***Russell v. Commissioner*, 5 T.C. 974 (1945)**

Trust income used to discharge a grantor's legal obligations is taxable to the grantor under Section 167 of the Internal Revenue Code, particularly when the trustees have the discretion to use the income for that purpose and do not have an adverse interest to the grantor.

Summary

The Tax Court held that income from a trust created by Clifton B. Russell was taxable to him to the extent it was used to discharge his pre-existing debts. Russell had transferred stock to a trust, some of which was encumbered by his personal debt. The trust agreement allowed the trustees to discharge debts against trust property, and they used trust income to pay off Russell's debt. The court reasoned that because the trustees had the discretion to use the income to benefit the grantor by paying his debt and had no adverse interest to the grantor, the income used for that purpose was taxable to Russell under Section 167 of the Internal Revenue Code. The court also addressed whether a bonus was constructively received. It found it was not because the petitioner didn't have the option to receive it directly.

Facts

In 1939, Clifton B. Russell created a trust for the benefit of his mother and daughter. He transferred 50 shares of Emery & Conant Co. stock free of debt and 350 shares subject to a $25,000 debt (Russell's personal obligation) to the trust.
The trust indenture granted the trustees the power to discharge any indebtedness against property conveyed into the trust and to make loans for this purpose, repaying them out of income.
In January 1940, the trustees paid off the $25,000 loan by borrowing $20,000 from Russell and using $5,000 of undistributed trust income.
The $20,000 loan from Russell was subsequently repaid with trust income.
In 1941, Emery & Conant Co. credited $25,000 to "Allan C. Emery as Trustee for Clifton B. Russell" as part of a bonus arrangement.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Russell's income tax for 1940 and 1941, including trust income used to pay his debts and the $25,000 bonus.
Russell petitioned the Tax Court for a redetermination of the deficiencies.
The Commissioner also moved for an increased deficiency, arguing that a larger portion of the trust income should have been attributed to Russell.

Issue(s)

Whether the income of the trust used to discharge the grantor's (Russell's) personal indebtedness is taxable to the grantor under Section 167(a) of the Internal Revenue

Code.
Whether a $25,000 bonus credited on the books of Emery & Conant Co. to “Allan C. Emery as Trustee for Clifton B. Russell” in 1941 was constructively received by Russell in that year, making it taxable income to him.

Holding

Yes, because the trust indenture gave the trustees the discretion to use the income to discharge indebtedness against the trust property, which benefited the grantor by satisfying his personal debt, and the trustees had no adverse interest to the grantor.
No, because Russell did not have the option to receive the $25,000 in cash, and the annuity trust was not set up until 1942; therefore, he did not constructively receive the income in 1941.

Court’s Reasoning

The court relied on Section 167(a)(2) of the Internal Revenue Code, which taxes to the grantor income of a trust that “may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor.”
The court emphasized that the trustees had the power under the trust indenture to discharge the indebtedness against the stock, and they had no interest adverse to Russell.
Even though the trustees borrowed from Russell to pay the debt, the substance of the transaction was that the debt was paid out of trust income, as intended by Russell.
The court cited *Lucy A. Blumenthal*, 30 B.T.A. 591, as precedent.
Regarding the bonus, the court distinguished *Richard R. Deupree*, 1 T.C. 113, noting that in *Deupree*, the taxpayer had the option to receive cash but chose to have it used for an annuity. In Russell’s case, the decision on how the bonus was to be paid was delegated to the company treasurer.
Since the annuity trust was not established until 1942, the $25,000 was not actually or constructively received by Russell in 1941. The court analogized the facts to those in *Renton K. Brodie*, 1 T.C. 275, but distinguished it by noting that the annuity policy was turned over to the taxpayer in the Brodie case during the tax year. In Russell’s case, the trust was not set up until the following year.

Practical Implications

This case reinforces the principle that trust income used to satisfy a grantor’s legal obligations can be taxed to the grantor, especially when the trust grants the trustee discretion to do so, and the trustee lacks an adverse interest.
When drafting trust agreements, grantors should be aware that granting trustees broad discretion to use income for the grantor’s benefit can result in the income being taxed to the grantor, even if not directly distributed to them.
The case highlights the importance of analyzing the substance of transactions rather

than merely focusing on their form.

For constructive receipt, taxpayers must have unfettered control and discretion to receive the income. If there are substantial restrictions or the decision rests with a third party, constructive receipt may not apply.

Practitioners should carefully analyze the terms of trust indentures and the relationships between grantors and trustees to determine potential tax liabilities under Section 167.