Trust Under the Will of Bella Mabury, Deceased, Walter R. Hilker, Jr. , Trustee v. Commissioner of Internal Revenue, 80 T. C. 718 (1983)

A charitable trust is not required to distribute income that it is mandated to accumulate under its governing instrument if it has unsuccessfully sought judicial reformation or permission to deviate from such requirements.

Summary

In Trust Under the Will of Bella Mabury v. Commissioner, the U. S. Tax Court ruled that a charitable trust created under Bella Mabury's will was not liable for excise taxes under IRC section 4942 for failing to distribute its income, as it was required to accumulate all its income under the terms of its governing instrument. The trust had unsuccessfully sought judicial reformation to distribute income to avoid the taxes. The court held that since the judicial proceedings to reform the trust had terminated before the tax years in question, and the trust's adjusted net income exceeded its minimum investment return, the trust was not required to distribute its income during those years. This decision emphasizes the importance of the terms of a trust's governing instrument and the impact of judicial proceedings on the applicability of tax regulations to charitable trusts.

Facts

Bella Mabury's will established a charitable trust with specific terms for income accumulation and distribution. The trust was to accumulate all income until its termination, which was to occur either upon the publication of a designated book or 21 years after the death of certain individuals. The trust's assets were to be distributed to specified organizations upon termination. The trustee sought judicial reformation to distribute income and avoid excise taxes under IRC section 4942, but the court denied the request. The trust's adjusted net income exceeded its minimum investment return for the fiscal years in question.

Procedural History

The trustee filed petitions in the Los Angeles County Superior Court to change the terms of the trust and for instructions regarding the applicability of IRC section 4942. The court denied the petition to change the trust's terms on December 9, 1971. A subsequent petition in 1974 was also unsuccessful, leading to an appeal that resulted in an order to seek a federal court ruling. The case ultimately reached the U. S. Tax Court, where the trust challenged the excise taxes assessed by the IRS for the fiscal years ending September 30, 1974, and September 30, 1975.

Issue(s)

1. Whether the Mabury Trust had "undistributed income" for its taxable year ended September 30, 1974, and is liable for an initial excise tax imposed under IRC section 4942(a) for each of its taxable years ended September 30, 1975, through September

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30, 1979.
2. Whether the Mabury Trust had “undistributed income” for its taxable year ended September 30, 1975, and is liable for an initial excise tax imposed under IRC section 4942(a) for each of its taxable years ended September 30, 1976, through September 30, 1979.
3. Whether the Mabury Trust is liable for the 100-percent additional excise tax imposed by IRC section 4942(b) on “undistributed income” for its taxable years ended September 30, 1974, and September 30, 1975.

Holding

1. No, because the trust’s governing instrument required accumulation of income, and judicial proceedings to reform the trust had terminated before the years in question, making the trust exempt from IRC section 4942 to the extent it was required to accumulate income.
2. No, for the same reasons as Issue 1.
3. No, because the trust had no “undistributed income” for the years in question, as its adjusted net income exceeded its minimum investment return and it was required to accumulate all its income.

Court’s Reasoning

The court applied IRC section 4942, which generally requires private foundations to make qualifying distributions. However, section 101(l)(3) of the Tax Reform Act of 1969 provides an exception for trusts organized before May 27, 1969, that are required to accumulate income under their governing instruments. The court found that the Mabury Trust fell under this exception because it had unsuccessfully sought judicial reformation to distribute income. The court also considered California Civil Code section 2271, which did not automatically reform the trust’s governing instrument to require income distribution. The court’s decision was influenced by the policy of not overburdening state courts with reformation proceedings and the need to respect the terms of trust instruments.

Practical Implications

This decision impacts how charitable trusts structured before May 27, 1969, should analyze their obligations under IRC section 4942. Trusts with mandatory income accumulation provisions in their governing instruments may be exempt from excise taxes if they have unsuccessfully sought judicial reformation. Legal practitioners must carefully review the terms of trust instruments and the status of any judicial proceedings when advising clients on compliance with tax regulations. This ruling also highlights the importance of state laws, like California Civil Code section 2271, in the context of federal tax regulations. Subsequent cases may need to distinguish this ruling based on the specific terms of the trust and the outcome of any judicial proceedings related to reformation.

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