3 T.C. 189 (1944)

A grantor of an alimony trust remains taxable on the trust income to the extent the income satisfies a continuing legal obligation, including a contractual guarantee to supplement trust income, but is not taxable on the remaining trust income if they do not retain control or beneficial interest.

Summary

Max Friedmann created a trust as part of a divorce settlement, funded with stock and guaranteeing a minimum income. The Tax Court addressed whether Friedmann was taxable on the trust income distributed to his ex-wife. The court held that Friedmann remained taxable on the portion of the trust income attributable to his guarantee because it satisfied a contractual obligation. However, he was not taxable on the remaining trust income because he did not retain substantial control or beneficial interest after the divorce settlement. The court distinguished the case from situations where the trust was primarily for the grantor's benefit.

Facts

Prior to December 8, 1934, Max Friedmann and Freda Friedmann were married with two children, Freda and Maxine. In December 1934, Freda initiated divorce proceedings in Wisconsin. As part of a written stipulation, Max and Freda agreed to settle their property rights and custody arrangements. Max agreed to transfer certain property into a trust for Freda and the children's benefit. This included stock in Ed. Schuster & Co., of which Max was president. The trust agreement stipulated that if the stock dividends did not reach $10,000 annually, Max would cover the difference, to be repaid if dividends later exceeded that amount. The divorce court approved the trust agreement. During 1935-1937, the trustee distributed all trust income to Freda, who used part for the children's support and the rest for herself.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Friedmann's income tax for 1935, 1936, and 1937, arguing that the trust income was taxable to him. Friedmann conceded that the portion of the trust income used for child support was taxable to him, but contested the taxability of the remaining income. The Tax Court reviewed the Commissioner's determination and Friedmann's objections.

Issue(s)

1. Whether the payments made to the ex-wife were pursuant to a continuing liability created by local law or the petitioner's contract, and therefore taxable to the petitioner to the extent of his guaranty?
2. Whether the amount used for the support of the children and conceded by the petitioner to be taxable to him can be included within the amount held taxable to him by reason of his guaranty?

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3. Whether the balance of the trust income after deducting the amount held taxable to the petitioner by reason of his guaranty and the amount conceded by the petitioner to be taxable to him by reason of its use for the support of his children is taxable to the petitioner under Section 167(a)(2) of the Revenue Acts of 1934 and 1936 or under the rule of Helvering v. Clifford?

Holding

1. Yes, because the payments were made in part pursuant to a continuing liability created by the petitioner's contract, specifically his guarantee, rather than solely by local law.
2. No, because, in the absence of specific directions in the trust agreement, the amount used for child support and conceded to be taxable cannot be included within the guaranteed amount.
3. No, because the petitioner did not retain substantial control over the trust that would trigger taxability under Section 167(a)(2) or the rule of *Helvering v. Clifford*.

Court's Reasoning

The Tax Court relied on *Helvering v. Leonard*, which held that a grantor is taxable on trust income used to satisfy their legal obligations. The court found that Max's guarantee to supplement the trust income constituted a continuing contractual obligation, making him taxable on that portion of the income. The court emphasized that the divorce decree didn't relieve Max of this contingent obligation; rather, it sanctioned it.

The court distinguished this case from *Jessie W. Donahue* and *Bush v. Commissioner* because those cases involved trusts where the grantor was guaranteeing income from property that had previously belonged to the beneficiary or was funded by third parties. Here, Max was guaranteeing income from assets he transferred.

The court held that Section 167(a)(2) and the rule of *Helvering v. Clifford* were inapplicable because Max didn't retain substantial control or interest in the trust beyond his guarantee. He was not a beneficiary, and the trust was irrevocable. The court stated, "The trust is irrevocable and to the extent of this balance of the trust income the settlor retained no right or interest in the trust property and therefore ceased to be the owner for purposes of the Federal revenue acts."

Practical Implications

This case clarifies the tax implications of alimony trusts created as part of divorce settlements. Attorneys must carefully draft trust agreements to avoid inadvertently creating continuing obligations that could result in the grantor being taxed on trust income. The key takeaway is that guarantees of trust income can be considered continuing obligations, even if contingent, and will likely lead to taxability for the grantor to the extent of the guarantee. If the grantor truly relinquishes control and

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beneficial interest in the trust assets beyond the guarantee, the remaining trust income will not be taxable to the grantor.

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