Lewis Testamentary Trust B v. Commissioner, 83 T. C. 246; 1984 U. S. Tax Ct. LEXIS 38; 83 T. C. No. 16 (1984)

A trust's capital gain from selling a home used as a principal residence by its beneficiary is not excluded from the minimum tax under IRC § 57(a)(9)(D) if the trust itself did not use the property as its principal residence.

Summary

The Lewis Testamentary Trust B sold its one-half interest in a home that served as the principal residence of its income beneficiary, the decedent's surviving spouse. The issue was whether the trust's net capital gain deduction from this sale was subject to the minimum tax as an item of tax preference. The court held that it was, as the trust itself did not use the home as its principal residence. This ruling clarified that the tax exclusion for principal residence sales under IRC § 57(a)(9)(D) applies only when the taxpayer itself uses the property, not when it is used by a beneficiary.

Facts

Frank MacBoyle Lewis created a testamentary trust upon his death, dividing his community property into Trust A and Trust B. His surviving spouse, Frances W. Lewis, was the sole income beneficiary of both trusts. The personal residence at 245 Madrone Avenue, Belvedere, CA, was split equally between the two trusts. In 1978, both trusts sold their respective half interests in the residence. Trust B, the petitioner, reported the capital gain from its share but did not report it as a minimum tax preference item, claiming it was excluded under IRC § 57(a)(9)(D) because the property was the principal residence of its beneficiary, Mrs. Lewis.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the trust's income tax and an addition to tax, later conceding the addition. The case was submitted to the U. S. Tax Court fully stipulated. The court's decision was to be entered under Rule 155, determining the tax preference status of the trust's capital gain.

Issue(s)

1. Whether the net capital gain deduction from the sale of a trust's one-half interest in a home, used as the principal residence by the trust's income beneficiary, is an item of tax preference under IRC § 57(a)(9).

Holding

1. Yes, because the trust itself did not use the property as its principal residence, the net capital gain deduction is an item of tax preference subject to the minimum tax under IRC § 57(a)(9)(A) and not excluded under IRC § 57(a)(9)(D).

Court’s Reasoning

The court applied the literal language of IRC § 57(a)(9)(D), which excludes from tax preference only gains from the sale of a principal residence “used by the taxpayer. ” The trust, as the taxpayer, did not use the residence; it was used by its beneficiary, Mrs. Lewis. The court rejected the trust’s argument that Mrs. Lewis’ use could be imputed to the trust, emphasizing that federal tax law governs what interests are taxed, not state law classifications of ownership. The court distinguished this case from others where trusts were disregarded for tax purposes, noting that Trust B was a separate taxable entity, not a grantor trust. The court also considered the legislative history of the exclusion, finding no intent to extend it to trusts in the trust’s position. The court concluded that the trust’s capital gain was subject to the minimum tax.

Practical Implications

This decision impacts how trusts and estates plan for the sale of property used as a principal residence by a beneficiary. Trusts cannot claim the principal residence exclusion for minimum tax purposes unless they themselves use the property as a principal residence. Estate planners must consider this ruling when structuring trusts to avoid unintended tax consequences. The case also underscores the importance of considering the separate tax status of trusts in estate planning, as the benefits of trusts (like income splitting and estate tax exclusion) come with potential tax drawbacks. Subsequent cases have followed this ruling, reinforcing the principle that a trust’s tax treatment is determined by its own actions, not those of its beneficiaries.

