5 T.C. 1018 (1945)

A grantor who retains the power to revoke a trust is treated as the owner of the trust and is taxable on the trust's income, even if the income is distributed to another beneficiary or set aside for charitable purposes.

Summary

The Tax Court addressed whether a grantor was taxable on the income of five trusts she created, where she retained the power to revoke the trusts. The grantor argued that $18,000 paid to her annually was a gift and thus exempt from taxation, and that income set aside for charitable purposes was not taxable to her due to renunciation. The court held that because the grantor had the power to revoke the trusts, she was the equivalent of the owner of the trust corpora and was taxable on the trust's income. This power made her taxable on the entire trust income, less deductions for charitable contributions.

Facts

The petitioner's husband created five trusts in 1937, with the petitioner as the beneficiary. Paragraph 1 of each trust directed $300 per month be paid to the petitioner. Paragraph 5 granted the petitioner the "full power and authority to cancel or revoke this trust at any time in whole or in part." The trust income for 1939, 1940, and 1941 was $28,943.62, $25,837.52, and $44,949.46, respectively. The fiduciary reported $10,943.62 of the 1939 trust income as "set aside for religious, charitable, and educational purposes." In her tax returns for 1940 and 1941, the petitioner reported some of the trust income, but argued that the $18,000 annual payments were gifts and that she had renounced the right to the charitable contributions.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against the petitioner for the years 1939, 1940, and 1941, arguing that the petitioner was taxable on all of the trust income because of her power to revoke the trusts. The petitioner appealed to the Tax Court. The assessment for 1939 was challenged as being barred by the statute of limitations, which depended on whether the unreported income exceeded 25% of the reported gross income.

Issue(s)

1. Whether the petitioner is taxable on the income of the five trusts created by her husband, given her power to revoke the trusts.

2. Whether the assessment of the deficiency for 1939 is barred by the statute of limitations.

Holding

1. No, the petitioner is taxable on all income of the five trusts after deductions for charitable contributions; because the petitioner possessed the equivalent of ownership of the corpora of the trusts due to her power to cancel or revoke the trust at any time.

2. No, the assessment of the deficiency for the year 1939 is not barred by the statute of limitations; because the amount of unreported income taxable to the petitioner is in excess of 25 percent of the reported gross income, and the notice of deficiency was mailed to the petitioner within five years after her return was filed.

Court's Reasoning

The court reasoned that the power vested in the petitioner under paragraph 5 of the trusts, which granted her "full power and authority to cancel or revoke this trust at any time in whole or in part," made her the equivalent of the owner of the trust corpora. The court relied on cases such as *Richardson v. Commissioner*, 121 F.2d 1 (where the husband had an unqualified right to revoke the trust); *Ella E. Russell*, 45 B.T.A. 397 (where the beneficiary could direct the trustees to pay her the principal); *Jergens v. Commissioner*, 136 F.2d 497 (where the beneficiary had power to alter, amend, or modify the trust or to revoke it); and *Mallinckrodt v. Nunan*, 146 F.2d 1 (where the beneficiary could request payment of the trust income). The court distinguished *Plimpton v. Commissioner*, 135 F.2d 482, where the taxpayer-beneficiary could only have certain income distributed to him "in the discretion of the trustees," of which he was only one.

Practical Implications

This case emphasizes that the power to revoke a trust carries significant tax consequences. Even if a beneficiary receives distributions that would otherwise be considered gifts, the grantor who retains the power to revoke the trust will be taxed on the trust's income. Attorneys should advise clients creating trusts that retaining such powers will likely result in the trust's income being taxed to them, regardless of how the income is distributed. It clarifies that retaining the power to revoke a trust essentially equates to ownership for tax purposes, distinguishing it from situations where a beneficiary's access to trust income is subject to the discretion of an independent trustee. The case confirms the IRS's ability to assess deficiencies beyond the typical statute of limitations if unreported income exceeds 25% of gross income, highlighting the importance of accurate income reporting related to trusts.