3 T.C. 1246 (1944)

A life beneficiary of a trust is taxable on all trust income, except that specifically allocated for maintenance of a property pursuant to the trust document, and is entitled to deduct depreciation on the entire property, not just the income-producing portion.

Summary

Charles McVeigh, the life beneficiary of a trust established by his aunt's will, requested the trustees to sell a property called Knollwood. The will stipulated that if such a request were made, any maintenance costs of Knollwood exceeding its income should be paid from the trust's principal, not its income. The court addressed whether McVeigh was taxable on all trust income, excluding that from Knollwood, and whether he could deduct depreciation on the entire Knollwood property. The Tax Court held that McVeigh was taxable on all trust income excluding Knollwood and could deduct depreciation on the entire Knollwood property, rejecting a surrogate court decree attempting to reclassify the expenses.

Facts

Gustavia Senff's will established a trust with McVeigh as the life beneficiary, directing the trustees to pay him the net income after deducting proper charges. The residuary estate included Knollwood, a large estate. Article Twentieth of the will stipulated that if McVeigh requested the sale of Knollwood, the trustees were to sell it and, pending the sale, maintain it. Any costs of maintaining Knollwood exceeding its income would be paid from the trust's principal and not charged against the income. McVeigh requested the sale of Knollwood. The trustees initially sold the property but reacquired it after a default. The trustees tried to lease the property, and McVeigh temporarily occupied the residence during some summers.

Procedural History

The trustees filed an intermediate account in Surrogate's Court, Nassau County, stating that the excess expenditures on Knollwood were charged to principal, which the court approved. Subsequently, a new decree was sought to restate the account, treating the excess expenses as payable out of income. The Surrogate Court issued a new decree stating expenses were payable out of principal. The Commissioner of Internal Revenue later determined deficiencies in McVeigh's income tax, leading to a case in the Tax Court.

Issue(s)

1. Whether McVeigh is taxable on amounts equivalent to the excess expenses of maintaining Knollwood, which he contends were paid from trust corpus.

2. Whether McVeigh, as the life beneficiary, is entitled to deduct depreciation on the

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entire Knollwood property, or only on the portions that generated income.

Holding

1. Yes, McVeigh is taxable on the income because the trust directed that the excess expenses for Knollwood should be paid by the trustees out of the principal, and shall not be a charge against the income thereof, effectively segregating it from the trust's distributable income to the beneficiary.

2. Yes, McVeigh is entitled to deduct depreciation on the entire Knollwood property because section 23 (1) of the Revenue Act of 1938 provides that in the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each, and here there are no specific provisions.

Court's Reasoning

The Tax Court found the Surrogate Court decree to be collusive, as it was obtained without a genuine controversy and primarily to affect McVeigh's tax liability. The court emphasized that the will directed excess Knollwood expenses to be paid from trust corpus, not income. Therefore, the amounts McVeigh received were taxable income, not distributions of corpus. The court referenced that the testatrix, although she provided in article 15 of the will that after deduction of all proper charges the net income of the estate should be paid to the petitioner, also set up in article 20, in substance, that if the petitioner requested the trustees to sell Knollwood they should, pending such sale, maintain Knollwood in a manner conducive to sale and that thereafter taxes, insurance, and maintenance charges should, to the extent of any excess thereof over rents and profits derived from Knollwood, "be paid by my trustees out of the principal of the trust estate and shall not be a charge against the income thereof." The court held that, as life beneficiary entitled to all trust income, McVeigh could deduct depreciation on the entire property under section 23 (1) of the Revenue Act of 1938, which allows for depreciation deductions for property held for the production of income. It found that Knollwood was held for the production of income.

Practical Implications

This case highlights the importance of clear and unambiguous language in trust documents regarding the allocation of expenses and income. It clarifies that state court decrees obtained without a genuine adversarial proceeding will not bind federal tax determinations. The case demonstrates that a life beneficiary is entitled to the entire depreciation deduction as long as they receive all the trust income, and that

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