16 T.C. 528 (1951)

A trust beneficiary can deduct payments made to settle a judgment against the trust if the judgment relates to income previously distributed to the beneficiary, but not if the payment satisfies a claim against the beneficiary's deceased parent's estate.

Summary

This case concerns whether two taxpayers, Erminnie Hettler and Edgar Crilly, could deduct payments they made related to a trust's liability for unpaid rent. Crilly, a trust beneficiary, could deduct his payment as a loss because it related to income previously distributed to him. Hettler, whose payment satisfied a claim against her deceased mother's estate (who was also a beneficiary), could not deduct her payment. The Tax Court emphasized that Crilly's payment was directly related to prior income distributions, while Hettler's was to settle a debt inherited from her mother.

Facts

Daniel Crilly established a testamentary trust primarily consisting of a leasehold on which he built an office building. The lease required rent payments based on periodic appraisals of the land. A 1925 appraisal led to increased rent, which the trustees (including Edgar Crilly) contested. During the dispute, the trustees distributed trust income to the beneficiaries without setting aside funds for the potential increased rent. The Board of Education sued Edgar Crilly and his brother George (also a trustee) personally for the unpaid rent. The Board repossessed the property, leaving the trust with minimal assets. A judgment was entered against Edgar and George Crilly. Erminnie Hettler's mother, also a beneficiary, died in 1939. Hettler agreed to cover her mother's share of the judgment to avoid a claim against her mother's estate. To settle the judgment, the beneficiaries used funds from a separate *inter vivos* trust established by Daniel Crilly. Edgar Crilly and Erminnie Hettler each sought to deduct their respective portions of the payment.

Procedural History

The Commissioner of Internal Revenue disallowed the deductions claimed by Hettler and Crilly. Hettler and Crilly petitioned the Tax Court for review of the Commissioner's determination.

Issue(s)

1. Whether Edgar Crilly, as a beneficiary of a trust, can deduct as a loss his pro rata share of a payment made by another trust to settle a judgment against him arising from unpaid rent owed by the first trust, where the income from which the rent should have been paid was previously distributed to the beneficiaries.

2. Whether Erminnie Hettler can deduct as an expense or loss her payment of her

deceased mother's share of the same judgment, made to avoid a claim against her mother's estate.

Holding

1. Yes, because the payment by Edgar Crilly represented a restoration of income previously received and should have been used to pay rent.

2. No, because Erminnie Hettler's payment satisfied a charge against her mother's estate, not a personal obligation or a loss incurred in a transaction entered into for profit.

Court's Reasoning

The court reasoned that Edgar Crilly, as a trust beneficiary, received income that should have been used to pay the rent. His payment to settle the judgment was essentially a repayment of income he had previously received under a "claim of right" but was later obligated to restore. Therefore, it constituted a deductible loss under Section 23(e)(2) of the Internal Revenue Code. The court cited *North American Oil Consolidated v. Burnet, 286 U.S. 417* in support of the proposition that income received under a claim of right but later required to be repaid is deductible in the year of repayment.

As for Erminnie Hettler, the court found that she was satisfying a claim against her mother's estate, not a personal obligation. Her agreement to pay her mother's share was based on the understanding that the estate was liable. She received her mother's estate subject to this claim; therefore, her payment was not deductible as a nonbusiness expense or a loss.

The court also dismissed the Commissioner's argument that the payment should be treated as a capital expenditure, stating that the funds were provided as an accommodation and the beneficiaries were repaying income that had been erroneously received previously. Finally, the court refused to consider the Commissioner's argument, raised for the first time on brief, that the payment was not made in 1945, because this issue was not properly raised in the pleadings or during the trial.

Practical Implications

This case clarifies the deductibility of payments made by trust beneficiaries to satisfy trust liabilities. It emphasizes that the deductibility depends on the nature of the liability and the beneficiary's relationship to it. If the payment relates to income previously distributed to the beneficiary that should have been used to satisfy the liability, the beneficiary can deduct the payment as a loss in the year it is made. However, if the payment satisfies a debt or obligation inherited from another party (like a deceased relative), it is generally not deductible. This case highlights the importance of tracing the origin and nature of the liability when determining deductibility for tax purposes. This case also serves as a reminder that new issues should be raised during trial or in pleadings, and not for the first time in a brief.