8 T.C. 1091 (1947)

Under California law, if a trust is not expressly made irrevocable in the trust instrument, it is deemed revocable, and the grantor will be taxed on the trust's income.

Summary

Erik and Dagny Krag created trusts for their children but failed to explicitly state in the trust documents that the trusts were irrevocable. California law dictates that trusts are revocable unless expressly stated otherwise. Later, the Krags obtained a state court order retroactively reforming the trusts to be irrevocable. The Tax Court addressed whether the trust income was taxable to the grantors. The court held that because the trusts were initially revocable under California law, the trust income was includible in the grantors' taxable income, notwithstanding the later state court reformation.

Facts

- Erik and Dagny Krag, husband and wife, created separate "Deeds of Gift and Trust Agreement" in November 1941 for the benefit of their children.
- Each trust was funded with 75 shares of Interocean Steamship Corporation stock for each child.
- The trust agreements did not contain explicit language stating that the trusts were irrevocable.
- The Krags intended the trusts to be irrevocable and reported them as such on gift tax returns.
- In 1944, the Krags sought and obtained a decree from a California Superior Court reforming the trust agreements retroactively to make them expressly irrevocable from their original date.
- During 1942 and 1943, the trusts generated income from dividends.

Procedural History

- The Commissioner of Internal Revenue determined deficiencies in the Krags' income tax for 1943, asserting that the trust income was taxable to them because the trusts were revocable.
- The Krags petitioned the Tax Court to contest the Commissioner's determination.

Issue(s)

1. Whether the trusts created by the Krags were revocable under California law because the trust instruments did not expressly state they were irrevocable?
2. Whether a state court order retroactively reforming the trust agreements to make them irrevocable changes the federal tax consequences for the years prior to the reformation?

Holding

1. Yes, because California Civil Code Section 2280 states that a voluntary trust is revocable unless the trust instrument expressly states it is irrevocable. The original trust documents did not contain this explicit language.
2. No, because the state court's reformation of the trust agreement cannot retroactively alter federal tax liabilities.

Court's Reasoning

- The court relied on California Civil Code Section 2280, which mandates that a trust must be "expressly made irrevocable" to be considered irrevocable. The absence of this explicit language in the original trust documents meant the trusts were revocable under California law.
- The court rejected the argument that the term "Deed of Gift" implied irrevocability, distinguishing between gifts inter vivos and gifts in trust.
- The court found the state court reformation decree was not binding for federal tax purposes because it was essentially a consent decree, lacking a genuine controversy. The court quoted Freuler v. Helvering, 291 U.S. 35, emphasizing the decision must be on issues "regularly submitted and not in any sense a consent decree."
- The court cited Sinopoulo v. Jones, 154 F.2d 648, which held that a retroactive reformation of a trust by a state court could not affect the government's rights under tax laws.
- The court stated that gift tax returns reporting the trusts as irrevocable were not determinative: "These returns were simply a report to the Government required by law and did not purport to change the nature of the trust. Any effective changes had to be in the instrument itself."

Practical Implications

- This case underscores the importance of clear and precise language in trust documents, particularly regarding irrevocability.
- Attorneys drafting trusts in California (and states with similar laws) must explicitly state that the trust is irrevocable if that is the grantor's intent.
- A state court's retroactive reformation of a trust will not necessarily be binding on federal tax authorities, especially if the reformation is based on a non-adversarial proceeding.
- This ruling reinforces the principle that federal tax liabilities are determined by the actual terms of the trust document during the tax year in question, not by subsequent modifications or interpretations.
- The case provides a cautionary tale for grantors seeking to avoid income tax liability through trusts; careful planning and drafting are essential.