

January 1943

## Status of Short Term Trusts and Trusts Where the Control Remains in the Grantor Under the Federal Income Tax

Virginia T. Merrills

Follow this and additional works at: [http://openscholarship.wustl.edu/law\\_lawreview](http://openscholarship.wustl.edu/law_lawreview)



Part of the [Law Commons](#)

---

### Recommended Citation

Virginia T. Merrills, *Status of Short Term Trusts and Trusts Where the Control Remains in the Grantor Under the Federal Income Tax*, 28 WASH. U. L. Q. 099 (1943).

Available at: [http://openscholarship.wustl.edu/law\\_lawreview/vol28/iss2/4](http://openscholarship.wustl.edu/law_lawreview/vol28/iss2/4)

This Note is brought to you for free and open access by the Law School at Washington University Open Scholarship. It has been accepted for inclusion in Washington University Law Review by an authorized administrator of Washington University Open Scholarship. For more information, please contact [digital@wumail.wustl.edu](mailto:digital@wumail.wustl.edu).

## NOTES

### STATUS OF SHORT TERM TRUSTS AND TRUSTS WHERE THE CONTROL REMAINS IN THE GRANTOR UNDER THE FEDERAL INCOME TAX

#### BACKGROUND OF THE TAXATION TO THE GRANTOR OF INCOME FROM TRUSTS

The history of the taxation to the grantor of income from trusts is a history of the attempts of taxpayers to avoid the payment of taxes in the higher surtax brackets by the use of the trust device, while still in fact retaining the beneficial use of the income, and of the frustration of these attempts by statutes and court decisions. The basis for these attempts is the general rule, although there are exceptions,<sup>1</sup> that the income of a trust is not

---

1. Before the case of *Helvering v. Clifford* (1940) 309 U. S. 331, the exceptions to this general rule were provided by §219 (g) and (h) of the Revenue Act of 1924, and their later versions, §§166 and 167 of the Revenue Act of 1932, 47 Stat. 221, c. 209 §§166, 167, 26 U. S. C. A. §§166, 167.

#### Section 166: REVOCABLE TRUSTS

"Where at any time during the taxable year the power to revest in the grantor title to any part of the corpus of the trust is vested—

- (1) in the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, or
- (2) in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom, then the income of such part of the trust for said taxable year shall be included in computing the net income of the grantor.

#### Section 167: INCOME FOR THE BENEFIT OF GRANTOR

(a) Where any part of the income of a trust—

- (1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or
- (2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or
- (3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23 (n), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

- (b) As used in this section the term "in the discretion of the grantor" means "in the discretion of the grantor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of the part of the income in question."

taxable to the grantor but to the beneficiary or to the trustee, according to the nature of the trust.<sup>2</sup>

Before the Revenue Act of 1924,<sup>3</sup> the income of revocable trusts was not taxed to the grantor, and therefore the revocable trust was freely used to distribute property among the family group of a grantor with a large income, in order to escape the surtaxes on the higher brackets.<sup>4</sup> In an effort to close this loophole, the Revenue Act of 1924 provided that the grantor should include the income from the trust in his gross income, if the trust were revocable by him during the tax year.<sup>5</sup> This language, however, permitted grantors, by postponing the power of revocation to a subsequent year, to avoid the tax during intervening years. Accordingly, the statute, now Section 166 of the Internal Revenue Code, was amended in 1932, making trust income taxable to the grantor, if the trust is revocable by him at any time.<sup>6</sup>

Another device employed by taxpayers to avoid the higher brackets was the creation of trusts to pay the premiums on insurance on the settlor's life. This loophole too was closed by the Revenue Act of 1924, which requires the grantor to include in his gross income, trust income used to carry insurance on his own life, whether or not the trust was revocable and whether or not the policies are payable to his estate.<sup>7</sup>

After the enactment of these statutory expedients to prevent tax avoidance through trusts, there remained still one possible avenue of escape. That was the short term irrevocable trust with

2. 4 Paul and Mertens, *Law of Federal Income Taxation*, (1st ed. 1934) 53, ". . . the income of a trust for the taxable year which is distributable to the beneficiaries must be returned by, and will be taxed to, the respective beneficiaries, and that the income of a trust which is to be accumulated or held for future distribution, whether consisting of ordinary income or gain from the sale of assets included in the corpus of the trust, must be returned by, and will be taxed to, the trustee."

3. Internal Revenue Code (1924) 43 Stat. 277, c. 234 §219 (g), 26 U. S. C. A. §166.

4. Altman, *Recent Developments in Income Tax Avoidance* (1934) 29 Ill. L. Rev. 154, 166. It was later held that revocable trusts set up before the Revenue Act of 1924 were ineffective for this purpose. *O'Donnell v. Commissioner of Internal Revenue* (C. C. A. 9, 1933) 64 F. (2d) 634, Cert. den. 54 S. Ct. 208.

5. Internal Revenue Code (1924) 43 Stat. 277, c. 234 §219 (g), 26 U. S. C. A. §166. This section was held constitutional in *Corliss v. Bowers*, (1929) 281 U. S. 376, on the theory that income "—that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

6. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

7. Internal Revenue Code (1924) 43 Stat. 277, c. 234 §219 (h), 26 U. S. C. A. §167. This section was held constitutional in *Burnet v. Wells*, (1933) 289 U. S. 670, even though the trust was irrevocable and the policies were payable to others than the insured or his estate.

reversion in the grantor, by means of which, the grantor could rely upon recovering his property, without the need of reserving a power of revocation. Such a trust is, of course, not literally within the language of Section 166,<sup>8</sup> but its purpose and effect come dangerously close to violating the statutory policy. Accordingly, the courts, without additional legislative aid, proceeded in half steps to close up this gap. At first, this was accomplished by steadily broadening the scope of Sections 166<sup>9</sup> and 167<sup>10</sup> and by realistically looking beyond the legal title in each trust, to determine where the actual dominion over the trust property lay.

In *Corliss v. Bowers*,<sup>11</sup> sustaining the constitutionality of Section 219 (g), now Section 166,<sup>12</sup> the Supreme Court reasoned that the income from revocable trusts ought to be taxable to the grantor because he possessed the power to enjoy the income, whether he actually did so or not. A few years later, in *Burnet v. Wells*,<sup>13</sup> sustaining the constitutionality of Section 219 (h), now Section 167,<sup>14</sup> Mr. Justice Cardozo recognized a new kind of tax avoidance effectuated by means of the solidarity of the family group, which made it possible for the taxpayer "to surrender title to another and to keep dominion for himself, or, if not technical dominion, at least the substance of enjoyment," and he issued a warning to taxpayers seeking to avoid the higher brackets by means of the trust device, that "escape has been blocked by the resources of the judicial process without the aid of legislation."<sup>15</sup> In the companion case of *Du Pont v. Commissioner of Internal Revenue*,<sup>16</sup> the trust, for the benefit of the grantor's family, was irrevocable for a three year term, renewable for a like term at the option of the grantor at the end of the period, and the corpus was composed of stock, the income from which was to pay premiums on policies of insurance on the grantor's life. The deed made separate provision for the disposition of the policies and

8. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

9. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

10. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §167, 26 U. S. C. A. §167.

11. (1930) 281 U. S. 376.

12. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

13. (1933) 289 U. S. 670. Justices Sutherland, Butler, McReynolds, and Van Devanter dissenting.

14. Internal Revenue Code (1932), 47 Stat. 221, c. 209 §167, 26 U. S. C. A. §167.

15. (1933) 289 U. S. 670, 673.

16. (1933) 289 U. S. 685.

for the distribution of the shares: if the trust was terminated before the grantor's death, all interest in the policies was to vest in the beneficiaries and the shares and accumulated income were to go to the grantor; if, on the other hand, the grantor died while the policies were in force, the trustee was to collect the insurance and hold the proceeds in trust for the beneficiaries, and the shares were to be divided among the grantor's children or their issue. The Court held the grantor liable for the tax on the income of the trust because it was within the rule of *Burnet v. Wells*,<sup>17</sup> that the grantor is liable for the tax on the income of a trust set up to pay premiums on insurance on the grantor's life, even though the trust is irrevocable and the policies are payable to others than the insured or his estate. Justices Van Devanter, McReynolds, Sutherland, and Butler, who had dissented in *Burnet v. Wells*<sup>18</sup> on the ground that in that case the trust was an irrevocable gift, concurred in the *Du Pont* case for the reasons stated in the last paragraph of the majority opinion by Justice Cardozo:

"Here the grantor did not divest himself of the title in any permanent or definitive way, did not strip himself of every interest in the subject matter of the trust estate. During a term of three years the trustee was to apply the income to the preservation of the policies and while thus applying the income was to hold the principal intact for the return to the grantor unless instructed to retain it longer. The situation in its legal effect would not be greatly different if the trusts had been created for a month or from day to day. One who retains for himself so many of the attributes of ownership is not the victim of despotic power when for the purpose of taxation he is treated as the owner altogether."<sup>19</sup>

The dicta in these cases indicated the trend of the courts and provided a basis for considering the problem of the short term trust.

The next significant decision, *Summer v. Commissioner of Internal Revenue*,<sup>20</sup> concerned an irrevocable trust of securities for a one year period, the trustee of which was the grantor, and his wife the beneficiary. The Board of Tax Appeals in taxing the grantor for the income of the trust, placed its decision squarely on the *Du Pont* case since there was in the instant case, "—as slight a divestiture of title, as much command over the

---

17. (1933) 289 U. S. 670.

18. (1933) 289 U. S. 670.

19. (1933) 289 U. S. 685, 688.

20. (1939) 40 B. T. A. 811.

disposition of the trust, a retention of as many attributes of ownership, here as there were in that case."<sup>21</sup>

After the *Du Pont* case, trust draftsmen with increasing dexterity drew up trust instruments which permitted the grantor a great measure of control over the corpus, without giving him the power to revest the corpus or income in himself. For example, in the case of *Warren Corning*,<sup>22</sup> the grantor made a trust company the trustee and gave to his father, the power to revoke or change the beneficial interests. After the death of the grantor's father, the grantor retained power to remove the trustee and substitute another, and to pass upon all trust investments. The grantor was the income beneficiary for life, his wife to be life income beneficiary upon the death of the grantor; and if there were no descendants of the grantor living when the wife died, the grantor's father was to take the corpus. The grantor's father, pursuant to his power to alter the terms of the trust, had provided that the income should be accumulated during the life of the grantor. No income payments had been made, therefore, to the grantor, during the tax years in question. The Board of Tax Appeals taxed the grantor on the income of the trust holding that he had the right to revest the corpus in himself at some time in the future, within the scope of Section 166,<sup>23</sup> and that only the power to exercise this right, and not its existence, was contingent. The Board, not forgetting that the grantor retained a great deal of control over the corpus, also fixed the tax liability to the grantor by finally stating the "Substance of Enjoyment" test:

"Under the rule adopted by some courts and this Board, if the trusts are of such character that petitioner [grantor] although transferring the legal title to a trust, has retained in himself such general powers of control and management<sup>24</sup> that the trust property may be used for his own benefit to the extent that would give him the 'substance of enjoyment', then the income is taxable to petitioner [grantor] either upon the theory that such trusts do not have separate taxable entities or they amount to no more than an assignment of income."<sup>25</sup>

21. (1939) 40 B. T. A. 811, 814.

22. *Corning v. Commissioner of Internal Revenue* (1937) 36 B. T. A. 801.

23. Internal Revenue Act (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

24. The grantor retained power to substitute trustees. The trustee was permitted under the trust instrument to lend money to the grantor's estate or invest the corpus without liability for loss if he had obtained the approval of the grantor's father, or, after the death of the grantor's father, of the grantor himself.

25. The Board cited *Douglas v. Willcuts* (1935) 296 U. S. 1. There, a

The view of the Board however, was reversed upon appeal where the Circuit Court of Appeals for the Sixth Circuit rejected the "Substance of Enjoyment" concept and held that the grantor, for two reasons, had no power to revest the corpus or income in himself, within the scope of section 166:<sup>26</sup> first, because his power to recapture either the corpus or the income was based upon a contingency which might never occur; and second, because the father, a possible beneficiary, had the substantial adverse interest required to exempt the trust from the operation of Section 166.<sup>27</sup>

Later, in the case of *Estate of O'Laughlin, Deceased, First National Bank of Chicago, as Executor*<sup>28</sup> the grantor, naming himself trustee, executed a trust for the benefit of members of his family and retained vast powers of control over the corpus, which was composed of stock in a family corporation; the trust was created in 1931 and was irrevocable by the grantor until 1934, after which the grantor could revoke and regain both the corpus and accumulated income. The advisory trustees ordered an accumulation, and no income payments were made to the beneficiaries at any time. The tax years in question were 1932 and 1933, when the trust was irrevocable. The Board of Tax Appeals placed its decision of tax liability to the grantor on the ground provided in Section 167,<sup>29</sup> because the income had been accumulated for possible distribution to the grantor, and because he retained at all times the substance of enjoyment of the trust property by virtue of his retention of control over it. This decision of the Board was affirmed on appeal.<sup>30</sup>

Thus the decisions concerning short term trusts prior to the *Clifford* case,<sup>31</sup> exhibited a conflict between the Board of Tax Appeals and the courts, the former using the "substance of en-

---

court having power to alter its decrees with respect to alimony, granted a decree of divorce to a wife, which provided that the husband set up a trust for the benefit of his wife, instead of paying alimony to her. The husband was forced to include the income of the trust in his gross income under section 22 (a) of the Internal Revenue Code.

26. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §166, 26 U. S. C. A. §166.

27. *Ibid.*

28. (1938) 38 B. T. A. 1120.

29. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §167, 26 U. S. C. A. §167.

30. *First National Bank of Chicago v. Commissioner of Internal Revenue* (C. C. A. 7, 1940) 110 F. (2d) 448. The Board's decision was affirmed after the decision of *Helvering v. Clifford*. The opinion of the Circuit Court of Appeals contained dictum to the effect that the income of the trust for the tax years in question, was also taxable to the grantor under the rule of the *Clifford* case.

31. *Helvering v. Clifford* (1940) 309 U. S. 331.

joyment" test, and the latter rejecting it, while affirming or reversing Board decisions according to some indistinct pattern of their own. The vagueness of the courts can easily be understood. The "substance of enjoyment" test had been developed in a different type of case,<sup>32</sup> and it had no statutory standing. Nor could the courts reasonably hold that Sections 166 and 167<sup>33</sup> applied to short term trusts, because the Supreme Court had recognized a distinction between revocable trusts and trusts certain to be terminated soon.<sup>34</sup> This was the state of the law when, in *Helvering v. Clifford*,<sup>35</sup> the problem was flatly presented. The Supreme Court, with much ingenuity, applied the "substance of enjoyment" test and justified the application by referring it to the definition of "income" in Section 22 (a),<sup>36</sup> rather than to the narrower provisions of Sections 166 and 167.<sup>37</sup>

#### THE INCLUSION OF TRUST INCOME IN THE GRANTOR'S GROSS INCOME, UNDER SECTION 22 (a)

The typical situation of income tax liability to the grantor for the income of the trust is of course, furnished by the *Clifford* case. There the grantor created a five year irrevocable trust for the benefit of his wife, and named himself the trustee with the following powers: to vote the stock in the corpus, to sell or mortgage the trust securities without regard to the law of trust investment, to collect the income, to hold the property in his own name and to change the distributive provisions in the trust. The Court in forcing the grantor to include the income from this short term irrevocable trust in his gross income, under Section 22 (a),<sup>38</sup> closed the loophole provided by Section 166<sup>39</sup> and Section 167.<sup>40</sup> The decision seems to be an effort on the part of the Court to give effect to the purpose of the revenue laws without additional legislation: that is, to tax income to the person who

32. See supra, Note 25 and accompanying text.

33. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §§166, 167, 26 U. S. C. A. §§166, 167.

34. *Helvering v. Wood* (1940) 309 U. S. 344.

35. (1940) 309 U. S. 331. Justice Roberts dissenting.

36. Internal Revenue Code (1939) 53 Stat. 9, §22 (a), 26 U. S. C. A. §22 (a). Provisions similar to 22 (a) have been part of the Internal Revenue Code from 1913 to the present time.

37. Internal Revenue Code (1932) 47 Stat. 221, c. 209 §§166, 167, 26 U. S. C. A. §§166, 167.

38. Internal Revenue Code (1939) 53 Stat. 9, §22 (a), 26 U. S. C. A. §22 (a).

39. Internal Revenue Code (1932) 47 Stat. 221, c. 209, §166, 26 U. S. C. A. §166.

40. Internal Revenue Code (1932) 47 Stat. 221, c. 209, §167, 26 U. S. C. A. §167.

earns it or creates the right to receive it.<sup>41</sup> The conclusion reached is based on the fact that the grantor is just as much the real owner of the income after the trust is created, as he was before. Four factors present in the *Clifford* case seemed to signify to the court that the trust was a medium of tax avoidance: the grantor as trustee; the members of the grantor's family group as beneficiaries; the length of the trust term; and the grantor's retention of vast powers over the corpus which was to return to him at the end of the term.<sup>42</sup>

The four factors present in the *Clifford* case established only a basic pattern, a broad outline of income tax liability; the succeeding cases have, to some extent, filled in the interstices.<sup>43</sup> It must be noted, however, that the courts do not consider it necessary that all four factors be present in any given case;<sup>44</sup> one factor or a concurrence of several may establish the grantor's tax liability for the income of the trust. Generally perhaps the most important factors are the kinds of control retained by the grantor, or the length of the term.

#### *Trustee*

The grantor has been forced to include the income of the trust in his gross income where he not only retains some control over the corpus, but also names himself the only trustee.<sup>45</sup> The grantor must also include the trust income in his gross income where he is dominant trustee,<sup>46</sup> where the grantor co-trustee has joint power with his wife to remove the other trustee,<sup>47</sup> where the grantor-trustee has the power to appoint a new trustee,<sup>48</sup> where the grantor's wife is the trustee,<sup>49</sup> and where the trustee

41. *Helvering v. Horst* (1940) 311 U. S. 112, 119.

42. Pavenstedt, *The Broadened Scope of Section 22 (a): The Evolution of the Clifford Doctrine* (1941) 51 *Yale L. J.* 213, 221.

43. *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689.

44. *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689; Ray, *The Income Tax on Short Term and Revocable Trusts* (1940) 53 *Harvard L. Rev.* 1322; Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions* (1941) 35 *Ill. L. Rev.* 779; Note (1940) 38 *Mich. L. Rev.* 885.

45. *Penn v. Commissioner of Internal Revenue* (C. C. A. 8, 1940) 109 F. (2d) 954; *Commissioner of Internal Revenue v. Goulder* (C. C. A. 6, 1941) 123 F. (2d) 686; *Reuter v. U. S.* (1940) 92 Ct. Cl. 74, 34 F. Supp. 1014; Warren v. Commissioner of Internal Revenue (1941) 45 B. T. A. 379; Pavenstedt, *The Broadened Scope of 22 (a): The Evolution of the Clifford Doctrine* (1941) 51 *Yale L. J.* 213, 223.

46. *White v. Higgins* (C. C. A. 1, 1940) 116 F. (2d) 312.

47. *Hormel v. Helvering* (1941) 312 U. S. 552.

48. *Commissioner of Internal Revenue v. Buck* (C. C. A. 2, 1941) 120 F. (2d) 775.

49. *Commissioner of Internal Revenue v. Woolley* (C. C. A. 2, 1941) 122 F. (2d) 167; *Richter v. Commissioner of Internal Revenue* (1942) 46 B. T. A. No. 94.

is apparently the grantor's attorney and the grantor has retained certain administrative powers over the trust and may substitute himself as trustee.<sup>50</sup>

### *Relationship of Beneficiaries*

The relationship of the beneficiaries to the grantor is important since the court in the Clifford case recognized that to the head of the family in the higher brackets ". . . it may well make but little difference . . . (except income-tax-wise) where portions of the income are routed . . . so long as it stays in the family group."<sup>51</sup> While the family flavor has been the determinative factor of taxability to the grantor in a great many cases, still the courts will not rest the decision of a case on the close relationship of the beneficiaries to the grantor, unless the re-allocation of the income among the family group is clearly shown by the Commissioner of Internal Revenue.<sup>52</sup> Just what the relationship of the beneficiaries to the grantor must be, to constitute them members of his family group is not clear from the decided cases. Certainly a grantor's wife and children are members of his family group.<sup>53</sup> However in *Commissioner of Internal Revenue v. Branch*,<sup>54</sup> the trust made the grantor's wife the life income beneficiary, and provided for reversion in the grantor. The grantor was not taxed on the trust income since the court viewed the transfer as an outright gift and seemed to ignore the family solidarity concept because—"Congress has not provided for taxing the family income as a unit."<sup>55</sup> A grantor's father and mother have also been considered members of his family group<sup>56</sup> although not necessarily living in the grantor's household.<sup>57</sup> A grantor's nephew has also been considered a member of his family group.<sup>58</sup> On the other hand, a trust for the benefit of an adult married daughter, living apart from the grantor, her mother, seemed to indicate to the court

50. *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689.

51. (1940) 309 U. S. 331, 336.

52. *Kraft v. Commissioner of Internal Revenue* (C. C. A. 3, 1940) 111 F. (2d) 370.

53. *Commissioner of Internal Revenue v. Buck* (C. C. A. 2, 1941) 120 F. (2d) 775; *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689.

54. (C. C. A. 1, 1940) 114 F. (2d) 985.

55. *Id.* at 986.

56. *Reuter v. U. S.* (1940) 92 Ct. Cl. 74, 34 F. Supp. 1014.

57. *Commissioner of Internal Revenue v. Barbour* (C. C. A. 2, 1941) 122 F. (2d) 165.

58. *Commissioner of Internal Revenue v. Woolley* (C. C. A. 2, 1941) 122 F. (2d) 167.

no family flavor.<sup>59</sup> Likewise, where the beneficiaries were the sister-in-law and uncle of the grantor, the court found that the relationship was not sufficiently close to justify the application of the *Clifford* rule.<sup>60</sup> The courts tend to examine carefully the relationship of the beneficiaries to the grantor of the trust, and the absence of the family element alone, has been the determinative factor in holding the grantor not liable for income taxes.<sup>61</sup>

#### *Length of the Term*

While the tendency is toward requiring the grantor of the short term trust to include the trust income in his gross income, the length of the term is not conclusive. The cases do not make a clear distinction between a short term and a long term. Trusts ranging from three years<sup>62</sup> to ten years<sup>63</sup> have been held short term trusts; the Board of Tax Appeals has recently held that even a trust for the life of the beneficiaries with reversion in the grantor, and revocable by his wife, who was a beneficiary, is within the rule of the *Clifford* case. The Board said:

“—the function of the length of the trust term is no more than to act as an indicator or contributing factor in the determination of the other criteria.”<sup>64</sup>

Again in *Commissioner of Internal Revenue v. Buck*,<sup>65</sup> even though the wife was the life income beneficiary, and after her death the income and finally the corpus was to go to her children, the grantor was held liable for the income tax since he retained broad powers of control. On the other hand the grantor of a twenty year trust was not compelled to include the income of the trust in his gross income.<sup>66</sup> The grantor also escaped the income tax on a three year trust which was later extended to a life estate in the income for the beneficiary in the *Bok* case;<sup>67</sup> the decision was rested on the fact that the grantor retained only slight powers of control, and no significance was attached to the length of the term.

---

59. *Commissioner of Internal Revenue v. Armour* (C. C. A. 7, 1942) 125 F. (2d) 467.

60. *Milbank v. Commissioner of Internal Revenue* (1940) 41 B. T. A. 1014.

61. *Commissioner of Internal Revenue v. Chamberlain* (C. C. A. 2, 1941) 121 F. (2d) 765.

62. *Commissioner of Internal Revenue v. Woolley* (C. C. A. 2, 1941) 122 F. (2d) 167.

63. *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689.

64. *Howard Phipps v. Commissioner of Internal Revenue* (1942) 47 B. T. A. No. 53.

65. (C. C. A. 2, 1941) 120 F. (2d) 775.

66. *Jones v. Norris* (C. C. A. 10, 1941) 122 F. (2d) 6.

67. *Mary Louise Bok* (1942) 46 B. T. A. 678.

*Control*

Since the essence of liability to the grantor is ownership, it is important to consider just what controls retained by him will have this result. Even the grantor's unlimited power of control, by itself will not make him liable for the income tax, if the trust is an outright gift, so that he can receive no economic benefits from it.<sup>68</sup> However, it is evident from the decided cases that not every control indicative of ownership need be present in order to result in taxability to the grantor.<sup>69</sup> The grantor has been taxed where he retains the power to direct trust investments and vote the stock in the corpus,<sup>70</sup> but the courts seemingly make no distinction, although the opportunity has been presented, between closely held stock or stock in a family corporation, and stock in a quasi-public corporation. In *Helvering v. Stuart*,<sup>71</sup> however, the court stated that it could not regard as significant the fact that the corpus was composed of stock in a company in which the grantors were high officers because there were no findings, on this point, by the Board of Tax Appeals; but perhaps this is an indication by the court of its willingness to consider this problem if properly presented.

The grantor also seems to be liable for the income tax where he can revest the principal in himself<sup>72</sup> or where he retains the right to change the distributive provisions of the trust, or the beneficiaries, even though the right of alteration could not result in payments of income to the grantor during the life of the beneficiary.<sup>73</sup> On the other hand, in *Commissioner v. Brown*,<sup>74</sup> the grantor could not revoke, but retained power to change the beneficiaries or modify their interests, and even the power to return the income to his family group. The income for the tax years in question was not used for the members of the grantor's family group and the grantor was not taxed, although the case was afterwards remanded to the Board on other grounds.

The grantor has been held liable where he retains the power to borrow from the trust corpus, even though the right to borrow is expressly for the protection of the trust estate.<sup>75</sup> On the

---

68. *Jones v. Norris* (C. C. A. 10, 1941) 122 F. (2d) 6.

69. *McKnight v. Commissioner of Internal Revenue* (C. C. A. 8, 1941) 128 F. (2d) 240.

70. *Commissioner of Internal Revenue v. Cory* (C. C. A. 3, 1942) 126 F. (2d) 689.

71. *Helvering v. Stuart* (1942) 63 S. Ct. 140, 87 L. Ed. 109.

72. *White v. Higgins* (C. C. A. 1, 1940) 116 F. (2d) 312.

73. *Stein v. Commissioner of Internal Revenue* (1940) 41 B. T. A. 994.

74. (C. C. A. 3, 1941) 122 F. (2d) 800.

75. *First National Bank of Chicago v. Commissioner of Internal Revenue* (C. C. A. 7, 1940) 110 F. (2d) 448.

other hand, in the *Branch* case,<sup>76</sup> the grantor had pledged the stock in the corpus for his individual debt before he created the trust, and he retained the power to repledge the stock in the corpus; but this seemed unimportant to the court, since he covenanted to reimburse the trust estate for any loss resulting from the transaction. The retention of the right to appoint a trustee also, in part, resulted in the grantor's tax liability although the power was limited to the naming of a substitute trustee,<sup>77</sup> or to the appointment of additional trustees.<sup>78</sup> Liability to the grantor has also resulted where he retained the right to remove a trustee.<sup>79</sup> A grantor has been held liable under Section 22 (a) for the income taxes where he retains the power to buy the trust property at his own price<sup>80</sup> (though this basis for the result was not necessary, since this had been held "a power to revest" the corpus in the grantor within the scope of Section 166<sup>81</sup>).

There are a few cases of short term trusts for the benefit of members of the grantor's immediate family, where the grantor has retained some control over the trust property, which have not resulted in taxability to the grantor. Notwithstanding rather broad powers of control retained by the grantor, he was not held liable in *Commissioner of Internal Revenue v. Branch*,<sup>82</sup> there the beneficiary had the power to terminate the trust and appoint it to new uses, or to vest the corpus in herself. In *Commissioner of Internal Revenue v. Bateman*,<sup>83</sup> there was no possibility of reverter of the trust corpus or of the income to the grantor, nor any economic control reserved to the grantor save a power of appointment, and the trust was for a long term. In a suit to determine the grantor's liability for the accumulate income, the power of appointment was held insufficient to bring the case within the scope of the Clifford rule. The grantor has also escaped liability where he is neither a trustee nor retains any control over the trustee.<sup>84</sup>

The Court in the *Clifford* case did not see the necessity of

76. (C. C. A. 1, 1940) 114 F. (2d) 985, 132 A. L. R. 839.

77. *Cory v. Commissioner of Internal Revenue* (C. C. A. 3, 1942) 126 F. (2d) 689.

78. *Stein v. Commissioner of Internal Revenue* (1940) 41 B. T. A. 994.

79. *Deuble v. Commissioner* (1940) 42 B. T. A. 277.

80. *Commissioner v. Warren* (1941) 45 B. T. A. 379.

81. *Chandler v. Commissioner of Internal Revenue* (C. C. A. 3, 1941) 119 F. (2d) 623.

82. (C. C. A. 1, 1940) 114 F. (2d) 985, 132 A. L. R. 839.

83. (C. C. A. 1, 1942) 127 F. (2d) 266.

84. *Sühr v. Commissioner of Internal Revenue* (C. C. A. 6, 1942) 126 F. (2d) 283.

applying the rationale of the assignment of income<sup>85</sup> cases to the problem of taxing the income from a short term irrevocable trust to the grantor since Section 22 (a) adequately determined his liability.<sup>86</sup> But the reasoning in the assignment of income cases has been helpful to the courts in achieving the same result in long term trust cases where the grantor has retained control. In *Commissioner of Internal Revenue v. Buck*,<sup>87</sup> the grantor could vote the stock in the corpus, advise the trustee how to exercise his powers, remove the trustee and control all dispositions of the corpus except that he might not revoke the trust, or revest principal or income in himself. The trust gave a life estate in the income to his wife, with ultimate distribution to their children upon her death. The court taxed the trust income to the grantor on the theory that the grantor's retention of the power to change the beneficial interests was the equivalent of ownership, even though his only reversion was the share of any beneficiary who pre-deceased him. In reaching this result, the court relied upon *Helvering v. Horst*,<sup>88</sup> in which the court stated that the power to make gifts is a satisfaction of economic worth. An opposite result was apparently reached in *Jones v. Norris*,<sup>89</sup> upon very similar facts. The only distinguishing factor is that the grantor in the *Jones* case could not get back the corpus or income under any conditions. Nevertheless the court in the *Jones* case failed to recognize the power to make gifts as "a satisfaction of economic worth,"<sup>90</sup> and therefore a basis for taxation to the grantor. Again in *Helvering v. Stuart*<sup>91</sup> the opportunity was presented for the application of the *Horst* rule. Here two

---

85. Contemporaneous with the development of the *Clifford* rule, the courts were using Section 22 (a) as a basis for the decision of the assignment of income cases. *Helvering v. Horst* (1940) 311 U. S. 113, is a typical case. There, a taxpayer gave coupons of bonds to his son before they had matured. Ordinarily a taxpayer who acquires a right to receive income is taxed on it when it is received, regardless of when the right to receive it is accrued. But under the doctrine of the *Horst* case, when the donor procures the payment of the income to another, he is realizing the income and must therefore, pay the income tax upon it, since the power to dispose of the income is the equivalent of ownership of it.

There is a close analogy between the short term irrevocable trust for the benefit of the grantor's immediate family, where the grantor retains not only control of the corpus, but also a reversion, and the assignment or gift of income not yet received. In neither situation has the grantor disposed of the res which produced the income.

86. (1940) 309 U. S. 331, 338.

87. (C. C. A. 2, 1941) 120 F. (2d) 775.

88. (1940) 311 U. S. 113, 119.

89. (C. C. A. 10, 1941) 122 F. (2d) 6.

90. *Commissioner v. Buck* (C. C. A. 2, 1941) 120 F. (2d) 775, 777.

91. (1942) 63 S. Ct. 140, 87 L. Ed. 109. Justices Stone, Black, and Douglas dissented in the case of the trust for adult children.

brothers created trusts for the benefit of their children; the beneficiaries in one trust were minors, while the beneficiaries of the other were adults. The trust for the adult children was revocable by the grantor at first, but he subsequently gave up this power, and the trustees, (the grantor, his wife, and brother) had powers of absolute ownership. They were to distribute income to the beneficiaries within their discretion, and to accumulate the rest of it. After a fifteen year period the beneficiaries were to get the income for life, and the corpus was to go to their issue, or to named beneficiaries. The Court in refusing to apply the rule of the *Horst* case seemed to state a limitation to it: These distributions and accumulations it reasoned were to be used for the economic advantage of the children and would satisfy the normal desire of a parent to make gifts to his children, but this parental motive was a 'non-material' satisfaction and was insufficient to constitute economic gain realized by or realizable by the grantor.<sup>92</sup>

#### CONCLUSION

It is hard to ascertain the precise limits of the applicability of the *Clifford* rule and the rationale of the assignment of income cases. But under the latest pronouncement of the Supreme Court,<sup>93</sup> it is still safe, from an income tax point of view, for a grantor to create a trust for the members of his family, if the trust is an out and out gift. A complicating factor in the pattern of the income taxation of trusts has recently been added by the Revenue Act of 1942. This is the amendment of Section 22 (b) (3).<sup>94</sup> Until the change was made, property acquired by gifts, bequests or devises was excluded from the taxpayer's gross income, although the income from such property was included in gross income. The recent amendment provides that property acquired by gift, bequest, devise or inheritance need not be included in the taxpayer's gross income unless the transfer is a gift, bequest, devise or inheritance of income; in this event the taxpayer is required to include the value of the property in his gross income. No change has been made respecting the income from gifts, bequests, devises, or inheritances. There are two possible constructions of Section 22 (b) (3)<sup>95</sup> as amended; the more unlikely construction would be tantamount to overruling by legislation, the cases which have slowly evolved the principle

---

92. *Helvering v. Stuart* (1942) 63 S. Ct. 140, 147, 87 L. Ed. 109, 116.

93. *Helvering v. Stuart* (1942) 63 S. Ct. 140, 87 L. Ed. 109.

94. Internal Revenue Code (1942 Supp.) 26 U. S. C. A. § 22 (b) (3).

95. *Ibid.*

of taxing income to the person who earned it or created the right to receive it.<sup>96</sup> A more logical construction is that Congress intended not to take away grantor liability for the tax where it already exists, but perhaps to add grantee liability in the situations where the exclusion is no longer permitted.

VIRGINIA T. MERRILLS

---

96. *Helvering v. Horst* (1940) 311 U. S. 113, 119.

# It Took 70 Years



..... to make Shepard's Citations as good as it is today.

You can't name one of the really great law books that is a newcomer. Great law books aren't invented like a mechanical gadget. They can't be copied like a hat. More like a man, they must develop character—they must grow great with the years.

Seventy years have come and gone since Frank Shepard edited the first edition of Shepard's Citations. He established a service to which the experience and skill of nearly three-quarters of a century has been added.

You find all this in every copy of Shepard's Citations today.



## Shepard's Citations

The Frank Shepard Company  
111 Eighth Avenue  
New York

Copyright, 1942, by The Frank Shepard Company

Please mention **THE LAW QUARTERLY** when dealing with our advertisers.