Leonard v. Commissioner, 4 T.C. 1271 (1945)

A grantor's control as trustee does not automatically make trust income taxable to the grantor under Section 22(a) if the grantor has relinquished substantial control and beneficial ownership, the trust is irrevocable, and the trustee's powers are not so broad as to allow shifting of income or corpus beneficial ownership.

Summary

The Tax Court addressed whether the income from six irrevocable trusts established by J.M. and Leonard Leonard for their three minor daughters was taxable to the grantors under Sections 22(a), 166, or 167 of the Revenue Act of 1938 and the Internal Revenue Code. The IRS argued that because one of the grantors was the sole trustee, the grantors maintained sufficient control to be treated as the owners of the trust corpus. The court held that the trust income was not taxable to the grantors, as the trusts were irrevocable, for the benefit of the daughters, with vested interests and limitations on the trustee's powers. The court emphasized that each case depends on its own facts and circumstances.

Facts

J.M. and Leonard Leonard created six irrevocable trusts for the benefit of their three minor daughters. Two sets of trusts were created: the "1938 trusts" and the "1940 trusts." Leonard Leonard served as the sole trustee. The trusts specified dates for termination and distribution of assets to the beneficiaries, with provisions for distribution to others in case of a beneficiary's death before termination. The grantors retained no power to alter or amend the trusts or to direct income or principal to beneficiaries other than those named. The grantors provided for the support and education of their children from their own funds.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Leonards' income tax for the years 1938, 1939, and 1940, arguing that the trust income was taxable to them. The Leonards petitioned the Tax Court for redetermination. The Tax Court consolidated the cases and heard them on stipulated facts.

Issue(s)

1. Whether the income of the six trusts is taxable to the grantors under Section 22(a) of the Revenue Act of 1938 and the Internal Revenue Code.
2. Whether the income of the six trusts is taxable to the grantors under Section 166 of the Revenue Act of 1938 and the Internal Revenue Code.
3. Whether the income of the six trusts is taxable to the grantors under Section 167 of the Revenue Act of 1938 and the Internal Revenue Code.

Holding

1. No, because the grantors relinquished substantial control and beneficial ownership of the trust assets, and the terms of the trusts ensured the beneficiaries' interests were protected.
2. No, because the grantors did not retain the power to revest title to the trust corpus in themselves.
3. No, because the trustee was either limited in making distributions to the beneficiaries or prohibited from doing so until they reached a certain age, and the grantors provided for the support of their children from their own funds.

Court's Reasoning

Regarding Section 22(a), the court distinguished *Helvering v. Clifford*, emphasizing that in this case, the grantors had relinquished substantial control over the trust assets. The court noted the trusts were irrevocable, for the benefit of the grantors' daughters, and contained provisions preventing the grantors from altering or amending the trusts. The court distinguished *Louis Stockstrom*, noting that in *Stockstrom*, the trustee had the power to shift income from one beneficiary to another, which was not present here. The court quoted *Commissioner v. Branch*, stating, "Where the grantor has stripped himself of all command over the income for an indefinite period, and in all probability, under the terms of the trust instrument, will never regain beneficial ownership of the corpus, there seems to be no statutory basis for treating the income as that of the grantor under Section 22(a) merely because he has made himself trustee with broad power in that capacity to manage the trust estate."

Regarding Section 166, the court found no provisions in the trust instruments that would allow the grantors to revest title to the trust corpus in themselves. The court distinguished *Chandler v. Commissioner*, where the settlor retained the right to direct the trustee to sell trust property to the settlor at prices fixed by the latter.

Regarding Section 167, the court noted that the respondent did not argue this point. The court agreed with the petitioners, finding that the trustee's power to make distributions was limited, and the grantors provided for the support of their children from their own funds.

Practical Implications

Leonard v. Commissioner clarifies the circumstances under which trust income will be taxed to the grantor when the grantor serves as trustee. It emphasizes that the grantor's powers must be carefully limited to avoid taxation under Section 22(a). The case underscores the importance of the irrevocability of the trust, the vesting of the beneficiaries' interests, and the absence of powers that would allow the grantor to shift income or corpus among beneficiaries. Later cases will analyze trust agreements to determine if the grantor-trustee retained powers similar to those in *Stockstrom* or *Chandler* or if the powers are limited, as in *Leonard*. This ruling allows settlors to create trusts for family members without the income being taxed back to them as long as they genuinely relinquish control over the trust assets.

