Hemphill v. Commissioner, 8 T.C. 532 (1947)

A grantor is not taxed on trust income under Section 22(a) or 167 of the Internal Revenue Code merely because of broad management powers as trustee or minor irregularities in trust administration, provided the trust was created for the genuine benefit of the beneficiaries and the grantor does not retain substantial economic control or benefit.

Summary

The Tax Court determined that the grantor of two trusts, created for the benefit of his children, was not taxable on the trust income. The trusts were funded with stock in a company the grantor controlled, but he later lost majority control. The court found the trusts were genuinely for the children's benefit, with income irrevocably set aside for them. While the grantor, as trustee, had broad management powers and engaged in some questionable transactions (like purchasing a beach house), these were deemed minor irregularities insufficient to impute economic ownership to the grantor under the Clifford rule or trigger Section 167.

Facts

- Petitioner, Hemphill, created two trusts in 1938 for the benefit of his two children, funding them with stock in Industries, Inc., a company he controlled.
- The trust instruments stated the trusts were for the exclusive use and benefit of the beneficiaries.
- Initially, Hemphill owned 53,500 of the 100,000 outstanding shares of Industries. The trusts each received 5,000 shares.
- After April 24, 1939, Hemphill's stock, combined with the trust holdings, constituted a minority of the stock in both Industries and a successor company, Aero-Crafts.
- The trust allowed for income or corpus to be used for the children's support only in cases of "accident, sickness or unforeseen emergency" if the parent was unable to fulfill his parental obligations. No such expenditures were made during the tax years in question.
- The trustee purchased a beach house and two boats as trust investments; however, the beach house title was held in Hemphill's name, and no rent was initially paid by Hemphill's family for its use. The cost of the boats was later repaid to one of the trusts.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Hemphill, arguing the trust income was taxable to him under Section 22(a) and Section 167 of the Internal Revenue Code. Hemphill appealed to the Tax Court.

Issue(s)

© 2025 SCOTUSreports.com. All rights reserved.

1. Whether the income of the trusts is taxable to the grantor under Section 167 of the Internal Revenue Code because the trust terms permitted income to be used for the support of his children.
2. Whether the income of the trusts is taxable to the grantor under Section 22(a) of the Internal Revenue Code, applying the principles established in *Helvering v. Clifford*, 309 U.S. 331 (1940), due to the grantor's retained control and benefit.

Holding

1. No, because the trust terms allowed the use of funds for support only in specific emergency circumstances when the parent was unable to provide support, and no such circumstances arose during the tax years in question.
2. No, because despite the grantor's powers as trustee and minor irregularities in trust administration, the trust was genuinely for the benefit of the children, and the grantor did not retain substantial economic control or benefit.

Court's Reasoning

Regarding Section 167, the court relied on *David Small, 3 T.C. 1142* and *Estate of O.M. Banfield, 4 T.C. 29*, holding that income not actually used for the beneficiary's support is not taxable to the grantor. The court construed the trust as not permitting the trustee to devote the trust income and corpus to discharging his parental obligation, except in specific emergency circumstances. Since no such circumstances arose, Section 167 was inapplicable.

Regarding Section 22(a) and the *Clifford* rule, the court analyzed the terms of the trust and the circumstances of its creation and operation. The court emphasized that the trusts were created for the exclusive benefit of the beneficiaries. Although the petitioner initially controlled Industries, the court noted that after April 1939, the petitioner's stock, plus that owned by the trusts, constituted a minority of the stock. The court determined that the trusts were not created to provide a means of continuing the control of the corporation for the grantor's personal and pecuniary gain. The court stated, "The terms of the trust make clear the facts that the trust income was definitely and irrevocably set aside for the children's use and enjoyment and that the petitioner and his wife could receive no immediate or ultimate benefit therefrom."

The court addressed the respondent's contention that the trust property was actually used for the grantor's economic benefit. The court found the petitioner received his salary and dividends directly from Industries and its successor, unrelated to the trusts' stock ownership. Regarding the beach house and boats, the court found the beach property was purchased as an investment of the trusts, even though title was held in the grantor's name. The court viewed the failure to pay rent initially as an error that was later rectified. The court stated, "We do not hold that these minor irregularities, if such they were, on the part of the petitioner as trustee,

© 2025 SCOTUSreports.com. All rights reserved.

transform an income otherwise taxable to the trusts into income taxable to him individually.” The court concluded that the intent and purpose of the trust were solely for the children’s benefit, and the petitioner’s treatment of the trust property did not contravene that fundamental fact.

Practical Implications

Hemphill illustrates that broad trustee powers alone do not trigger grantor trust rules. The case emphasizes the importance of the grantor not retaining substantial economic benefits or control over the trust property. It also shows that minor irregularities in trust administration, if rectified, are not necessarily fatal to the trust’s validity for tax purposes. This case suggests that, even with some questionable transactions, the primary focus is on the overall intent and operation of the trust. Practitioners can use this case to argue against the application of grantor trust rules when the grantor’s actions, viewed in totality, are consistent with a genuine intent to benefit the beneficiaries, and the grantor does not retain significant economic control or benefit. Later cases distinguish *Hemphill* based on the degree of control and benefit retained by the grantor.

© 2025 SCOTUSreports.com. All rights reserved.