Estate of Alice Gwynne Preston v. Commissioner, 14 T.C. 1391 (1950)

When a trust grantor borrows funds from the trust under a legally binding obligation to repay, the trust is not considered revocable under Section 166 of the Internal Revenue Code, and the trust income is taxable to the beneficiary, not the grantor.

Summary

The Tax Court addressed whether the income from a trust should be taxed to the beneficiary (Alice Gwynne Preston's estate) or to the grantor (William P.T. Preston). The Commissioner argued the income was taxable to the beneficiary under Section 162(b) of the Internal Revenue Code. The petitioner contended that the trust was revocable under Section 166 because the grantor had borrowed a substantial amount from the trust. The court held that because the grantor had a legal obligation to repay the loan, the trust was not revocable, and the income was taxable to the beneficiary.

Facts

William P.T. Preston established a trust (the Alice Gwynne Preston trust). The trust instrument granted the trustee broad powers, including the power to loan funds to the grantor. The trustee loaned $125,000 to Preston, who executed a bond under seal, obligating him to repay the loan. Alice Gwynne Preston was the beneficiary of the trust and received distributions of income from the trust during the tax years in question. The Commissioner sought to tax the trust income distributed to Alice Gwynne Preston to her estate.

Procedural History

The Commissioner determined that the trust income was taxable to Alice Gwynne Preston's estate. The estate challenged this determination in the Tax Court. Prior related litigation involving the grantor and the trust occurred in New York state courts and before the Board of Tax Appeals (now the Tax Court), and the Second Circuit Court of Appeals.

Issue(s)

Whether the Alice Gwynne Preston trust was a revocable trust under Section 166 of the Internal Revenue Code, such that the trust income should be taxed to the grantor, William P.T. Preston, rather than the beneficiary, Alice Gwynne Preston.

Holding

No, because William P.T. Preston had a legal obligation to repay the loan to the trust, he did not have the power to revest the trust corpus in himself; therefore, the trust was not revocable under Section 166, and the trust income was taxable to the beneficiary, Alice Gwynne Preston's estate.

© 2025 SCOTUSreports.com. All rights reserved.

Court’s Reasoning

The court reasoned that Section 166 of the Internal Revenue Code applies when the grantor has the power to revest title to the trust corpus in themselves, either alone or in conjunction with someone lacking a substantial adverse interest. The court relied heavily on the prior decision of the New York Appellate Division, which held that Preston had made a valid gift to the trust, the trustee acted properly in loaning funds to Preston, and Preston was legally obligated to repay the loan. Because Preston (or his estate) was legally obligated to repay the loan, he could not revest the trust corpus in himself. The court distinguished this case from *Chandler v. Commissioner*, where the grantor specifically reserved the power to direct the trustee to buy from or sell to himself at prices fixed by him. In this case, the trustee had complete discretion over investments and loan terms. The court also distinguished *William J. Garland* because, in that case, there was no requirement that loans made from the trust be repaid. Because a New York court had construed the trust indenture to require repayment, this case was distinguishable.

Practical Implications

This case clarifies that a grantor’s borrowing from a trust does not automatically render the trust revocable for tax purposes. The key factor is whether the grantor has a legally binding obligation to repay the loan. If such an obligation exists, the trust is less likely to be considered revocable, and the income will be taxed to the beneficiary. This decision emphasizes the importance of carefully structuring trust agreements and loan transactions between grantors and trusts to achieve the desired tax consequences. It highlights the significance of state court decisions construing trust instruments in determining federal tax liabilities. This case has been cited in subsequent cases involving grantor trust rules and the determination of whether a trust is properly classified as a grantor trust for tax purposes. Later cases citing Preston often involve situations where a grantor attempts to retain significant control over trust assets, and the courts examine the substance of the grantor’s obligations and powers to determine if Section 166 applies.

© 2025 SCOTUSreports.com. All rights reserved.