32 T.C. 301 (1959)

When a trust instrument, as interpreted by a court, requires the trustee to retain a portion of income for the purpose of keeping the trust corpus intact, the trustee, not the income beneficiaries, is entitled to the full depletion deduction for oil and gas royalties.

Summary

The U.S. Tax Court addressed the allocation of depletion deductions between a trust and its income beneficiaries. The William R. Sloan Trust received income from oil and gas royalties. The trust instrument, as interpreted by a California court, required the trustees to retain a portion of the income to protect the corpus. The income beneficiaries claimed the depletion deduction on the royalties distributed to them. The Tax Court held that, because the trust instrument provided for the preservation of the corpus, the trustees, not the beneficiaries, were entitled to the full depletion deduction under Section 23(m) of the 1939 Internal Revenue Code, as interpreted by the relevant Treasury Regulations.

Facts

William R. Sloan died in 1923, establishing a testamentary trust for his wife and daughters, with the remainder to charities. The trust's principal income source was oil royalties from mineral interests, including interests in the Pleasant Valley Farming Company and Richfield Oil Company. A California court decree, interpreting the trust instrument, directed the trustees to allocate 72.5% of the royalty income to the income beneficiaries (daughters) and 27.5% to the trust. The purpose of retaining a portion of income was to protect the corpus of the trust. The IRS determined that the trust, not the beneficiaries, was entitled to claim the full depletion deduction. The beneficiaries challenged this determination.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax for the years 1952 and 1953 against the income beneficiaries. The beneficiaries, John R. Upton and Anna L. S. Upton, and Margaret St. Aubyn, filed petitions with the U.S. Tax Court to challenge the Commissioner's determination regarding the allocation of the depletion deduction. The Tax Court consolidated the cases and issued a decision in favor of the Commissioner.

Issue(s)

1. Whether the income beneficiaries of the William R. Sloan Trust are entitled to percentage depletion on the oil royalties paid and distributed to them by the trustees.

2. Whether certain legal fees paid by the trust in 1949 and 1950 were deductible

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only in the years paid or ratably over a 20-year period.

Holding

1. No, because the trust instrument, as interpreted by the California court, required the trustee to retain a portion of the income to preserve the corpus, the trustee is entitled to the full depletion deduction.

2. No, the legal fees were not deductible over a 20-year period.

Court's Reasoning

The court focused on Section 23(m) of the Internal Revenue Code of 1939, which allows a depletion deduction for property held in trust and specifies how the deduction is to be apportioned. The statute states that the deduction is apportioned according to the trust instrument's provisions or, if the instrument is silent, on the basis of trust income allocable to each. The court emphasized that the key factor was the California court's interpretation of the will, which effectively required the trustees to retain a portion of the royalty income. The court cited Regulations 118, which state: "...if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee." The court found that the California court's decree, which directed the trustees to retain a portion of the royalty income, fell squarely within the regulatory provision, and therefore the trustees, not the beneficiaries, were entitled to the depletion deduction.

The court also referenced cases like Helvering v. Reynolds Co., 306 U.S. 110 and Crane v. Commissioner, 331 U.S. 1 to underscore the weight given to regulations that have been in force for a considerable period and remain unchanged. Concerning the second issue, the court decided against the petitioners based on prior holdings in L. S. Munger, 14 T.C. 1236 and Dorothy Cockburn, 16 T.C. 775, and didn't allocate any part of the legal fees over a 20-year period.

Practical Implications

This case provides critical guidance on allocating depletion deductions in trust situations. Attorneys advising trustees and beneficiaries must carefully examine the trust instrument and any relevant court interpretations to determine if the instrument requires the trustee to protect the trust corpus. If such a requirement exists, the trustee, not the beneficiaries, is typically entitled to the full depletion deduction. When drafting trust documents, drafters should explicitly state how depletion deductions are to be allocated, making sure that it aligns with the intent of the trustor. This case also highlights the importance of adhering to IRS regulations

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and respecting the courts' interpretations. Subsequent cases in the area of trust taxation will likely refer back to this case, particularly where the trust instrument has a similar provision regarding preserving the trust's corpus.

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