1 T.C. 365 (1942)

A trust beneficiary entitled to income can deduct depreciation on trust property even if the income is not currently distributed due to concerns about potential surcharges, as long as the trust instrument does not allocate depreciation to the trustee.

Summary

Edna Gutman, the beneficiary of a trust, sought to deduct depreciation on real estate held by the trust, even though she received no income from the trust in 1937 and 1938. The trustee withheld income due to potential surcharges under New York law relating to mortgage salvage operations. The Tax Court held that Gutman was entitled to the depreciation deduction because the trust instrument did not allocate depreciation to the trustee, and Gutman was entitled to all trust income. The court also held that Gutman was not required to include the undistributed income in her gross income.

Facts

Jacob F. Cullman created a trust, directing the trustees to pay the net income to his daughter, Edna Gutman, for life. The trust corpus included real properties acquired by the trustees through mortgage foreclosures. Due to concerns about potential surcharges under New York law concerning mortgage salvage operations, the trustees did not distribute the net rental income to Gutman in 1937 or 1938. Gutman claimed depreciation deductions on her tax returns for these properties, which the Commissioner disallowed.

Procedural History

The Commissioner determined deficiencies in Gutman's income tax for 1937 and 1938, disallowing the depreciation deductions. Gutman petitioned the Tax Court for review. The Commissioner amended the answer, arguing that if Gutman was entitled to depreciation, then the trust income should be included in her gross income.

Issue(s)

1. Whether the beneficiary of a trust is entitled to deduct depreciation on trust property when the trust instrument is silent on the allocation of depreciation, and the income is not currently distributed due to concerns about potential surcharges.
2. If the beneficiary is entitled to the depreciation deduction, whether the undistributed trust income should be included in the beneficiary's gross income.

Holding

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1. Yes, because the trust instrument did not allocate the depreciation deduction to the trustee, and the beneficiary was entitled to all the trust income.
2. No, because the income was not currently distributable to the beneficiary under New York law.

Court’s Reasoning

The court relied on Section 23(l) of the Revenue Acts of 1936 and 1938, which states that in the absence of trust provisions, depreciation should be apportioned between income beneficiaries and the trustee based on the trust income allocable to each. The court cited *Sue Carol, 30 B.T.A. 443*, where it was held that a beneficiary was entitled to the entire depreciation deduction because the trust instrument made no provision for the trustee to deduct depreciation, and the entire income was payable to the beneficiary, even if no income was actually distributed. The court reasoned that the New York law requiring the impounding of rents did not diminish the beneficiary’s equitable interest in the income, as no trust income was allocable to the trustee. The court stated, “To the extent that he is entitled to income, he is to be considered the equitable owner of the property.” Regarding the inclusion of income, the court held that under New York law, the income was not currently distributable. To charge the petitioner with income she did not receive, and might never receive, would violate the realism in the law of taxation of income.

Practical Implications

This case clarifies that a trust beneficiary can deduct depreciation even if the income is not currently distributed, provided the trust document doesn’t assign the depreciation deduction to the trustee. Attorneys should carefully review trust instruments to determine how depreciation is allocated. The decision emphasizes the importance of state law in determining when income is considered “currently distributable” for tax purposes. This case is significant for trusts holding real property, particularly in states with complex rules regarding income allocation during mortgage salvage operations. Later cases may distinguish *Gutman* if the trust instrument explicitly addresses depreciation or if the state law creates a different type of property interest.

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