Estate of Mary Jane Little, Deceased, Bank of America National Trust and Savings Association, Executor, Petitioner, v. Commissioner of Internal Revenue, Respondent, 30 T.C. 936 (1958)

When a trust instrument is modified, the modified instrument, not the original, constitutes the "instrument creating the trust" for purposes of allocating tax deductions for depreciation and depletion between income beneficiaries and the trustee.

Summary

The Estate of Mary Jane Little contested the Commissioner's determination of income tax deficiencies, arguing that Little, as an income beneficiary of a trust, was entitled to a portion of the deductions for depletion and depreciation on trust oil properties. The Tax Court held that the trust agreement, which modified the original testamentary will, constituted the "instrument creating the trust." Since the agreement directed the trustee to allocate receipts according to applicable law, which included provisions for setting aside reserves for depreciation and depletion to corpus, the court ruled that the trust, and not the income beneficiary, was entitled to the entire deduction. The court emphasized that the 1944 modification removed the broad discretion the original will afforded the trustee and mandated adherence to the law in allocating income and corpus.

Facts

Gloria D. Foster's will created a testamentary trust, naming Mary Jane Little as the life beneficiary. The trust held significant oil and gas properties. Initially, the will gave broad discretion to the trustees. However, in 1944, Little and other beneficiaries entered a settlement agreement modifying the trust. The modification replaced the original trustees with a new trustee and specified that the trustee allocate income and corpus "in accordance with the provisions of law applicable at the time." Under Texas law (the governing jurisdiction), the amounts of depreciation and depletion were to be allocated to the corpus of the trust. The trustee, following the 1944 agreement, allocated the entire depletion and depreciation deductions to the trust's corpus. Little, in her income tax returns, claimed a portion of these deductions, resulting in deficiencies claimed by the Commissioner. The trustee allocated receipts from oil and gas properties to the corpus of the trust. The Texas District Court, in a separate proceeding, had previously ruled that the trustee properly allocated depletion and depreciation to the corpus.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Mary Jane Little's income tax for the years 1949 through 1952, disallowing her claimed share of depletion and depreciation deductions from the trust's oil properties. Little, through her estate, petitioned the United States Tax Court to contest these deficiencies. The

Tax Court reviewed the case based on stipulated facts, as all facts were agreed upon. The Tax Court sided with the Commissioner and entered a decision in favor of the respondent.

Issue(s)

Whether the original will of Gloria D. Foster or the modified trust agreement of 1944 is the "instrument creating the trust" for purposes of allocating deductions for depletion and depreciation under sections 23(l) and 23(m) of the Internal Revenue Code of 1939.

Holding

Yes, the 1944 modified trust agreement is the "instrument creating the trust" because the modification fundamentally changed the trust's operational and allocation provisions.

Court's Reasoning

The court based its decision on the interpretation of sections 23(l) and 23(m) of the Internal Revenue Code of 1939, which directed that the allocation of depreciation and depletion deductions between income beneficiaries and the trustee be determined by the "pertinent provisions of the instrument creating the trust." The court determined that the 1944 agreement, which modified the original will, constituted the relevant "instrument." The court reasoned that the 1944 agreement's directive to allocate income and corpus according to applicable law was a provision of the instrument that mandated how the deductions should be allocated. The court referred to the Texas Trust Act, which provided that, absent specific trust provisions, depletion was to be treated as principal, and the balance was to be treated as income. The court emphasized that the 1944 agreement effectively incorporated Texas law, thus dictating that the entire deduction be taken by the trust. Additionally, the court considered a 1948 decision by the District Court of Dallas County, Texas, that supported the trustee's allocation of depletion and depreciation to corpus, further reinforcing the court's view that the modified trust controlled.

Practical Implications

This case establishes that when a trust instrument is modified, the amended document becomes the operative document for tax deduction allocation. Attorneys and tax professionals must carefully examine all trust documents, including any modifications, when determining how to allocate depletion and depreciation deductions for tax purposes. This is particularly crucial in states where there are specific laws governing the treatment of depreciation and depletion in trust accounting. Furthermore, the court's reliance on prior judicial interpretations by a state court, such as the ruling from the Texas District Court, highlights the importance of considering any existing state court decisions relating to the trust's interpretation or operation, which could further clarify the allocation of deductions. Lastly, the case reinforces the importance of clear and explicit language in trust documents regarding the allocation of deductions. Absent such language, default rules, such as those in the Texas Trust Act, will govern the allocation.

