3 T.C. 1171 (1944)

A grantor is not taxed on trust income where the grantor retains broad management powers as a trustee, but cannot revest title to the corpus in themselves or accumulate income for their own benefit, especially when state law imposes fiduciary duties on trustees.

Summary

Herbert and Louise Cherry created irrevocable trusts for their spouses and children, naming themselves as trustees. The Commissioner of Internal Revenue argued that the trust income was taxable to the grantors under grantor trust rules, specifically sections 166 and 167 of the Internal Revenue Code and the principle established in *Helvering v. Clifford*. The Tax Court held that the income was not taxable to the grantors because they could not revest title in themselves or accumulate income for their own benefit, and state law imposed fiduciary duties preventing self-dealing.

Facts

Herbert and Louise Cherry, husband and wife, each created separate irrevocable trusts on December 17, 1938. Each trust named the settlor, their son, their daughter, and a bank as trustees. Herbert transferred 2,400 shares of Cherry-Burrell Corporation common stock to his trust; Louise transferred 3,800 shares to her trust. The trusts provided income to the settlor's spouse during their lifetime, and then for their children. Herbert's trust paid his wife up to $2,400/year, and Louise's trust paid her husband up to $3,800/year. Each settlor retained broad discretionary management powers over the trust during their lifetime as a trustee. The trusts terminated no later than 21 years after the death of the last survivor of the trustors and all beneficiaries living when the trusts were created.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Cherry's income tax for 1939 and 1940, including the dividend income from the trusts in their gross income. The Cherrys petitioned the Tax Court, arguing the trust income was not taxable to them. The Tax Court consolidated the proceedings and ruled in favor of the taxpayers, holding that the trust income was not taxable to them under the applicable statutes or *Helvering v. Clifford*. The decision was entered under Rule 50, implying a recomputation of the deficiencies based on the court's ruling.

Issue(s)

1. Whether the income from trusts created by Herbert and Louise Cherry is taxable to them as the grantors under Section 22(a) of the Internal Revenue Code and the principles of *Helvering v. Clifford*, due to the dominion and control they retained over the trust corpus and income.

2. Whether the dividend income is taxable to each grantor under Section 166 of the Internal Revenue Code because the retained powers enabled each settlor to revest title in themselves.

3. Whether the dividend income is taxable to each grantor under Section 167 of the Internal Revenue Code because each settlor could, in their discretion, hold or accumulate dividends for future distribution to themselves.

Holding

1. No, because broad powers of management alone are not sufficient to make the trust income taxable to the grantor, especially where there is no reversionary interest and the income cannot be used or accumulated for the grantor's benefit.

2. No, because the powers were given to the trustee as a fiduciary, and they did not have the power to alter, amend, or terminate the trust or vest title in the corpus to themselves.

3. No, because the trust indentures specifically provided that the accumulated income should be held for the benefit of the annuitant (the spouse) and those appointed by her.

Court's Reasoning

The court analyzed the trust indentures, emphasizing that the grantors' powers were held in a fiduciary capacity. The court referenced Iowa law, where the trusts were created, which prohibits trustees from acting for their personal benefit or engaging in self-dealing. The court distinguished the case from *Helvering v. Clifford*, noting the absence of a reversionary interest and the inability of the grantors to use or accumulate income for their own benefit. While the grantors had broad management powers, these powers were deemed insufficient to trigger grantor trust treatment under Section 22(a). Regarding Sections 166 and 167, the court held that the grantors lacked the power to revest title to the corpus in themselves or accumulate income for their own benefit. The court stated, "the trusts 'stand as though an Iowa statute or a provision of the instruments forbade assignments of any of the corpora or of the income to the grantors except as may be specifically provided by their terms.'"

Practical Implications

This case demonstrates that a grantor can serve as a trustee of a trust without necessarily causing the trust income to be taxed to them, provided they do not retain powers that allow them to revest title to the corpus in themselves or accumulate income for their own benefit. The case emphasizes the importance of fiduciary duties imposed by state law on trustees. The decision also suggests that broad management powers, by themselves, are insufficient to trigger grantor trust treatment. This ruling provides guidance for attorneys drafting trust documents where the grantor desires to serve as a trustee while avoiding grantor trust status. Later cases will often turn on the specific language of the trust documents and the scope of the trustee’s powers under applicable state law.

