
SUPREME COURT OF THE UNITED STATES

October Term 2007

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

No. 2007-15

Elke Mee

Respondent

On Writ of Certiorari to the Court of Appeals

for the Thirteenth Circuit

UNITED STATES COURT OF APPEALS

For the Thirteenth Circuit

Elke Mee

Appellant

No. 2006-46

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

Before: Vertical, Tony, and Trover, Circuit Judges

Trover, Circuit Judge

In 2001 (effective January 1, 2002) the State of Mugel enacted its revised version of the Uniform Principal and Income Act, identical to the statute enacted in New York in the same year (Estates Powers and Trusts Law, §§ 11.2.3(b)(5), 11-2.3-A, 11-2.4, and Article 11-A).

Under that statute, the trustee of a trust required to pay the income to a beneficiary may elect to convert the trust to a 4% unitrust, so that such income beneficiary thereafter will receive (instead of the income of the trust) the “unitrust amount”, equal to 4% of the value of the entire corpus, valued annually.

The primary purpose of providing such a unitrust election is to permit a trustee to invest for “total return” and thereby eliminate the historic investment conflict between income beneficiaries and remainder beneficiaries.

The taxpayer in the present case was the income beneficiary of a trust established by her mother’s will. Under that instrument the trust income was required to be distributed to the taxpayer for her life, and on the taxpayer’s death the remainder was to be distributed to the taxpayer’s issue.

In the year 2005 the trustee exercised the unitrust election, pursuant to which the trust commenced as a unitrust in the calendar year 2006 and the taxpayer, on December 31, 2006, received a distribution of \$40,000 in cash.

The taxpayer reported that distribution on her income tax return for 2006 as the first installment payment (under § 453 of the Internal Revenue Code) of the proceeds of the sale of her income interest in the trust. Being required by §1001(e) to disregard any basis in her income interest, she reported the entire \$40,000, but characterized it as long term capital gain.

The Commissioner assessed a deficiency against the taxpayer for 2006 and the taxpayer petitioned the Tax Court for a re-determination of the deficiency.

The Commissioner’s position in the Tax Court was that under recently issued Treasury Regulations¹ the conversion of an “income only” trust to a 4% unitrust is not a taxable event and that even if it were, taxpayer must report payments as ordinary income rather than as long term capital gain.²

¹ Under Reg. 1.643(b)-1 “A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001...”

² Both the taxpayer and Commissioner have agreed that even if the taxpayer is correct on both issues, some portion of taxpayer’s payment must still be reported as unstated interest and thus ordinary income under § 483 or § 1274. Both also agree that if the taxpayer is incorrect on the §1001 issue, the taxpayer would have to report \$40,000 as ordinary income under § 652 of the Code

The Tax Court agreed with the Commissioner that the unitrust conversion was not a realization event and thus did not reach the ordinary income/capital gain issue. In its opinion,

“The pertinent regulation constitutes a reasonable interpretation of § 1001 as applied to a unitrust conversion. Under the principles set forth by the Supreme Court in Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), in contrast to the situation discussed in PLR 200231011, what the taxpayer had after the unitrust conversion was not ‘materially different’ from what he had before.”

We disagree and hold for the taxpayer on both issues.

On the issue of realization, we think the regulation in question is inconsistent with Cottage Savings. Prior to the unitrust conversion, taxpayer had an interest solely in so-called “trust accounting” income, i.e., basically an interest in dividends, interest, or rent. Only to the extent such income materialized would taxpayer receive anything. After the conversion, such income became irrelevant. Taxpayer would receive payments regardless of such income and, indeed, would receive increased payments to the extent the trust corpus increased in value, even if such increase was not itself realized as taxable income. To consider such a change not to be “materially different” flies in the face of Cottage Savings.

We hold, therefore, that what taxpayer received from the trust in 2006 was not a distribution under Subchapter J of the Code but, rather, proceeds from the sale of her income interest in the trust. See Trust Estate of Lonergan v. Commissioner, 6 T.C. 715 (1946).

The capital gain issue is, in our opinion, more difficult. The Commissioner relies heavily on a recent line of cases in which taxpayers who sell annuities received as lottery prizes are held to have received ordinary income. See, e.g., Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006), cert. denied, 127 S.Ct. 1328 (2007). Those cases essentially adopt as controlling the Supreme Court’s substitute-for-future-ordinary-income rationale emanating from Hort v. Commissioner, 313 U.S. 28 (1941) and Commissioner v. P.G. Lakes, 356 U.S. 260 (1958). As

additional support for such analysis the lottery cases point to footnote 5 of Arkansas Best Corp. v. Commissioner, 485 U.S. 212, at 217 (1988) where the Supreme Court stated:

“Petitioner mistakenly relies on cases in which this Court, in narrowly applying the general definition of “capital asset,” has “construed ‘capital asset’ to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income,” even though these items are property in the broad sense of the word. United States v. Midland-Ross Corp., 381 U.S. 54, 57, 85 S.Ct. 1308, 1310, 14 L.Ed.2d 214 (1965). See, e.g., Commissioner v. Gillette Motor Co., 364 U.S. 130, 80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960) (“capital asset” does not include compensation awarded taxpayer that represented fair rental value of its facilities); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 243 (1958) (“capital asset” does not include proceeds from sale of oil payment rights); Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941) (“capital asset” does not include payment to lessor for cancellation of unexpired portion of a lease). This line of cases, based on the premise that § 1221 “property” does not include claims or rights to ordinary income, has no application in the present context. Petitioner sold capital stock, not a claim to ordinary income.”

We do not think the present case is governed by the lottery cases or the above footnote from Arkansas Best. Winning a lottery is not the same as the sale of a capital asset, and collecting prize money in advance represents merely the lump sum receipt of previously accrued ordinary income.

We think that the applicable precedent here is McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946). In McAllister, the life income beneficiary of a testamentary trust released that interest in return for a lump sum paid by the remainder beneficiary. In holding that this transaction constituted the sale of a capital asset, the Court stated:

“The issue, as stated by the Tax Court and presented by the parties, reduces itself to the question whether the case is within the rule of Blair v. Commissioner of Internal Revenue, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465, or that of Hort v. Commissioner of Internal Revenue, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168. In the Blair case, the life beneficiary of a trust assigned to his children specified sums to be paid each year for the duration of the estate. The Supreme Court held that each transfer was the assignment of a property right in the trust and that, since the tax liability attached to ownership of the property, the assignee, and not the assignor, was liable for the income taxes in the years in question. The continued authority of the case was recognized in Helvering v.

Horst, 311 U.S. 112, 118, 119, 61 S.Ct. 144, 85 L.Ed. 75, 131 A.L.R. 655, although a majority of the Court thought it not applicable on the facts, and in Harrison v. Schaffner, 312 U.S. 579, 582, 61 S.Ct. 759, 85 L.Ed. 1055, where the Court very properly distinguished it from the situation where an assignor transferred a portion of his income for a single year. We think that its reasoning and conclusion support the taxpayer's position here." 157 F.2d at 236.

We think Blair also controls in the instant case. We, therefore, hold for the taxpayer.

Reversed.

ORDER
SUPREME COURT OF THE UNITED STATES

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

No. 2007-15

v.

Elke Mee

Respondent

The petition herein for a writ of certiorari to the Court of Appeals for the Thirteenth Circuit is granted in order that this court may consider all of the questions raised by the record, and it is

ORDERED, that this case be set down for argument in the October 2007 term of this Court.

June 15, 2006