4 T.C. 218 (1944)

A life income beneficiary of a testamentary trust is not taxable on trust income that was initially distributed to them but subsequently refunded to the trust to cover interest payments on an estate tax deficiency, when the beneficiary was legally obligated to make the refund under state law.

Summary

Forrest Pearson, the life income beneficiary of a trust established by his deceased wife's will, received income distributions from the trust. Later, the trustees paid an estate tax deficiency and interest. They determined that under Pennsylvania law, while the estate tax was payable from the corpus, the interest should be paid from the trust's income. Consequently, they demanded Pearson refund a portion of the distributed income equal to the interest paid. Pearson complied. The Tax Court held that because Pearson was legally obligated to refund the income, the refunded amount was not taxable income to him.

Facts

Olive Pearson died, leaving a will that created a testamentary trust with her husband, Forrest, as the sole life income beneficiary. The will directed that all estate taxes be paid out of her general estate. After the estate's assets were transferred to the trust, a deficiency in estate tax was assessed due to the inclusion of an *inter vivos* trust in Olive's gross estate. The executors, who were also the trustees, paid the deficiency plus interest. Under Pennsylvania law, the trustees determined the interest on the estate tax deficiency should be paid from the trust's income. They requested, and Forrest Pearson refunded, the amount of previously distributed income equal to the interest payment.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Forrest Pearson's income tax for 1940, including the refunded trust income as taxable income and disallowing the interest deduction. Pearson petitioned the Tax Court, contesting the Commissioner's adjustments. He conceded one adjustment but maintained that the refunded income should not be included in his taxable income.

Issue(s)

1. Whether the interest paid on the estate tax deficiency should be charged to the income of the testamentary trust distributable to the life beneficiary.
2. Whether Forrest Pearson was legally obligated to refund the over-distributed income to the testamentary trust to cover the interest payment.

Holding

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1. Yes, because under Pennsylvania law, absent a specific direction in the will, interest on estate tax deficiencies is payable out of the income of the estate, not the corpus.
2. Yes, because the trustees had a right to demand the return of the overpayment, and Pearson was fulfilling a legal obligation by returning the funds.

Court’s Reasoning

The Tax Court reasoned that while the will directed estate taxes be paid from the

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