185 F.2d 127 (3d Cir. 1950)

A beneficiary who, as trustee, has the power to distribute trust income to herself based on her own judgment of her needs, has sufficient control over the income to be taxed on it, regardless of whether she actually distributes all the income to herself.

Summary

Eleanor Funk established four trusts, naming herself as trustee, with the power to distribute income to herself or her husband based on their respective needs, with herself as the sole judge of those needs. The Commissioner argued that Funk was taxable on the entire trust income because of her control over it, per Section 22(a) of the Internal Revenue Code. The Tax Court agreed with the Commissioner, finding that Funk's control over the income was so unfettered as to be considered absolute for tax purposes. The Third Circuit affirmed the Tax Court's decision, holding that Funk's power to distribute income to herself at her discretion made her the de facto owner of the income for tax purposes.

Facts

Eleanor Funk created four trusts (A, B, C, and D), naming herself as the trustee for each. The trust instruments gave Funk, as trustee, the power to distribute annually all or part of the net income of the trusts to herself or her husband, Wilfred J. Funk, "in accordance with our respective needs, of which she shall be the sole judge." Funk distributed some income to her husband, characterizing these transfers as gifts, even though he did not need the funds. The trust instruments stipulated that any undistributed income would be added to the principal and not subsequently distributed.

Procedural History

The Commissioner of Internal Revenue determined that the income from the four trusts was taxable to Eleanor Funk. The Tax Court initially ruled in Eleanor Funk's favor (1 T.C. 890), but this decision was reversed and remanded by the Third Circuit (Funk v. Commissioner, 163 F.2d 80, 3rd Cir. 1947) for further proceedings and adequate findings of fact. On remand, the Tax Court considered the record from Wilfred J. Funk's case, and then ruled against Eleanor Funk, which she appealed to the Third Circuit.

Issue(s)

Whether Eleanor Funk, as trustee and beneficiary, had sufficient control over the trust income such that the income should be taxed to her personally under Section 22(a) of the Internal Revenue Code.

Holding

Yes, because the trust instruments gave Eleanor Funk, as trustee, the power to distribute income to herself based on her sole judgment of her needs, which constituted a command over the disposition of the annual income that was too little fettered to be regarded as less than absolute for purposes of taxation.

Court's Reasoning

The court relied on the language of the trust instruments, which gave Funk the discretion to pay herself all or part of the trust income annually "in accordance with her needs, of which she shall be the sole judge." The court cited *Emery v. Commissioner, 156 F.2d 728, 730 (1st Cir. 1946)*, stating, "the fact that the petitioner did not exercise her powers in her own favor during the taxable years does not make the income any less taxable to her." The court also noted that Funk had absolute control over the trusts' income and distributed it at her discretion, including making gifts to her husband even when he had no need for the funds. The court emphasized that Funk failed to prove what amount of income, if any, was not within her absolute control, as she did not present evidence regarding her husband's necessities compared to her own. The court cited *Stix v. Commissioner, 152 F.2d 562, 563 (2d Cir. 1945)*, stating taxpayers must show what part of the income they could have been compelled to pay to others, and how much, therefore, was not within their absolute control. Because Funk had failed to demonstrate what portion of the income she would have been compelled to distribute to her husband, she could not escape taxation on the entire income.

Practical Implications

This case reinforces the principle that a beneficiary's power to control trust income, even if framed as discretionary and based on needs, can lead to taxation of that income to the beneficiary, regardless of actual distributions. It emphasizes the importance of clear and objective standards for distributions to avoid the implication of absolute control. Drafters of trust instruments should avoid language that grants a trustee/beneficiary unfettered discretion. This case is frequently cited in cases where the IRS is attempting to tax a trust beneficiary on income they did not directly receive, arguing that the beneficiary had sufficient control over the trust assets. Later cases have distinguished *Funk* by focusing on the specific language of the trust agreement and the existence of ascertainable standards limiting the beneficiary's discretion.