25 T.C. 1230 (1956)

Under Section 167 of the Internal Revenue Code of 1939, trust income is taxable to the grantor if the income may be held or accumulated for future distribution to the grantor or distributed to the grantor at the discretion of a person who does not have a substantial adverse interest.

Summary

The U.S. Tax Court held that Peter B. Barker was taxable on the accumulated income of a trust he created. The trust, established for a 14-year term, provided for income distribution to Barker with the potential for the trustees to distribute accumulated income to him in the event of need. The court found that the trustees, including Barker's parents, did not possess a "substantial adverse interest" in the disposition of the income. Because the trustees could distribute accumulated income to Barker at their discretion, the court ruled that the accumulated income was taxable to Barker under Section 167 of the Internal Revenue Code of 1939.

Facts

In 1949, at age 21, Peter B. Barker established an irrevocable trust with a 14-year term. The City National Bank and Trust Company of Chicago, Barker's father, and Barker's mother were designated as trustees. The trust corpus included stock, Barker's interest in another trust, and life insurance policies. The trust agreement stipulated annual income payments to Barker. Trustees could, at their discretion, distribute accumulated income to Barker if he needed funds due to accident, sickness, or any other need. The trust was to terminate in 1963, distributing corpus and accumulated income to Barker, or to his wife and issue if he died before termination. The trust filed fiduciary income tax returns for 1949, 1950, and 1951. Barker included distributed income in his income tax returns but did not include the accumulated income. The Commissioner of Internal Revenue determined deficiencies in Barker's income tax for those years.

Procedural History

The Commissioner determined income tax deficiencies against Peter B. Barker for the years 1949, 1950, and 1951. Barker challenged the deficiencies in the U.S. Tax Court, arguing that he should not be taxed on the accumulated income of the trust. The Tax Court ruled in favor of the Commissioner, finding that the accumulated income was taxable to Barker under Section 167 of the Internal Revenue Code of 1939. The case was decided by Judge Tietjens.

Issue(s)

1. Whether the accumulated income of the Peter B. Barker Trust was properly included in petitioner's gross income under Section 22(a) or Section 167 of the Internal Revenue Code of 1939?

2. Whether Barker's parents, as trustees, held a "substantial adverse interest" in the disposition of the trust income?

Holding

1. Yes, because the court found that the accumulated income was taxable to Barker under Section 167 of the Internal Revenue Code of 1939.

2. No, because the court determined that Barker's parents did not possess a substantial adverse interest in the disposition of the trust income.

Court's Reasoning

The court focused its analysis on Section 167 of the Internal Revenue Code of 1939, which addresses the taxation of trust income to the grantor when the income is accumulated for future distribution to the grantor or may be distributed to the grantor at the discretion of a person without a "substantial adverse interest". The court determined that the corporate trustee had no adverse interest. It then considered whether Barker's parents, as co-trustees, had a substantial adverse interest. The court concluded that they did not because their interest in the accumulated income was contingent upon Barker's death before the trust's termination, which the court considered to be statistically unlikely given Barker's age. Moreover, the trustees had discretion to distribute accumulated income to Barker under certain conditions, essentially giving Barker access to the accumulated funds. The court cited the case of *Mary E. Wenger*, where the terms of the trust provided for distribution of income in the event of certain contingencies. The court found that the trustees' discretion to distribute income to Barker, combined with the low probability of the parents' interest vesting, meant they lacked a substantial adverse interest. Thus, under Section 167, the accumulated income was taxable to Barker.

Practical Implications

This case highlights the importance of determining whether any party involved in the trust has a "substantial adverse interest" in the disposition of the income. Attorneys drafting trust agreements must carefully consider the powers granted to trustees and the potential for those powers to cause the grantor to be taxed on undistributed trust income. Specifically, granting trustees the power to distribute accumulated income to the grantor triggers Section 167. Additionally, even when the terms of a trust are in some respects adverse to the grantor, this case shows that the remote chance of the trustees benefiting from the accumulated income (Barker's parents) is not considered a "substantial adverse interest". This case is frequently cited in trust and estate tax planning to demonstrate how broad discretion granted to trustees can result in the grantor being taxed on the trust's income. Subsequent cases have followed and clarified this principle, making it a key element of tax planning in these areas.