *Helvering v. Horst, 311 U.S. 112*.

Practical Implications

This case clarifies the application of Sections 166 and 167 regarding the taxability of trust income to grantors.
It reinforces the principle that a beneficiary's substantial adverse interest prevents

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the grantor from being taxed on the trust income, even in intrafamily arrangements. It highlights the importance of considering state law regarding parental support obligations when determining tax liability.

The case serves as a reminder that the mere existence of a family relationship does not automatically negate a beneficiary's adverse interest.

Later cases have cited *Newman* to illustrate the importance of establishing a clear, legally defensible trust structure to avoid grantor trust status.

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