4 T.C. 29 (1944)

A grantor is taxable on trust income if they retain substantial control over the trust, even if the trust is for the benefit of family members, unless the grantor relinquishes control; the grantor is only taxed on the distributed income if the trust is for the support of dependents per Section 134 of the Revenue Act of 1943.

Summary

The Tax Court addressed whether the grantor of several trusts was taxable on the trust income. The grantor, Banfield, created trusts for his wife and children. The court considered the degree of control Banfield retained over the trust assets. For the period prior to December 9, 1940, the court found Banfield taxable on the trust income because of his retained powers. However, after the trust instruments were amended on that date, eliminating Banfield's unrestricted power to deal with the trusts, the court held that the income was not taxable to him, except to the extent it was used for the support of his dependents. This case clarifies the application of grantor trust rules and the impact of the Revenue Act of 1943.

Facts

O.M. Banfield created trusts for the benefit of his wife and minor children, funding them with stock in a corporation where he was a director and officer. Initially, Banfield retained significant powers, including the right to buy and sell property to the trusts at prices he determined and the power to borrow from the trusts. On December 9, 1940, Banfield amended the trust instruments to renounce his power to borrow from or sell property to the trusts without court approval.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Banfield's income tax for the years 1938, 1939, and 1940. Banfield appealed to the Tax Court. The Tax Court previously ruled against Banfield on the taxability of income from these trusts for prior years, relying on *Ellis H. Warren, 45 B.T.A. 379 (1941)*, aff'd, 133 F.2d 312 (6th Cir. 1943). The current case concerned subsequent tax years and the effect of amendments to the trust agreements.

Issue(s)

1. Whether the income from trusts created by Banfield for the benefit of his wife and children is taxable to him as the grantor, given his retained powers before December 9, 1940?
2. Whether the income from the same trusts is taxable to Banfield after the trust instruments were amended on December 9, 1940, to restrict his powers?
3. Whether Section 134 of the Revenue Act of 1943 retroactively alters the taxability of trust income used for the support of the grantor's dependents?

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Holding

1. Yes, because before December 9, 1940, Banfield retained substantial control over the trusts, making him taxable on the income under the principles of *Helvering v. Clifford, 309 U.S. 331 (1940)*.
2. No, because after the amendments, Banfield's powers were sufficiently restricted to remove him from the scope of the *Clifford* doctrine, except for income actually used for the support of his dependents.
3. Yes, because Section 134 prevents trust income from being taxed to the grantor merely because it may be used for the support of dependents, except to the extent that it is actually so used.

Court's Reasoning

The court relied on its prior decision in *Ellis H. Warren*, which involved similar facts and trust provisions. The court found that Banfield's initial powers, including the right to deal with the trusts at his own discretion, constituted substantial control, akin to a power of revocation. The court stated, "What we thought decisive in the *Warren* case was 'the whole nexus of relations between the settlor, the trustee and the beneficiary'." Regarding the period after the amendments, the court distinguished the case from *Warren* and relied on *David Small, 3 T.C. 1142 (1944)*, finding that the restrictions on Banfield's powers were sufficient to shift the tax burden away from him. The court also addressed the impact of Section 134 of the Revenue Act of 1943, clarifying that it only prevents taxation of the grantor when the power to use income for support is the *sole* basis for taxation. The court quoted the Ways and Means Committee report, stating that trust income remains taxable to the grantor under section 22 (a) "if the terms of the trust, not excluding the discretionary power to apply trust income, and all the circumstances attendant on its creation and operation indicate that the grantor has retained a control of the trust so complete that he is still, in practical effect, the owner of its income."

Practical Implications

This case highlights the importance of carefully drafting trust instruments to avoid grantor trust status. Grantors must relinquish substantial control over trust assets to avoid being taxed on trust income. The case also clarifies the limited scope of Section 134 of the Revenue Act of 1943: while it protects grantors from taxation *solely* based on the possibility of income being used for dependent support, it does not shield them from taxation if they retain other significant powers. Later cases will look to the totality of the circumstances to determine if the grantor has retained enough control to be treated as the owner of the trust assets. Careful attention must be paid to the grantor's retained powers, especially the power to deal with the trust for their own benefit. The decision emphasizes that even if a trust is irrevocable, the grantor's ability to modify the trust is a factor that supports taxation to the grantor.

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