Kelly's Trust No. 2 v. Commissioner, 8 T.C. 1269 (1947)

The number of trusts created by a trust agreement is determined by the grantor's intent as expressed in the trust document, and the mere division of a trust into separate accounts for beneficiaries does not necessarily create multiple trusts for tax purposes.

Summary

Kelly's Trust No. 2 sought a determination that three trust deeds each created multiple trusts for tax purposes. The Tax Court held that each trust deed created only one trust. The court found that the grantor's intent, as evidenced by the repeated use of the singular term "trust" and the absence of provisions requiring multiple trusts, indicated a single trust with separable shares for beneficiaries. The court emphasized that trustees cannot unilaterally create multiple trusts for tax advantages where the trust document does not explicitly provide for them. A state court decision was deemed non-binding due to a lack of genuine adversity in the state court proceedings.

Facts

Garrard E. Kelly established three trust deeds. Each deed initially created a single trust with multiple beneficiaries. After the death of the last surviving life beneficiary, the trustees divided each trust into separate accounts for the remaining beneficiaries, W.C. Kelly II and Lucy Gayle Kelly II. The trustees then claimed that each original trust had effectively become multiple trusts for federal income tax purposes, seeking to lower the overall tax burden.

Procedural History

The Commissioner of Internal Revenue determined that each trust deed created only one trust. Kelly's Trust No. 2 petitioned the Tax Court for review. Meanwhile, the trustees initiated a proceeding in the New York State Supreme Court to settle their accounts and sought a declaration regarding the number of trusts. The state court ruled that four separate trusts were created by each deed. This ruling was affirmed by the appellate division, although one judge dissented. The Tax Court then considered the Commissioner's determination and the state court ruling.

Issue(s)

Whether each of the three trust deeds created a single trust or multiple trusts for federal income tax purposes during the taxable years 1940, 1941, and 1942.

Holding

No, because the grantor's intent, as evidenced by the language of the trust deeds, indicated the creation of a single trust with separable shares for beneficiaries, and the trustees could not unilaterally create multiple trusts for tax advantages where the trust documents did not explicitly provide for them.

Court's Reasoning

The Tax Court emphasized that the grantor's intent, as expressed in the trust deeds, is the controlling factor. The court noted the repeated use of the singular term "trust" throughout each deed. Section 12(a) of trust deed #2 stated that when any child of Garrard E. Kelly reached the age of 30 years, after the death of Garrard E. Kelly, "the Trust as to such child shall be terminated, and his or her then share of the Trust property and funds shall be conveyed, delivered and paid over to him or her." The court interpreted this as indicating a single trust with separate shares. The court distinguished *United States Trust Co. v. Commissioner*, 296 U.S. 481 (1935), because in that case, the grantor had reserved the power to amend the trust, which was not present here. The court also gave little weight to the state court decision, finding that the proceedings lacked genuine adversity, resembling a consent judgment designed to bolster the petitioners' tax position. The court stated that "[i]t is not within the province of trustees, for matters of convenience or for the purpose of saving taxes, to establish trusts which are neither expressly provided for nor intended by the grantor."

Practical Implications

This case highlights the importance of clearly defining the intended number of trusts within a trust document. Attorneys drafting trust agreements must use precise language to avoid ambiguity. Trustees should not assume they can create multiple trusts solely for tax benefits if the trust document does not explicitly authorize it. *Kelly's Trust No. 2* emphasizes that substance, not form, governs the determination of the number of trusts. Later cases applying this ruling focus on examining the grantor's intent through the entirety of the trust document, giving less weight to subsequent actions by trustees aimed at minimizing taxes. It also cautions against relying on state court decisions in tax matters when those decisions are non-adversarial or appear to be driven by tax considerations.

