Scheft v. Commissioner, 59 T. C. 428 (1972)

Capital gains from a grantor trust are taxable to the grantor in the year the property is sold, not in the trust's fiscal year, when the grantor retains the right to receive the gains.

Summary

In Scheft v. Commissioner, William Scheft created six trusts for his children's benefit, with the trusts' capital gains to be distributed to him upon termination. The trusts sold assets in 1968, within their fiscal year ending March 31, 1969, generating capital gains. The issue was whether these gains should be taxed to Scheft in 1968 or 1969. The Tax Court held that under IRC sections 451(a), 671, and 677(a)(2), Scheft should be taxed on the gains in 1968, as he was treated as the owner of the trust portion generating these gains, and the gains were deemed received by him in the year of sale.

Facts

William Scheft established six trusts on November 22, 1966, each for one of his six children. The trusts were to distribute net income to the beneficiaries annually, with any undistributed income and capital gains to be paid to Scheft or his estate upon termination. Scheft used a calendar year for tax reporting, while the trusts used a fiscal year ending March 31. In 1968, the trusts sold assets, realizing capital gains of $383,943. These sales occurred within the trusts' fiscal year ending March 31, 1969. Scheft conceded he was taxable on these gains under IRC section 677(a), but disputed whether the gains should be taxed in 1968 or 1969.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Scheft's 1968 income tax and Scheft petitioned the United States Tax Court. The Tax Court considered whether the capital gains realized by the trusts should be included in Scheft's income for 1968 or 1969.

Issue(s)

1. Whether, under IRC sections 451(a), 671, and 677(a)(2), the capital gains realized by the trusts in 1968 are taxable to William Scheft in 1968 or in 1969, when the trusts' fiscal year ended.

Holding

1. Yes, because under IRC sections 451(a), 671, and 677(a)(2), William Scheft is treated as the owner of the portion of the trusts generating the capital gains, and those gains are considered received by him in the year the property was sold, which was 1968.

Court’s Reasoning

The Tax Court, applying IRC sections 451(a), 671, and 677(a)(2), reasoned that since Scheft retained the right to receive the capital gains upon trust termination, he was treated as the owner of the trust portion generating these gains. The court emphasized that under section 671, the grantor must include items of income attributable to the portion of the trust of which he is treated as the owner. Section 1. 671-2(c) of the Income Tax Regulations further specifies that such items are treated as if received directly by the grantor. Therefore, the court held that the capital gains must be included in Scheft’s income in 1968, the year they were realized, rather than in the trusts’ fiscal year ending in 1969. The court rejected Scheft’s arguments that the trust’s fiscal year should control, emphasizing the statutory scheme’s intent to tax the grantor as if the trust did not exist for tax purposes related to the owned portion.

Practical Implications

This decision clarifies that when a grantor retains the right to receive capital gains from a trust, those gains are taxable to the grantor in the year the property is sold, regardless of the trust’s fiscal year. This impacts how grantor trusts are structured and reported for tax purposes, emphasizing the importance of aligning the grantor’s tax year with the timing of asset sales within the trust. The ruling discourages the use of trusts as a means to defer taxation of capital gains and influences estate planning strategies involving trusts. Subsequent cases and IRS guidance have followed this principle, reinforcing the alignment of taxation with the economic reality of income realization.

