4 T.C. 1195 (1945)

A grantor is taxable on trust income when the grantor retains substantial control over the trust, including the power to designate beneficiaries and alter the trust's terms, even if the income is initially accumulated.

Summary

Stanley J. Klein created a trust with preferred stock from his company, naming himself and a business associate as co-trustees. The trust accumulated income for a set period, after which the income would be paid to Klein's wife or another beneficiary he designated. Klein retained the power to modify the trust, remove trustees, and ultimately decide who would receive the corpus. The Tax Court held that the trust income was taxable to Klein under Section 22(a) of the Internal Revenue Code because he retained substantial control over the trust and its assets, despite the initial accumulation period.

Facts

Stanley J. Klein owned all the common and preferred stock of Empire Box Corporation. In anticipation of substantial dividend payments on the preferred stock, Klein created a trust, transferring his preferred shares to it. He and a business associate were named as co-trustees. The trust agreement stipulated that income would be accumulated for 20 years or until the death of Klein or his wife. After the accumulation period, income would be paid to his wife or another beneficiary designated by Klein. Klein retained the power to modify the trust terms and designate who would ultimately receive the trust corpus. The purpose of the trust was to prevent Klein from reinvesting dividends directly back into the business and to minimize income taxes.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Klein's income tax for 1941, including the trust income in Klein's taxable income. Klein petitioned the Tax Court, arguing the trust income should not be taxed to him due to the accumulation requirement. The Tax Court ruled in favor of the Commissioner, holding the trust income was taxable to Klein.

Issue(s)

Whether the income from a trust, where the grantor is also a trustee with the power to designate beneficiaries and modify the trust terms, is taxable to the grantor under Section 22(a) of the Internal Revenue Code, even if the income is initially required to be accumulated.

Holding

Yes, because Klein retained substantial control over the trust income and corpus, including the power to designate beneficiaries, modify the trust, and remove trustees, making him the effective owner of the trust income for tax purposes.

Court's Reasoning

The court relied on the principle established in *Helvering v. Clifford, 309 U.S. 331*, that a grantor is taxable on trust income when they retain substantial dominion and control over the trust property. The court distinguished this case from *Commissioner v. Bateman, 127 F.2d 266*, where the settlor had relinquished more control to independent trustees. In this case, Klein's powers as co-trustee, his ability to remove the other trustee, the nature of the trust assets (securities from a company he controlled), and his power to designate beneficiaries demonstrated substantial control. The court emphasized that there was no beneficiary with a vested, indefeasible equitable interest, as Klein could alter who benefited from the trust. The court concluded that Klein used the trust to accumulate funds for future distribution to beneficiaries of his choosing, avoiding taxes he would have paid had he accumulated the funds directly.

Practical Implications

This case reinforces the principle that grantors cannot avoid income tax by creating trusts if they retain significant control over the trust assets and income. Attorneys drafting trust agreements must carefully consider the extent of the grantor's powers to avoid triggering grantor trust rules. This decision serves as a reminder that the substance of a trust arrangement, not just its form, will determine its tax consequences. Later cases have cited *Klein v. Commissioner* to emphasize the importance of examining the totality of circumstances to determine whether a grantor has retained sufficient control to be taxed on trust income. It highlights the importance of establishing genuine economic consequences for beneficiaries other than the grantor.

