4 T.C. 1242 (1945)

A grantor is taxed on trust income when the grantor retains substantial control over the trust, but not when control is limited and benefits a third party.

Summary

Alex and Alma McCutchin created four irrevocable trusts, naming a corporation controlled by Alex as trustee. The IRS argued the trust income should be taxed to the McCutchins because of retained control. The Tax Court held that income from trusts for their children was not taxable to the McCutchins because the powers were limited, but income from trusts for Alex's parents was taxable because Alex retained broad discretionary powers over distributions. The court also held that intangible drilling costs had to be capitalized because the drilling was required to acquire the lease.

Facts

Alex and Alma McCutchin created four irrevocable trusts: two for their children (Jerry and Gene), and two for Alex's parents (Carrie and J.A.). The McCutchin Investment Co., controlled by Alex, was named trustee. The trusts held oil interests. The trust for the children accumulated income until age 21, with some discretionary distributions allowed until age 25. The trusts for Alex's parents allowed the trustee to distribute income or corpus at its discretion. Alex also acquired an oil and gas lease that required him to drill wells.

Procedural History

The IRS assessed deficiencies against Alex and Alma McCutchin, arguing that the trust income should be included in their gross income. The McCutchins petitioned the Tax Court for review. The IRS amended its answer to disallow deductions for intangible drilling costs related to the oil and gas lease.

Issue(s)

1. Whether the income from the four trusts should be taxed to the grantors (Alex and Alma McCutchin) under Section 22(a) of the Internal Revenue Code and the principles of *Helvering v. Clifford*.
2. Whether the intangible drilling and development costs incurred in drilling oil wells pursuant to a lease agreement are deductible as expenses or must be capitalized.

Holding

1. No, the income from the Jerry and Gene McCutchin trusts is not taxable to the grantors because the grantors did not retain sufficient control to be considered the owners of the trust property under *Helvering v. Clifford*. Yes, the income

from the Carrie and J.A. McCutchin trusts is taxable to the grantors because the grantors retained broad discretionary powers over the distribution of income and corpus.
2. The intangible drilling and development costs must be capitalized because the drilling was a requirement for acquiring the lease.

Court's Reasoning

The court determined that the McCutchin Investment Co. was an *alter ego* of Alex McCutchin, so he was effectively the trustee. Applying *Helvering v. Clifford*, the court analyzed whether the grantors retained enough control to be treated as the owners of the trust property.

For the trusts for the children, the court emphasized that the trustee's discretion was limited and that the trusts were irrevocable with no reversionary interest. The court distinguished *Louis Stockstrom* and *Commissioner v. Buck*, where the grantor had much broader powers to alter or amend the trusts. The court compared the facts to *David Small* and *Frederick Ayer*, where similar management powers were held not to trigger grantor trust treatment.

For the trusts for Alex's parents, the court found that the broad discretionary powers to distribute income or corpus were akin to those in *Louis Stockstrom*, making the grantor taxable on the trust income. This power, the court reasoned, gave the grantor the ability to shift beneficial interests.

Regarding the intangible drilling costs, the court stated that the option to expense or capitalize such costs does not apply when drilling is required as part of the consideration for acquiring the lease. The court cited *F.F. Hardesty*, *Hunt v. Commissioner*, and *F.H.E. Oil Co.*, noting that the Fifth Circuit in *F.H.E. Oil Co.* suggested drilling costs should always be capitalized.

Practical Implications

This case clarifies the application of grantor trust rules, especially in the context of family trusts. It demonstrates that broad administrative powers alone are insufficient to trigger grantor trust treatment; the grantor must also retain significant control over beneficial enjoyment. The case also reinforces the principle that costs incurred to acquire an asset, such as drilling costs required by a lease, must be capitalized. This ruling affects how attorneys structure trusts and advise clients on deducting drilling costs. Subsequent cases distinguish *McCutchin* based on the specific powers retained by the grantor and the economic benefits derived from the trust.

