***33 T.C. 548 (1959)***

The characterization of trustee fees as chargeable to trust income or principal, for federal income tax purposes, is determined by the relevant state law and the intent of the trust instrument and involved parties.

**Summary**

In 1953, the Commissioner of Internal Revenue determined a tax deficiency against Norfleet H. Rand, a beneficiary of a Missouri trust, because Rand did not include in his income taxes the full amount of the trust's net income, which was calculated without deducting trustees' fees paid at the trust's termination. The U.S. Tax Court considered whether the trustees' fees were properly paid out of trust income, thereby reducing the taxable income distributable to the beneficiary. The court concluded that, under Missouri law, the fees were properly charged against income, thus reducing the distributable income taxable to Rand. This ruling hinged on the agreement between trustees and beneficiaries, as well as the nature of the services rendered.

**Facts**

Frank C. Rand created an irrevocable trust in 1926 for the benefit of his son, Norfleet H. Rand. The trust assets included stock in International Shoe Company. In 1942, the original trustee resigned, and the Mercantile-Commerce Bank & Trust Co., Richard O. Rumer, and Norfleet H. Rand were appointed as successor trustees. The successor trustees agreed that their compensation would be 3% of the gross income and 3% of the value of the principal of the trust when it was distributed. The trustees' fees were consistently paid out of the income account. In 1953, the trust terminated and distributed its assets to Norfleet H. Rand. The trustees paid fees computed on the value of the principal at the time of distribution. The Commissioner increased the amount of Rand's distributable income, arguing that these fees were chargeable to the corpus of the trust, not income, and were therefore not deductible in calculating Rand's taxable income.

**Procedural History**

The Commissioner of Internal Revenue determined a deficiency in income tax for the calendar year 1953. Rand challenged this determination in the U.S. Tax Court. The Tax Court examined the facts, the trust agreement, the actions of the trustees, and Missouri law to resolve the dispute.

**Issue(s)**

Whether, under Missouri law, the trustees' fees computed on the value of the principal were properly payable out of the income of the trust and reduced the distributable income taxable to the beneficiary.

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## Holding

Yes, because the Tax Court found that, under Missouri law and the specific facts, the trustees' fees were properly paid out of income, thereby reducing the amount of distributable income taxable to the beneficiary.

## Court's Reasoning

The court's decision centered on interpreting Missouri law regarding the allocation of trustee fees. The court emphasized that, in the absence of a specific provision in the trust instrument, and absent any contract upon the matter, Missouri law generally dictates that trustees' commissions are based on the yearly income received and paid out. The court referenced the case *In re Buder*, which stated that in the absence of express provisions in the trust instrument, trustees' fees are often based on yearly income. The court considered the agreement among the trustees and the beneficiary, finding that their actions and the manner in which fees were consistently handled indicated an intent to charge the fees against income, even though the fees were measured by the value of principal. Furthermore, the court noted the normal and ordinary nature of the trustees' duties, which did not warrant any deviation from the general rule of charging fees to income. The Court distinguished this case from those applying New York law, and relied on the intent of the parties and the established practices in Missouri law. The court held that the payment of fees out of income was consistent with the parties' agreement and understanding, despite fees being calculated on the value of the trust's principal.

## Practical Implications

This case underscores the importance of understanding the applicable state law when determining the characterization of trustee fees for tax purposes. It highlights that the intent of the parties to a trust agreement and their actions are crucial in determining whether trustee fees are allocated to income or principal. Attorneys must carefully review trust instruments, understand local precedent, and advise clients on the implications of fee arrangements. The decision emphasizes that the actual practice of paying fees from a particular account can be strong evidence of the parties' intent, even if the trust document is silent or ambiguous. This can affect the tax liability of beneficiaries, especially in the year of a trust's termination. Subsequent cases should examine if trustee fees are a "business expense" vs. an expense for the beneficiary. This case informs tax planning for trusts.

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