10 T.C. 1053 (1948)

A grantor is taxable on trust income when they retain substantial control over the trust or when the income can be used to discharge the grantor's legal obligations, subject to certain statutory exceptions.

Summary

Curtis Herberts created several trusts for his children, Evelyn and Curtis Jr., funded with stock from his company. The trusts evolved from oral agreements to formal, written instruments. The key issue was whether Herberts retained enough control over the trusts, or if the trust income could be used to satisfy his legal obligations, making him taxable on the trust income. The Tax Court determined that Herberts was taxable on the income from the trust for Evelyn because he had discretionary control over its distribution, but not for Curtis Jr.'s trust, subject to whether the Commissioner allowed a late filing of consent. The court analyzed the complex series of trust arrangements to determine the extent of Herberts' retained control and obligation to support his children.

Facts

Curtis Herberts gifted stock to his wife and children before 1941. In January 1941, he transferred stock to himself as trustee under oral trusts. Written, irrevocable trusts were created in December 1941. The Evelyn trust allowed the trustee (Herberts) discretion to use income for her support during her lifetime, with the remainder to Herberts and his wife. The Curtis, Jr. trust allowed income for his support and education during minority, with the principal to him at age 21. The Herberts Machinery Co. stock was liquidated in 1942, and assets were transferred to a single family trust in 1943. Evelyn suffered from a mental illness, and Curtis, Jr. was a minor.

Procedural History

The Commissioner of Internal Revenue assessed deficiencies against Herberts for gift tax and income tax for 1941 and income tax for 1943, determining that income from the trusts was taxable to him. Herberts petitioned the Tax Court for review. The cases were consolidated. Amended returns and consents to retroactive application of tax code section 167(c) were filed late.

Issue(s)

1. Whether the petitioner is taxable on dividend income and capital gains received by trusts purportedly created for his children under sections 22(a) and 167 of the Internal Revenue Code.
2. Whether the petitioner is taxable on income reported for his son in an individual return for 1942.
3. Whether the petitioner is taxable on parts of the income received by the Herberts

trust during 1943.

Holding

1. No, as to income attributable to pre-1941 gifts; Yes, as to income received under purported trusts during 1941; Yes, as to income received under written irrevocable trusts for Evelyn, but not for Curtis, Jr., subject to the Commissioner's decision on extending the time for filing consents because of the application of section 167(c).

2. Yes, because petitioner failed to present sufficient evidence that the determination was in error.

3. No, as to income distributable to petitioner as "trustee" for Curtis, Jr. during 1943.

Court's Reasoning

The court determined that the pre-1941 gifts were complete and effective, thus income from that stock wasn't taxable to Herberts. Income from stock transferred to the trusts in 1941 was taxable to him because the trusts were either invalid for uncertainty or revocable, giving him control. For later years, the court distinguished between the Evelyn and Curtis, Jr. trusts. Because Herberts, as trustee, had discretion to distribute income from the Evelyn trust for her support, and the remainder went to him and his wife, he retained control, making the income taxable to him under section 22(a), following the principles of *Helvering v. Clifford*. However, the Curtis, Jr. trust was different. While Herberts had discretion to use income for Curtis, Jr.'s support, the principal and undistributed income would go to Curtis, Jr. at age 21. Although the court held that income available for the discharge of a grantor's parental obligation is taxable to him, citing *Helvering v. Stuart*, section 167(c) modified this rule. The court left the final determination to the Commissioner on whether to allow a late filing of consents, which would render section 167(c) applicable.

Practical Implications

This case illustrates the importance of carefully structuring trusts to avoid grantor taxation. Retaining excessive control over trust distributions or allowing trust income to discharge the grantor's legal obligations can result in the trust income being taxed to the grantor. Later cases have distinguished *Herberts* based on specific trust provisions and the grantor's retained powers. The case underscores the ongoing tension between legitimate tax planning and attempts to avoid taxation through trust arrangements where the grantor retains significant economic benefits or control. It highlights the critical role of contemporaneous documentation in demonstrating the intent and operation of the trust, especially where a settlor also acts as trustee.

