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TAXATION-INCOME TAX-DISCRETIONARY APPLICATION OF INCOME OF IRREVOCABLE TRUST TO MAINTENANCE OF SETTLOR'S CHILDREN-TAXABILITY TO SETTLOR

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TAXATION — INCOME TAX — DISCRETIONARY APPLICATION OF INCOME OF IRREVOCABLE TRUST TO MAINTENANCE OF SETTLOR'S CHILDREN — TAXABILITY TO SETTLOR — Settlers, husband and wife, established certain irrevocable trusts with themselves and another as trustees, and the children of the settlers as beneficiaries. The income from the trust property was to be accumulated, and a certain percentage of the corpus and accumulated income was to be distributed to the beneficiaries as they respectively reached certain specified ages. The trust agreement further provided that the trustees should have the power to expend from the corpus or income such sums as they should deem necessary and advisable for the maintenance, education and support of the beneficiaries, or to defray expenses arising from sickness, accident, or unusual circumstances. The income from the trust property was taxed as income to the settlers, though none of it had been distributed, on the basis that the income could have been used to satisfy a legal obligation of the settlers. In an action to recover taxes paid under protest on such income, *held*, that since no part of the income of the trust estate was used for the support of settlers' children during the tax year, plaintiffs were entitled to recover that portion of the taxes paid based on income derived from the trust estates. *Hudson v. Jones*, (D. C. Okla. 1938) 22 F. Supp. 938.

Taxpayers have frequently utilized the trust device in an attempt to deflect income and thus evade the higher surtax brackets.¹ To this end, settlers have

¹ Buck, "Income Tax Evasion and Avoidance: The Deflection of Income," 23 VA. L. REV. 107 (1936); Warren, "The Reduction of Income Taxes Through the Use of Trusts," 34 MICH. L. REV. 809 at 824 (1936); Sutter and Owen, "Federal

conveyed part of their property to a trustee, the income of such property to be used to satisfy various legal obligations of the settlor.² But since "The creation of a trust by the taxpayer as a channel for the application of the income to the discharge of his obligation leaves the nature of the transaction unaltered,"³ the courts have looked to the substance of the arrangements and taxed the income to the settlor.⁴ This was true when a settlor created an irrevocable trust for the support and maintenance of his minor children.⁵ In the instant case, the trustee had discretion either to use the income of the trust for the support of the settlors' children or to let it accumulate. The decision that the income from the trust property was not to be taxed to the settlors seems to be placed, however, not on the discretionary aspect of the application of the income, but on the ground that no income was in fact used for the support of the settlors' children. It seems a necessary implication from the language of the opinion⁶ that had the income been so used, it would have been regarded as income to the settlors, and taxed as such. Thus limited, the decision seems sound. It does not penalize the creation of trusts whereby income is to be accumulated for future distribution to dependent members of the family, or possible present distribution if the occasion, in the discretion of the trustee, demands it. At the same time, it does not permit use of the discretionary feature as a means of avoiding the rule taxing trust income to the settlor if used to satisfy his legal obligations. Quite apart from the question of any present application of trust income to the support of settlor's children, it has been suggested⁷ that a settlor may be taxed on trust income if invested and accumulated for minor children on the basis that the trust income is being used to discharge a moral obligation of the settlor.⁸ This point was not

Taxation of Settlers of Trusts," 33 MICH. L. REV. 1169 (1935); Leaphart, "The Use of the Trust to Escape the Imposition of Federal Income and Estate Taxes," 15 CORN. L. Q. 587 (1930).

² See citations in note 1, *supra*. See also notes in 34 MICH. L. REV. 443 (1936); 48 HARV. L. REV. 815, 1026 (1935).

³ *Douglas v. Willcuts*, 296 U. S. 1 at 9, 56 S. Ct. 59 (1935).

⁴ *Douglas v. Willcuts*, 296 U. S. 1, 56 S. Ct. 59 (1935); *Helvering v. Schweitzer*, 296 U. S. 551, 56 S. Ct. 304 (1935), reversing per curiam (C. C. A. 7th, 1935) 75 F. (2d) 702; *Helvering v. Stokes*, 296 U. S. 551, 56 S. Ct. 308 (1935), reversing per curiam (C. C. A. 3d, 1935) 79 F. (2d) 256; *Helvering v. Blumenthal*, 296 U. S. 552, 56 S. Ct. 305 (1935), reversing per curiam (C. C. A. 2d, 1935) 76 F. (2d) 507.

⁵ *Helvering v. Schweitzer*, 296 U. S. 551, 56 S. Ct. 304 (1935); *Helvering v. Stokes*, 296 U. S. 551, 56 S. Ct. 308 (1935); *Commissioner v. Grosvenor*, (C. C. A. 2d, 1936) 85 F. (2d) 2.

⁶ See the instant case, 22 F. Supp. 938 at 945-946: "The court, therefore, concludes . . . that, since no part of the income for said trust estates for the year 1932 was used by either of the plaintiffs herein, the income from said trust estates for the year 1932 was not taxable . . . to either of the plaintiffs, personally. . . ." Further, the court cites with approval *Commissioner v. Grosvenor*, (C. C. A. 2d, 1936) 85 F. (2d) 2, where the trustee was to be without liability to anyone for the expenditure of trust income but did in fact use such income for the support of settlor's children. This income was taxed to settlor.

⁷ Buck, "Income Tax Evasion and Avoidance: The Deflection of Income," 23 VA. L. REV. 107 at 117 (1936).

⁸ *Burnet v. Wells*, 289 U. S. 670, 53 S. Ct. 761 (1933).

argued in the instant case. However, it is believed that the moral obligation to make future provision for dependent members of the family would not be held a sufficient duty to warrant the holding that trust income used to discharge such an obligation is income taxable to the settlor.

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