Carson v. Commissioner, 92 T. C. 1134 (1989)

A grantor is treated as the owner of trust income if they retain the power to sprinkle that income among beneficiaries without the approval of an adverse party.

Summary

John and Jean Carson created a trust for their sons, with Jean as the sole trustee, which received rental income from a dental practice. The trust agreement allowed Jean to distribute income annually to the sons, which she did unequally in some years. The issue was whether Jean's power to distribute income unequally made her the owner of the trust income for tax purposes. The Tax Court held that under IRC section 674(a), Jean's retained power to sprinkle income between the beneficiaries without any restriction meant that all trust income was taxable to the Carsons, as they were treated as owners of the trust.

Facts

John M. Carson, a self-employed dentist, incorporated his practice and with his wife, Jean, created a trust for their sons, Jon and Derrick, on June 22, 1981. Jean served as the sole trustee. On June 30, 1981, the Carsons transferred the real property, equipment, and furnishings used in the dental practice to the trust. The trust then leased these assets back to the corporation, receiving rental income. The trust agreement required all net income to be distributed to the sons at least annually, which Jean did, but not always equally. For the trust's fiscal years ending in 1982, 1983, and 1984, Jean distributed income as follows: $6,414 to Jon and $6,413 to Derrick in 1982; $9,065 to Jon and $6,640 to Derrick in 1983; and $4,564 to Jon and $9,370 to Derrick in 1984.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Carsons' taxes for 1981, 1982, and 1983, asserting that the trust income was taxable to them. The Carsons petitioned the U. S. Tax Court, contesting the deficiencies for 1982 and 1983. The Commissioner moved to amend the pleadings to increase the 1983 deficiency, which the court granted. The case proceeded to trial on the issue of whether Jean Carson retained a sprinkling power over the trust income, making it taxable to the Carsons.

Issue(s)

1. Whether Jean Carson, as a grantor and sole trustee, retained the power to sprinkle trust income between the beneficiaries, Jon and Derrick Carson, such that the trust income is taxable to the Carsons under IRC section 674(a).

Holding

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1. Yes, because Jean Carson, as a grantor and sole trustee, had the power to distribute trust income unequally among the beneficiaries without any restriction, which constitutes a retained power of disposition under IRC section 674(a), making all trust income taxable to the Carsons.

Court's Reasoning

The Tax Court applied IRC section 674(a), which states that a grantor is treated as the owner of any portion of a trust over which they retain the power to dispose of the beneficial enjoyment of the income without the consent of an adverse party. The court found that the trust agreement did not restrict Jean's discretion in distributing income between the sons, and her actual distribution of income unequally in 1983 and 1984 demonstrated her retained power to sprinkle income. The court rejected the Carsons' argument that Jean's intent to equalize distributions over the trust's term was relevant, as the tax code focuses on the existence of the power, not its exercise. The court also distinguished the case from *Bennett v. Commissioner*, holding that Jean's distributions were consistent with the trust agreement, not a misadministration. The court concluded that Jean's retained power extended to all trust income, not just the excess distributed unequally.

Practical Implications

This decision emphasizes that when structuring trusts, attorneys must carefully consider the tax implications of any powers retained by the grantor, especially the power to sprinkle income among beneficiaries. Practitioners should draft trust agreements with clear restrictions on the trustee's discretion if the goal is to avoid grantor trust status under IRC section 674(a). This case may influence how trusts are structured to ensure that income is not inadvertently taxable to the grantor. For taxpayers, it highlights the importance of understanding the tax consequences of trust arrangements, particularly when a grantor or related party serves as trustee. Subsequent cases have applied this ruling to scrutinize the terms of trust agreements and the actual administration of trust income distributions.

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