Savage v. Commissioner, 4 T.C. 286 (1944)

Trust income is taxable to the grantor if a person without a substantial adverse interest has the power to distribute the income to the grantor, even if that power is not directly held by the grantor.

Summary

Clair and Margaret Savage created four trusts for their children, with the other spouse given the power to amend the trust, but not to benefit themselves directly. The Tax Court addressed whether the trust income was taxable to the grantors under Section 167 of the 1938 Revenue Act, because a person without a substantial adverse interest (the grantor's spouse) held the power to distribute the income to the grantor. The court held that the income was taxable to the grantors, reasoning that the spouse's contingent interest was not a "substantial adverse interest," and the power to amend could be used to benefit the grantors.

Facts

Clair R. Savage created two trusts for the benefit of his minor daughter, Marilyn Savage, naming his wife, Margaret D. Savage, as the person with the power to amend or modify the trust. Margaret D. Savage created two similar trusts for the benefit of their minor son, William Clair Savage, naming her husband, Clair R. Savage, as the person with the power to amend or modify those trusts. The power to amend was limited in that the person holding the power could not increase his or her own or the primary beneficiary's interest, nor could they alter the power of amendment or revocation. The trust could be revoked by the grantor's spouse and the primary beneficiary together after the beneficiary reached majority. The IRS sought to tax the trust income to the grantors.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' income tax for 1938, arguing that the trust income was taxable to them. The Tax Court reviewed the Commissioner's determination.

Issue(s)

Whether the income of the trusts is taxable to the grantors under Section 167 of the 1938 Revenue Act because the power to amend or modify the trust is held by a person (the grantor's spouse) who does not have a substantial adverse interest in the disposition of the trust income and who may use the power to distribute income to the grantor.

Holding

Yes, because the grantor's spouse did not have a substantial adverse interest in the

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disposition of the trust income, and the power to amend the trust could be used to distribute income to the grantor.

Court's Reasoning

The court reasoned that the spouse's power to amend the trust was not limited by any substantial adverse interest. The spouses had no present beneficial interest in the income or corpus of the trusts. Their interest was only that of a contingent remainderman, which would vest, if at all, only under almost impossible circumstances. The court emphasized that the statute requires a "substantial adverse interest," not merely a minor or technical one. Referring to Loeb v. Commissioner, 113 Fed. (2d) 664, the court stated that the statute presupposes that a trustee clothed with discretion to dispose of the income will be amenable to the wishes of the grantor of a trust, as he is likely to be, particularly in family trusts. That is the basis for treating the trust income as the grantor's, if the disposition of it lies in the discretion of any person who has not "a substantial adverse interest". This means, in our opinion, an interest sufficiently direct and adverse to rebut the presumption that the grantor can control in fact the exercise of discretion by such person."

The court found nothing in the trust indentures to prohibit their amendment to provide for complete diversion of income to the grantors. The court distinguished Meyer Katz, 46 B. T. A. 187, stating, "We do not feel that the doctrine of the Katz case should be extended to cover the facts before us, since a fair, independent analysis discloses only a remotely contingent interest, the value of which, if any, is negligible. Such a remote possibility of benefiting from a trust falls far short of the 'substantial' interest required by the statute."

Practical Implications

This case clarifies the meaning of "substantial adverse interest" in the context of grantor trusts and Section 167 of the Internal Revenue Code. It highlights that a contingent interest, no matter how remote, is not enough to prevent the trust income from being taxed to the grantor if another person has the power to distribute income to the grantor. The court's reasoning underscores that the relationship between the grantor and the person holding the power to amend (especially within a family) is a key factor in determining whether the grantor retains effective control over the trust income. When drafting trust agreements, practitioners must carefully consider the potential for a grantor to benefit from the trust, even indirectly, and the implications for taxation. Later cases will often cite this decision when evaluating the adverse nature of the non-grantor's interest.

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