

# **Federal Income Taxation of Trusts and Estates**

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# Federal Income Taxation of Trusts and Estates

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Cases, Problems, and Materials

*Third Edition*

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WASHINGTON AND LEE UNIVERSITY SCHOOL OF LAW

CAROLINA ACADEMIC PRESS

Durham, North Carolina

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ISBN: 978-1-59460-564-2  
LCCN: 2008928532

Carolina Academic Press  
700 Kent Street  
Durham, North Carolina 27701  
Telephone (919) 489-7486  
Fax (919) 493-5668  
[www.cap-press.com](http://www.cap-press.com)

Printed in the United States of America

*To Kerry  
and  
Johanna and Laura*

*To Lee-Anne, Dinah,  
Emmeline, and Robert Evan*



# Contents

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Table of Internal Revenue Code Sections	xiii
Table of Treasury Regulations	xix
Table of Cases	xxiii
Table of Revenue Rulings	xxxv
Table of Revenue Procedures	xxxvii
Table of Private Letter Rulings	xxxix
Preface	xli
Introduction	xlili
<b>Chapter 1 · Entities Subject to Income Taxation under Subchapter J</b>	<b>3</b>
A. Is an Entity Subject to Taxation?	3
Revenue Ruling 68-47	3
Illustrative Material	4
Revenue Ruling 76-486	5
Illustrative Material	7
<i>United States v. De Bonchamps</i>	10
Illustrative Material	18
B. How Is an Entity Taxed?	20
<i>Morrissey v. Commissioner</i>	20
Illustrative Material	24
<b>Chapter 2 · The Entity as Taxpayer: Basic Principles of Income Taxation under Subchapter J</b>	<b>27</b>
A. Gross Income	28
B. Deductions	30
1. Interest	31
2. Taxes	32
Revenue Ruling 61-86	32
Illustrative Material	32
3. Expenses Incurred in the Production of Income	33
a. In General	33
<i>Trust of Bingham v. Commissioner</i>	33
Illustrative Material	36
<i>Alfred I. duPont Testamentary Trust v. Commissioner</i>	37
Illustrative Material	40
<i>Knight v. Commissioner</i>	40
Illustrative Material	46
b. Disallowance of Expenses Attributable to Production of Tax-Exempt Income	47

<i>Manufacturers Hanover Trust Co. v. United States</i>	47
Illustrative Material	57
<i>Tucker v. Commissioner</i>	60
Illustrative Material	62
Revenue Ruling 77-355	62
Illustrative Material	64
<i>Whittemore v. United States</i>	64
Illustrative Material	70
<i>Fabens v. Commissioner</i>	70
Illustrative Material	73
Problem	73
4. Deduction for Personal Exemption	74
5. Income for Charity	74
<i>Hartwick College v. United States</i>	77
Illustrative Material	84
6. Depreciation and Depletion	86
<i>Hay v. United States</i>	87
<i>Dusek v. Commissioner</i>	92
Revenue Ruling 90-82	94
<i>Lamkin v. United States</i>	97
Illustrative Material	99
7. Expenses Deducted for Estate Tax Purposes	101
<i>Estate of Orville F. Yetter</i>	101
Illustrative Material	102
Problem	103
8. Passive Activity Rules	103
<i>Mattie K. Carter Trust v. United States</i>	103
Illustrative Material	107
<b>Chapter 3 · The Entity as Conduit: Allocating the Tax between the Entity and Its Beneficiaries</b>	109
A. “Income” or “Bequest”?	109
1. The Problem	109
<i>Irwin v. Gavit</i>	109
2. The Solution	111
<i>Harkness v. United States</i>	111
Illustrative Material	121
B. Distributable Net Income	123
<i>Baker v. Commissioner</i>	123
<i>Schaefer v. Commissioner</i>	130
<i>Crisp v. United States</i>	131
Revenue Ruling 68-392	140
Illustrative Material	141
Technical Advice Memorandum 8728001 (1986)	142
Private Letter Ruling 8429005 (1984)	145
Illustrative Material	148
Revenue Ruling 61-20	148
Problems	149
References	150
C. Distributions to Beneficiaries	150



<i>Brigham v. United States</i>	150
Illustrative Material	152
<i>Alfred I. duPont Testamentary Trust</i>	152
Illustrative Material	156
D. Simple Trusts	159
<i>Seligson v. Commissioner</i>	159
Illustrative Material	161
<i>Estate of Mildred Bruchmann</i>	163
Revenue Ruling 85-116	169
Illustrative Material	171
Revenue Ruling 74-257	175
Illustrative Material	176
Problems	176
E. Complex Trusts	178
1. In General	178
Revenue Ruling 67-117	179
Illustrative Material	180
2. The Separate Share Rule	182
Revenue Ruling 74-299	182
Illustrative Material	184
Private Letter Ruling 200618003 (2006)	184
Illustrative Material	186
Problems	186
F. Estates	188
1. In General	188
<i>Bohan v. United States</i>	188
Illustrative Material	190
<i>Estate of Johnson v. Commissioner</i>	193
Illustrative Material	196
2. Exclusion of Particular Distributions	196
Revenue Ruling 57-214	196
Revenue Ruling 68-49	197
Illustrative Material	198
<i>Mott v. United States</i>	198
Illustrative Material	204
3. Trapping Distributions	205
<i>Van Buren v. Commissioner</i>	205
Technical Advice Memorandum 8501011 (1984)	211
Illustrative Material	213
4. Termination	214
a. How Long Do Estates Last?	214
<i>Peter J. Maresca Trust v. Commissioner</i>	215
Illustrative Material	218
b. Excess Deductions	221
<i>Alan Nemser</i>	221
Revenue Ruling 57-31	223
<i>O'Bryan v. Commissioner</i>	224
Illustrative Material	229
G. Realization of Gain upon Distribution of Property in Kind	230

1. By the Entity	230
a. Mandatory	230
<i>Kenan v. Commissioner</i>	230
Illustrative Material	233
Revenue Ruling 67-74	234
Illustrative Material	234
Revenue Ruling 66-207	235
Illustrative Material	236
Revenue Ruling 82-4	236
Illustrative Material	238
Revenue Ruling 60-87	238
Reference	240
b. Elective	240
General Explanation of the Revenue Provisions of the	
Deficit Reduction Act of 1984	240
Illustrative Material	241
Problems	242
2. By the Beneficiary	242
Revenue Ruling 69-486	242
Illustrative Material	243
 <b>Chapter 4 · The Entity Ignored</b>	245
A. Assignment of Income	245
<i>Lucas v. Earl</i>	245
Illustrative Material	246
<i>Blair v. Commissioner</i>	247
<i>Helvering v. Horst</i>	250
Illustrative Material	253
<i>Harrison v. Schaffner</i>	254
Illustrative Material	256
B. Grantor Trusts: Income Taxation under Subpart E	257
1. Grantor as Owner	257
a. Judicial Origins	257
<i>Helvering v. Clifford</i>	257
b. The Code	261
Problems	266
<i>W. Clarke Swanson, Jr., 1950 Trust</i>	267
Illustrative Material	268
<i>Estate of Hilton W. Goodwyn</i>	269
Illustrative Material	273
Problems	274
<i>Benson v. Commissioner</i>	275
Illustrative Material	280
<i>Rothstein v. United States</i>	282
Illustrative Material	291
Problems	292
Revenue Ruling 62-148	292
Illustrative Material	293
Problems	294
<i>Duffy v. United States</i>	295

Illustrative Material	299
Revenue Ruling 58-242	300
Illustrative Material	301
Problems	302
<i>Victor W. Krause</i>	302
Illustrative Material	307
<i>Morrill v. United States</i>	309
<i>Wyche v. United States</i>	311
Illustrative Material	315
Problems	317
2. Others as Owners	317
a. Judicial Origins	317
<i>Mallinckrodt v. Nunan</i>	317
b. The Code	322
Revenue Ruling 67-241	322
Private Letter Ruling 8545076 (1985)	323
Private Letter Ruling 200022035 (2000)	324
Illustrative Material	326
Revenue Ruling 81-6	326
Illustrative Material	327
Problems	328
3. The Consequences of Grantor Trust Status	329
a. Attribution of Income, Deductions, and Credits	329
Revenue Ruling 69-70	329
Illustrative Material	329
<i>Glenn E. Edgar</i>	330
Illustrative Material	332
Problems	334
b. Collateral Consequences of Grantor Trust Status	334
<i>Estate of O'Connor</i>	335
Illustrative Material	345
<b>Chapter 5 • Manipulation of Entities: The Availability of Artificial Taxpayers</b>	
<b>under Subchapter J</b>	347
A. The Proliferation of Entities	347
<i>Estelle Morris Trusts</i>	347
Illustrative Material	356
<i>Edward L. Stephenson Trust v. Commissioner</i>	359
Illustrative Material	369
B. “Family Trusts”	370
<i>Schulz v. Commissioner</i>	370
Illustrative Material	376
C. Sales between Related Taxpayers	378
<i>Joseph E. Widener Trust v. Commissioner</i>	378
Illustrative Material	383
<i>Scully v. United States</i>	384
<b>Chapter 6 • Income in Respect of a Decedent</b>	391
A. Inclusion in Recipient’s Gross Income	391
1. Investment Income	391

a. Rent	391
<i>Estate of Davison v. United States</i>	391
Revenue Ruling 64-289	397
Illustrative Material	399
b. Interest	399
Revenue Ruling 58-435	399
<i>Apkin v. Commissioner</i>	402
Illustrative Material	404
c. Dividends	405
d. Annuities	405
Revenue Ruling 2005-30	405
Problem	407
2. Sales Proceeds	407
<i>Trust Company of Georgia v. Ross</i>	407
<i>Trust Company of Georgia v. Ross</i>	415
<i>Keck v. Commissioner</i>	416
Illustrative Material	419
<i>Estate of Harry B. Sidles</i>	419
Illustrative Material	426
Revenue Ruling 78-32	426
Illustrative Material	427
<i>Estate of Peterson v. Commissioner</i>	428
3. Compensation for Personal Services	434
<i>Edward D. Rollert Residuary Trust v. Commissioner</i>	434
Illustrative Material	440
4. Miscellaneous Deferred Receipts	443
<i>Sun First National Bank v. United States</i>	443
Illustrative Material	452
Revenue Ruling 60-227	454
Illustrative Material	456
B. Deductions in Respect of a Decedent	458
Revenue Ruling 58-69	458
Illustrative Material	459
Revenue Ruling 76-498	459
C. Deduction of Estate Tax	462
Revenue Ruling 67-242	462
Illustrative Material	465
<i>Thomas M. Chastain</i>	465
Illustrative Material	469
<i>Estate of Kincaid v. Commissioner</i>	469
Illustrative Material	472
<i>Estate of Cherry v. United States</i>	473
Illustrative Material	476
Appendix	477
Index	495

# Table of Internal Revenue Code Sections

---

1:	16	72(d):	405
1(a):	40	72(e):	405–406
1(e):	3, 7, 28, 146, 214, 218, 369	72(s):	405, 407
1(g):	5	101:	342
1(h):	230	101(a):	342–343
56:	365	101(a)(1):	343
58(b):	365	101(a)(2):	345
58(c):	365	101(a)(2)(B):	342–343, 345
61:	110, 157, 255, 272, 396, 398, 421, 440, 456	101(b):	432
61(a):	28, 40, 109, 245, 402, 447–448, 456	101(b)(1):	432
61(a)(3):	57	102:	109–110, 114, 198, 201, 432
61(a)(4):	31, 57	102(a):	109, 111, 117, 122, 199, 201
61(a)(5):	29	102(b):	109, 111, 122
61(a)(6):	29	102(b)(1):	199
61(a)(7):	57	102(b)(2):	122, 199, 201
61(a)(12):	29, 308	103:	33, 57, 64–65
61(a)(13):	130	105:	441–442
62:	16, 476	106:	441
62(a):	40	116:	126, 129
62(a)(5):	16	121:	427
63(d):	40	121(d)(11):	427
67:	41, 46, 333	151:	40, 74
67(a):	33, 41	162:	35, 378, 459
67(b):	33, 41	162(d):	114
67(b)(7):	476	163:	30–31, 162, 459
67(c):	33	163(a):	31
67(e):	33, 41–42, 44, 333	163(d):	31
67(e)(1):	41–46	163(d)(3)(A):	31
71:	157	163(h):	31
72:	183–184, 405–406	163(h)(2)(B):	31
72(a):	405	163(h)(2)(D):	31
72(b):	405	163(h)(2)(E):	31
72(c):	405	163(h)(2)(F):	31
		163(h)(3):	31

163(k):	31	302(c):	351
164:	32, 459	306:	351
164(a):	32–33	306(b)(4):	351
165:	386–387, 389–390, 459	337:	408, 417, 419–420
165(a):	388	355(a)(1)(D)(ii):	351
165(c):	30	357(b):	351
165(c)(1):	30	367:	352
165(c)(2):	30	401(a):	182
165(c)(3):	30	402(b):	183–184
166(f):	459	451(a):	447
167:	16	453:	146, 282, 287, 289, 446–447, 449, 452–453
167(d):	16, 86–87, 93, 95, 97–98, 100, 126, 331	453(b):	287
170:	332	453B:	334
170(a):	74	453B(a):	453
170(b):	75	453B(f):	453
170(c):	75, 77	454:	403–404
172:	331, 459	454(a):	399–400, 403
212:	32–33, 39, 41, 47–51, 54, 58–60, 64, 66–68, 70, 74, 153–154, 176, 459–461	454(c):	400
212(1):	38, 66–69	468B:	9, 269
212(2):	38, 66–69	469:	106–107
212(3):	34, 67	469(a):	103, 105
221:	31	469(a)(2):	105
261:	49	469(a)(2)(A):	106
262:	39	469(c)(1):	103, 105
263:	48–50	469(h):	105
263(a):	47	469(h)(1):	103, 106
265:	32, 51, 54–55, 57–58, 63, 66–67, 69, 72	482:	351
265(a)(1):	32–33, 47, 55, 63, 66–68, 71	501(a):	183
265(a)(2):	31	501(c)(3):	242–243
267:	241, 381–383, 388	532:	351
267(a)(1):	378, 386	611:	16, 86–88, 91, 459
267(b):	378, 388	611(a):	92
267(b)(2):	382	611(b):	17, 86, 100
267(b)(4):	384	611(b)(3):	87–89, 126
267(b)(5):	381, 384, 386–387	641:	5–7, 15–16, 52, 101, 110, 125, 131, 154, 164, 175–176, 208, 255, 357, 450
267(b)(6):	381, 384, 387	641(a):	3, 9, 13–15, 20–21, 28, 146, 199, 318, 347, 349, 361
267(b)(7):	381	641(a)(1):	8, 19–20
267(b)(13):	241, 383	641(a)(3):	29
267(c):	378	641(b):	13, 27–28, 30, 32, 34, 63, 143, 148, 212, 318, 330, 347, 349, 361
267(d):	378	642:	52, 130, 149, 154, 208
269:	351		
275(a)(1):	32		
301(c)(2):	64		

642(b):	58, 74, 175, 225–226, 228–229, 347, 365, 369	651(a):	52, 57–58, 63, 150, 160–162, 177, 208, 212, 234
642(b)(2)(C)(ii):	74	651(a)(1):	276
642(c):	63, 74, 77–79, 81–82, 85, 133, 140, 143, 146, 153, 170, 178, 200, 202–204, 216, 224–229, 332, 337–338, 340	651(b):	53, 58–59, 177, 207, 212
642(c)(1):	74–75, 84, 209–210	652:	6–7, 39, 59–62, 153, 159, 161–162, 170–171, 176, 178–179, 207, 209, 211, 255, 361
642(c)(2):	74–75, 81, 84	652(a):	52–53, 59, 160–162, 165, 177, 208, 213, 234
642(c)(2)(B):	225	652(b):	53, 55, 59, 61–63, 129, 156, 177, 208, 210
642(d):	148, 221	652(c):	172–174, 207, 332
642(e):	86, 95, 100, 331	661:	6–7, 27, 39, 103, 111, 125–126, 131, 133, 151, 153–155, 157–158, 161, 178, 188, 190, 197–198, 200–201, 203, 206, 227, 235, 237, 317–318, 331, 337, 339–341, 344, 361, 373, 458
642(g):	81, 101–103, 461–462	661(a):	72, 126, 132, 144, 150, 183, 185, 189–190, 196–198, 203–204, 211, 235, 237, 241, 337, 340–341
642(h):	126, 149, 221, 223–224, 226, 228–229	661(a)(1):	179–180, 187, 190–191, 201
642(h)(1):	126	661(a)(2):	147–148, 179–181, 187–188, 190–192, 194–195, 198–199, 201–204, 322–323, 337
642(h)(2):	65, 72–73, 126, 221–226, 228–229	661(b):	72
642(i):	7, 156	661(c):	126
643:	61, 125, 141, 154, 208, 332, 344	662:	6–7, 39, 111, 125–128, 151, 153–155, 157–158, 161, 178, 182, 188, 190, 197–198, 200–201, 203, 206, 227–229, 235, 237, 241–242, 317–318, 337, 361
643(a):	47, 52, 58, 62, 64, 72, 123, 125, 130–131, 133, 143, 146, 148–149, 151, 154, 170, 179, 183, 185, 208, 361	662(a):	114, 116–118, 121, 125, 127, 148, 180, 183–185, 195–196, 203–204, 211, 228, 235, 239
643(a)(1):	58	662(a)(1):	180, 190, 227
643(a)(2):	58		
643(a)(3):	58, 61–64, 72, 127, 132, 136, 140, 142–143, 145–146, 170		
643(a)(5):	58, 61		
643(b):	47, 52, 58, 95–97, 123, 159, 170, 208, 212–213		
643(c):	3, 7, 150–151, 158		
643(e):	198, 240–243, 369		
643(e)(3):	237		
643(f):	347, 356, 369–370		
644:	182, 220, 332–333		
644(a):	131:		
645:	74–75, 173		
645(a):	131, 219–220		
651:	6–7, 27, 39, 52, 56, 58–59, 62–63, 125, 133, 153–154, 159–162, 164–166, 169, 171, 175–176, 178–179, 206, 208, 255, 331, 361		

662(a)(2):	151, 179–180, 188–190, 192, 200–201, 208, 227, 322–323	674(a):	272–274, 329
662(a)(2)(B):	113–114, 117–121	674(b)(4):	274
662(b):	116, 128, 130, 156, 180, 206, 227	674(c):	271–272
662(c):	31, 173–174, 181, 220, 332	675:	261, 275, 277, 281–282, 285, 324
663:	111, 122, 125, 152, 190, 197, 200, 227	675(1):	278, 284
663(a):	178, 196, 237, 239	675(2):	278–279
663(a)(1):	114, 181, 197, 201–202, 236	675(3):	277–281, 283–289, 291
663(a)(2):	202	675(4):	278
663(a)(3):	190, 202	676:	251, 259–261, 277–278, 280, 292–293, 320
663(b):	178, 203	676(a):	292–294
663(b)(1):	144	677:	251, 260–261, 277, 294, 297–299, 301, 304–309, 314, 320, 324–325, 330, 332, 335, 446–447, 451, 460
663(b)(2):	181	677(a):	269, 288, 294–298, 302, 304, 307–311, 313, 315–316, 324, 448
663(c):	121, 152, 182–186	677(a)(1):	278, 294–295, 330, 450–451
664:	192	677(a)(2):	293, 296–297, 299–301
665:	61, 201, 367	677(a)(3):	302
665(b):	362, 370	677(b):	264, 278, 302, 309, 313, 315–317, 324
665(c):	370	678:	11–12, 261, 277, 322, 324, 328, 338–339, 344
666:	201, 372	678(a):	324, 325, 327
666(a):	362	678(a)(1):	322, 325, 327, 339
667:	201, 372	678(a)(2):	325–326
667(b):	364	678(b):	327
667(c):	367	678(c):	327
668:	201, 368	679:	277
668(b):	364	682:	157
669:	201	682(a):	157
671:	245, 261, 271–273, 277, 282, 286–292, 300, 304–305, 310, 323, 325, 329–330, 332–334, 338–339, 341, 343–344, 446, 451, 460	682(b):	157
672:	261–262, 272, 277, 298	691:	392, 394, 403–405, 407, 411–412, 415, 418–419, 421–424, 427, 429, 431–434, 437, 440, 444, 453, 461, 467–469, 471–476
672(a):	262, 298	691(a):	146–147, 391, 406, 424, 426–427, 432, 436, 444, 454–455, 462, 465–467, 473
672(c):	271, 278	691(a)(1):	400–402, 405, 411, 419, 428–431, 449, 463–464
672(e):	266		
673:	256, 261, 263–266, 277, 286, 297, 299, 301, 332, 334–335		
673(a):	263–265, 285, 300		
673(b):	265		
673(c):	265		
674:	261, 267–268, 272–275, 277, 281, 286, 342–343		



691(a)(1)(B):	449	2036(a)(2):	272–273
691(a)(2):	453	2042:	343
691(a)(3):	411–412	2052:	463, 466, 471
691(a)(4):	447, 449, 452–453	2053:	102, 461–462
691(a)(5):	453	2053(a):	101, 459
691(b):	30, 458–463, 466	2053(a)(2):	461–462
691(b)(1)(A):	458	2053(a)(3):	461
691(c):	392, 402, 444–445, 449, 452, 455, 462–469, 476	2053(b):	462
691(c)(1):	401–402, 406	2054:	101–102, 461
691(c)(1)(A):	470, 474	2055:	83
691(c)(2)(B):	467	2055(c):	82
691(c)(2)(C):	467–470, 472	2055(e)(2)(B):	234
691(d):	471	2056:	472–473
691(e):	442	2056(a):	469
701:	135	2056(c):	470
702:	135	2502:	304
702(a):	330	2513:	303
706(a):	174	2513(d):	304
736:	442	2518:	174
736(a)(1):	442	6012(a)(4):	333, 338
736(b)(2)(A):	442	6012(b)(4):	13
753:	442	6163:	31
852:	142	6166:	31
872(a):	173	6214(a):	127
951(a):	174	6324(b):	304
1001:	231, 243	6501:	461
1001(b):	447	6901:	417
1001(c):	447	7422:	79
1002:	243	7422(a):	79–80
1012:	231, 234	7520:	266
1014:	140, 231, 432, 453	7701(a):	7
1014(a):	391, 406, 429, 431–432, 434, 450, 454	7701(a)(3):	20–21
1014(b)(6):	453–454	7701(a)(6):	3, 13
1014(b)(9):	406, 450	7701(c):	151
1014(c):	198, 391, 406, 429, 431, 453–454	7805:	361
1015(a):	289	7805(a):	361
1022:	230		
1040:	230		
1221:	230		
1222:	230		
1311:	57		
1398:	9		
1399:	9		
1551:	351		
2036:	444–445, 462		
2036(a):	273		



# Table of Treasury Regulations

---

1.1-1(b):	173	1.641 (a)-2:	3
1.61-4:	396	1.641(b):	72
1.67-1:	33	1.641(b)-1:	30
1.67-2T(b)(1):	333	1.641(b)-2:	28
1.102-1:	111	1.641(b)-3:	214
1.102-1(d):	201	1.641(b)-3(a):	216, 218
1.165-1(b):	388		
1.167(h)-1:	86	1.641(b)-3(b):	218
1.167(h)-1(b):	86–87, 93	1.642(b)-1:	74
1.167(h)-1(b)(2):	95, 97	1.642(c)-1:	74
1.212-1:	33, 66	1.642(c)-1(a)(1):	75
1.212-1 (a)(1)(i):	67	1.642(c)-2(a):	74
1.212-1(a)(1)(ii):	67	1.642(c)-2(d):	86
1.212-1(a)(1)(iii):	67	1.642(c)-3(a):	74
1.212-1(b):	72	1.642(c)-3(b):	74
1.212-1(e):	66	1.642(d)-1:	221
1.212-1(i):	47, 49	1.642(e)-1:	86
1.212-1(k):	47, 49	1.642(g)-1:	101–102
1.213-1(g)(1):	457	1.642(g)-2:	101, 103, 461
1.263(a)-2(c):	49, 60	1.642(h)-2:	221
1.265-1:	47	1.642(h)-2(a):	229
1.265-1(a)(2):	66	1.642(h)-3:	221
1.265-1(c):	51, 54–55, 61, 63, 71–73	1.642(h)-3(a):	222
		1.642(h)-4:	221
1.267(a)-1(c):	378, 381, 388	1.643(a):	133
1.446-1(c)(1)(ii):	167	1.643(a)-0:	123, 132, 175, 212
1.446-1(c)(2)(i):	457	1.643(a)-1:	123, 175
1.451-1(a):	167	1.643(a)-2:	123, 175
1.454-1(c)(1)(i) :	404	1.643(a)-3:	127, 133–134, 141, 148, 175
1.468B-1:	269		
1.468B-2:	269	1.643(a)-3(a):	123, 140, 143–146
1.469-1T(b):	103	1.643(a)-3(a)(1):	134, 136, 147, 170–171
1.469-1T(b)(2):	107		
1.469-5T:	105	1.643(a)-3(a)(2):	147
1.611-1(c)(4):	89–90, 92, 99	1.643(a)-3(a)(3):	147
1.641(a)-0(c):	347, 359, 368	1.643(a)-3(b):	123
1.641(a)-0(c)(3):	365	1.643(a)-3(b)(1):	142, 148, 171
1.641(a)-1:	28	1.643(a)-3(d):	141, 147, 171

1.643(a)-3(e):	123, 148	1.662(a)-2(a):	227
1.643(a)-4:	123, 175	1.662(a)-2(c):	158
1.643(a)-5:	123, 175	1.662(a)-3:	121, 127, 178
1.643(a)-6:	143, 175	1.662(a)-3(a):	227
1.642(a)-7:	175	1.662(a)-3(b):	127, 158
1.643(b)-1:	95–96, 123, 159	1.662(a)-3(b)(6):	152
1.643(b)-2:	123	1.662(a)-4:	116
1.643(c)-1:	150, 158, 344	1.662(b)-1:	128, 178, 206
1.643(d)-2:	123	1.662(c)-1:	178, 181
1.645-1(e)(2):	173	1.662(c)-2:	178
1.645-1(e)(2)(i):	75, 220	1.662(c)-3:	178, 206
1.645-1(e)(2)(ii):	220	1.662(c)-4:	128–129, 178
1.645-1(e)(2)(ii)(A):	74	1.662(c)-4(e):	130
1.645-1(e)(3)(i):	75, 173, 220	1.662(c)-4(g):	130
1.651(a)-1:	153, 160–161, 174, 205, 208	1.663(a)-1:	196
1.651(a)-2:	166, 212	1.663(a)-1(b)(1):	202, 230, 235–237, 239–240
1.651(a)-2(a):	160–161	1.663(a)-2:	196, 202, 204, 337, 340
1.651(a)-2(c):	161	1.663(a)-3:	196
1.641(a)-2(d):	230	1.663(c)-1:	182
1.651(b)-1:	178	1.663(c)-1(a):	183
1.652(a)-1:	208	1.663(c)-2:	182
1.652(a)-2:	208	1.663(c)-2(a):	186
1.652(b)-1:	128, 208	1.663(c)-2(b)(1):	186
1.652(b)-2:	208–209	1.663(c)-2(c):	186
1.652(b)-2(b):	210	1.663(c)-3:	182
1.652(b)-3:	73, 128–129, 207, 211	1.663(c)-4:	182
1.652(b)-3(a):	129, 176	1.663(c)-4(a):	152
1.652(b)-3(b):	61, 63, 72, 129, 176	1.663(c)-5:	31, 152, 182
1.652(b)-3(c):	176	1.671-1:	261
1.652(c)-2:	173	1.671-1(a):	448
1.652(c)-3:	174	1.671-1(c):	245, 262, 277
1.652(c)-4:	54–55, 59	1.671-2:	329
1.652(c)-4(f):	178	1.671-2(a):	446
1.661(a)-1:	153, 178	1.671-2(b):	277
1.661(a)-2(a):	178, 183	1.671-2(c):	332–333
1.661(a)-2(b):	178	1.671-2(d):	322
1.661(a)-2(c):	178	1.671-2(e):	269
1.661(a)-2(d):	178	1.671-3:	277, 329, 341
1.661(a)-2(e):	158, 178, 196–197	1.671-3(a):	325–326, 446
1.661(a)-2(f):	230, 235–236, 238, 240–241	1.671-3(a)(1):	330, 332
1.661(a)-2(f)(1):	237	1.671-3(a)(2):	330
1.661(a)-2(f)(3):	241	1.671-3(b)(2):	278
1.661(b)-1:	178	1.671-3(b)(3):	344
1.661(c)-1:	126, 178	1.671-3(c):	330
1.661(c)-2:	126	1.671-4:	323, 329, 338
1.662(a)-1:	125, 178	1.671-4(a):	333
1.662(a)-2:	178	1.671-4(b):	333
		1.671-4(h)(2):	333

1.672(a)-1:	262, 298	301.7701-2(a)(1):	24
1.672(a)-1(a):	262	301.7701-2(a)(2):	24
1.672(b)-1:	262	301.7701-2(a)(3):	25
1.672(c)-1:	262	301.7701-4:	21
1.673(a)-1(b):	265, 300	301.7701-4(a):	3, 5-6, 8, 13, 20, 25, 339, 342
1.674(a)-1(a):	268	301.7701-4(b):	3, 20
1.675-1:	275	301.7701-6(b):	3
1.676(a)-1:	292		
1.677(a)-1:	294		
1.677(a)-1(c):	305		
1.677(a)-1(d):	302, 305, 310		
1.677(a)-1(e):	298		
1.677(a)-1(f):	298		
1.677(a)-1(g):	298, 330		
1.677(b)-1:	302		
1.678(a)-1:	322, 324		
1.678(b)-1:	322		
1.678(c)-1:	322		
1.691(a)-1:	391, 415, 429		
1.691(a)-1(b):	418, 424, 426, 429, 436, 454, 457		
1.691(a)-1(b)(3):	422, 427, 459		
1.691(a)-1(d):	427, 441		
1.691(a)-2:	391, 416, 429		
1.691(a)-2(b):	418, 425, 429–430, 443		
1.691(a)-3:	391, 429		
1.691(a)-4:	391		
1.691(b)-1:	458		
1.691(b)-1(a):	460		
1.691(c)-1:	462–463		
1.691(c)-1(a)(2):	463, 468–472, 475		
1.691(c)-1(b):	465		
1.691(c)-2:	402, 462		
1.691(d)-1(e):	468, 470–472		
1.1001-2(c):	345		
1.1014-4(a)(3):	140		
20.2031-7(d)(6):	266		
20.2031-7(d)(7):	266		
20.2031-10(f):	265		
20.2053-1(c):	462		
20.2053-8:	461–462		
1.6012-3:	4, 8		
1.6012-3(a)(4):	350		
301.6402-2(a)(1):	80		
301.6402-2(e):	80		
301.7701:	7		
301.7701-2:	21		
301.7701-2(a):	20		



# Table of Cases

---

- A. Magnano Co. v. Hamilton, 118  
 Abbot v. Welch, 29  
 Adams v. Prather, 10  
 Agatstein, Sylvan, 142  
 Ahmanson Foundation v. United States, 82  
 Alabama-Georgia Syrup Co., 191  
 All, Hansberry v., 440  
 Allen v. Commissioner, 25  
 Allen, Lewis G., Family Trust v. United States, 377  
 Alston v. Commissioner, 216  
 Aluminum Castings Co. v. Routzahn, 251  
 Amabile v. Commissioner, 295, 332  
 American Automobile Ass'n v. United States, 353  
 American National Bank & Trust Co. v. United States, 190  
 Amory, Harvard College v., 45  
 Anastasio, Joseph, 4  
 Anderson, Estate of, v. Commissioner, 443  
 Anderson v. Wilson, 29  
 Anesthesia Service Medical Group Inc. Employee Protective Trust v. Commissioner, 25, 308  
 Anglim, Hale v., 166  
*Apkin v. Commissioner*, 402–404  
 Arcadia Plumbing Trust v. Commissioner, 25  
 Armstrong, Estate of, v. Commissioner, 216–217  
 Armstrong, Estate of J.P., 219  
 Arrigo, Newburgh v., 315  
 Arrott v. Heiner, 29  
 Arrow Fastener Co. v. Commissioner, 361  
 Atlantic Veneer Corp. v. Commissioner, 403  
 Attorney-General, Partington v., 18  
 Aviall Services, Inc., Cooper Industries, Inc. v., 44  
*Baker v. Commissioner*, 123–130  
 Baldwin v. United States, 172  
 Balis v. Commissioner, 317, 376  
 Balkwill, George W., 331  
 Ballard v. Commissioner, 269, 274, 281, 440  
 Bank of America National Trust & Savings Ass'n v. Commissioner, 77  
 Bank of America National Trust & Savings Ass'n, United States v., 205, 208, 340  
 Bankhead, Emelil, Estate of, 30  
 Barker, Peter B., 262  
 Barnett's Will, In re, 461  
 Barnhill v. Commissioner, 29  
 Bartholomew v. Northampton Nat'l Bank, 284  
 Basch, Fred, Estate of, 399, 441  
 Basye, United States v., 247  
 Bausch's Estate v. Commissioner, 396, 440  
 Bay v. Commissioner, 333  
 Bedell, Estate of Harry M. Sr., Trust v. Commissioner, 25  
 Bedford, F.T., 165  
 Benedict, United States v., 83  
 Bennett v. Commissioner, 274, 280  
*Benson v. Commissioner*, 275–280  
 Bergan v. Commissioner, 155  
 Berger, Estate of v. Commissioner, 76, 219  
 Bernard v. United States, 412, 415, 440  
 Bibby, C.O., 264  
 Bickmeyer, Estate of, v. Commissioner, 426

- Bingham, Trust of, v. Commissioner*,  
 33–36, 38, 233, 460  
 Bingler v. Johnson, 361  
 Bishop v. Commissioner, 29  
 Black v. Lockhart, 442  
*Blair v. Commissioner*, 247–249, 252, 255,  
 258, 373  
 Blair v. Linn, 248  
 Blake's Will, In re, 80  
 Bliss, Helvering v., 83  
 Bloomfield, Norris, 9  
 Blumenthal, Helvering v., 310  
 Bluestein, Estate of, 85  
 Boeshore, Estate of, v. Commissioner,  
 361  
*Bohan v. United States*, 188–190  
 Boise Cascade Corp. v. United States, 261  
 Booth Trust, Tom R., 356  
 Bosch, Estate of, Commissioner v., 190,  
 448  
 Boston Elevated Railway Co., 167  
 Bowen, Martin Raymond, 191  
 Bowers, Corliss v., 11, 248, 250, 252, 255,  
 320–321  
 Bowers v. Kerbaugh-Empire Co., 251  
 Bowers v. Lumpkin, 49  
 Bowers, Potter v., 86  
 Bowers, Shanley v., 249  
 Bowers v. Slocum, 76  
 Bowers, Taft v., 117  
 Boyce v. United States, 354  
 Braden, Senior v., 249  
 Braun v. Commissioner, 273, 315  
 Breault, Estate of, In re, 386  
 Brewster v. Gage, 232  
 Bridges, Stinson v., 310  
*Brigham v. United States*, 150–152  
 Brittain v. Commissioner, 376  
 Brooke v. United States, 314  
 Brown v. Commissioner, 49, 219  
 Brown v. Fletcher, 249  
 Brown, Sam S., 29  
 Brown v. United States, 218, 328  
 Brown, United States v., 269  
 Brownstone v. United States, 85  
*Bruchmann, Mildred, Estate of*, 163–169,  
 Bruner, Peter Anthony, Estate of, 191  
 Bryan, Mary Z., Estate of, 219  
 Bryant, Edith M., 220  
 Buck, Commissioner v., 268  
 Buckmaster v. Commissioner 377  
 Buckmaster v. United States, 190  
 Buehner, Paul, 281  
 Buelow v. Commissioner, 376  
 Bunn, Willcuts v., 68  
 Bunney v. Commissioner, 443  
 Burk-Waggoner Oil Ass'n v. Hopkins, 22  
 Burnet v. Coronado Oil & Gas Co., 165  
 Burnet v. Guggenheim, 248, 252  
 Burnet v. Harmel, 233  
 Burnet v. Houston, 350, 389  
 Burnet v. Leiningner, 248, 250, 252, 254,  
 259  
 Burnet, North American Oil Consoli-  
 dated v., 11, 189  
 Burnet, Stearns v., 194  
 Burnet v. Wells, 11, 248, 250–251  
 Burnett v. Commissioner, 393  
 Burrow Trust, Mary E., 36, 176  
 Buttorff, United States v., 377  
 Byrum, United States v., 272  
 Cahill v. Commissioner, 293  
 Calvin v. United States, 126  
 Cameron v. Commissioner, 158  
 Campbell v. Campbell, 313  
 Caratan v. Commissioner, 216  
 Carol, Sue, 97  
 Carr, Florence E., Estate of, 442  
 Carson v. Commissioner, 219, 273  
 Carson v. United States, 158, 440  
 Carter, Estate of, v. Commissioner, 440  
*Carter Trust, Mattie K. v. United States*,  
 103–107  
 Cartwright, Estate of, v. Commissioner,  
 442  
 Casco Bank & Trust Co. v. United States,  
 205, 208, 340  
 Central Hanover Bank & Trust Co., Chase  
 National Bank of City of New York v.,  
 462  
 Chandler v. Commissioner, 155  
 Chapman, Robert F., 165  
 Chase National Bank of City of New York  
 v. Central Hanover Bank & Trust Co.,  
 462  
 Chase National Bank v. Commissioner,  
 262, 306



- Chastain, Thomas M.*, 465–470, 474  
 Cheek v. Commissioner, 376  
 Chemical Bank, Schaffner v., 205  
*Cherry, Estate of, v. United States*, 473–476  
 Chick v. Commissioner, 191, 216, 219  
 Citizens & Southern Nat. Bank, Commissioner v., 86  
 Claiborne v. United States, 427, 436  
 Clark, Commissioner v., 44  
 Clark Trust, William A., 7  
 Cleary, Robert E., 174  
*Clifford, Helvering v.*, 11, 251, 254–261, 271, 296, 304, 319, 321–322, 355, 373, 447  
 Coe, Will of, In re, 213  
 Cohen, Estate of, 29  
 Cold Metal Process Co., 167  
 Coleman v. Commissioner, 443  
 Coleman-Gilbert Associates v. Commissioner, 20  
 Collins v. United States, 440, 453  
 Comer, William L., Family Equity Trust v. United States, 377  
 Commercial Bank at Winter Park v. United States, 356, 358  
 Commissioner v. \_\_\_\_\_. See taxpayer's name.  
 Connecticut National Bank v. United States, 192  
 Cooke, United States v., 13, 17  
 Coolidge v. Long, 120  
 Cooper Industries, Inc. v. Aviall Services, Inc., 44  
 Corliss v. Bowers, 11, 248, 250, 252, 255, 320–321  
 Corning, Warren H., 268, 302  
 Coronado Oil & Gas Co., Burnet v.  
 Correll, United States v., 361  
 Coxey, Helvering v., 248, 310  
 Craig, George L., 29  
 Craig v. United States, 220  
 Crane v. Commissioner, 263  
 Crawford's Will, In re, 80  
 Crestar Bank v. Internal Revenue Service, 75  
*Crisp v. United States*, 131–139  
 Crooks v. Harrelson, 18  
 Crown Cork International Corp. v. Commissioner, 381, 383, 390  
 Crown, Rebecca K., Income Charitable Fund v. Commissioner, 85, 204  
 Culbertson, Commissioner v., 246, 354  
 Cummings v. United States, 158, 191, 340  
 Daniels, Wrenn v., 217  
 Davidson v. United States, 156  
 Davis, Arthur W., Estate of, 440  
 Davis, Estate of v. United States, 399  
 Davis, Kenneth W., Estate of, 308  
*Davison, Estate of, v. United States*, 391–397, 412, 415, 421, 425, 445, 473  
 de Amodio v. Commissioner, 294–295  
 Dean, Commissioner v., 161, 203  
 Dean, Estate of, v. Commissioner, 198  
*De Bonchamps, United States v.*, 10–18, 328  
 DeBrabant v. Commissioner, 162, 170  
 DeBrabant, Mary Clark, 165  
 Deputy v. DuPont, 39  
 Deutsch v. Commissioner, 151, 158  
 DeVilbiss v. United States, 179  
 di Borgo, Valerie Norrie Pozzo, 69  
 Dick H. McKenzie Family Estate v. Commissioner, 377  
 Dickinson, John L. Testamentary Trust, 356  
 Diedrich v. Commissioner, 308  
 Dixone v. Commissioner, 92  
 Dixon v. United States, 457  
 Dominion Nat. Bank, Hale v., 356  
 Dominion Trust Company v. United States, 196, 218–219  
 Don Gastineau Equity Trust v. United States, 377  
 Donnan, Heiner v., 120  
 Dorsey, Stephen H., 425, 456  
 Douglas v. Willcuts, 248, 251, 310  
 DuPont, Deputy v., 39  
*Duffy v. United States*, 295–299  
 Dula, Robert A., Estate of, 165  
 Dunbaugh v. Commissioner, 172  
 Dupont v. Commissioner, 259  
 duPont, Deputy, Administratrix v., 45  
*duPont Testamentary Trust, Alfred I.*, 37–40, 152–156

- duPont Testamentary Trust, Alfred I., v. Commissioner* 340
- Durbin Paper Stock Co. v. Commissioner*, 361
- Durey, Meeker v.*, 39
- Dusek v. Commissioner*, 92–94
- Earl, Lucas v.*, 245–246, 248, 250, 252, 254–255, 259, 272, 321, 372
- Eaton, Suisman v.*, 231–232, 235, 237
- Edgar, Glenn E.*, 330–331
- Edwards, James E. Family Trust v. United States*, 377
- Edwards, James F.*, 122
- Edwards v. Slocum*, 82
- Eisner v. Macomber*, 110, 117
- Ellis, United States v.*, 395, 412, 415, 442
- Elm Street Realty Trust v. Commissioner*, 26
- Emanuelson v. United States*, 84
- England, Skellenger v.*, 18
- Enright, Estate of, Helvering v.*, 393, 404, 411
- Estate Preservation Services, United States v.*, 377
- Eubank, Helvering v.*, 253–255
- Eustis v. Commissioner*, 161
- Ewing, Sherman*, 233
- Fabens v. Commissioner*, 70–73
- Faber v. United States*, 260
- Falkoff v. Commissioner*, 374
- Farkas v. Commissioner*, 256
- Farmers' Loan & Trust Co., Pollock v.*, 117
- Farrier v. Commissioner*, 216
- Fawcus Machine Co. v. United States*, 91
- Fear v. Commissioner*, 158
- Feldmeier v. Superior Court*, 165, 167
- Fender v. Fender*, 313
- Fender v. United States*, 381, 389
- Fennerty Testamentary Trust, Mary E.*, 181
- Ferguson v. Commissioner*, 256
- Ferguson v. Forstman*, 14, 168
- Fernandez v. Wiener*, 118
- Fidelity Union Trust Co. v. Kelly*, 356
- Field, Commissioner v.*, 249
- Field, United States v.*, 18
- Findlay v. Commissioner*, 440, 442, 470
- Fintzelberg, Luscomb v.*, 10
- First National Bank, Fojtik v.*, 106
- First National Bank of Mobile v. Commissioner*, 85
- First National Bank of Richmond v. Holland*, 217
- First Trust & Savings Bank, Smietanka v.*, 14, 17
- Fitch, Helvering v.*, 310
- Fitzpatrick, McHarg v.*, 349, 357
- Flacco v. Commissioner*, 253, 265
- Fleenor v. Hensley*, 271
- Fleming v. Commissioner*, 90
- Fletcher, Brown v.*, 249
- Fletcher Trust Co. v. Commissioner*, 304
- Fojtik v. First National Bank*, 106
- Folckemer, United States v.*, 31, 156
- Forstman, Ferguson v.*, 14, 168
- Fort Worth National Bank v. United States*, 356
- 4100 North High Limited, In re*, 9
- Foster, L.B.*, 302
- Fox v. Commissioner*, 372
- Frane, Estate of, v. Commissioner*, 453
- Frank Trust, Cecilia K.*, 181
- Frank Trust, W. K. v. Commissioner*, 75
- Frederich v. Commissioner*, 218
- Freuler v. Helvering*, 92, 162, 167, 173
- Freund, Estate of, v. Commissioner*, 82
- Fuller, Mortimer B., Estate of*, 39, 156
- Furman, Irvine K.*, 261, 354, 376
- Furstenberg v. Commissioner*, 182
- Gage, Brewster v.*, 232
- Garvey v. Commissioner*, 264
- Gastineau, Don, Equity Trust v. United States*, 377
- Gavin, Estate of v. United States*, 399
- Gavit, Irwin v.*, 109–111, 122, 199, 249, 256
- Geary, Mary DeF. Harrison*, 168
- Geftman v. Commissioner*, 158, 182
- General Investors Co. v. Commissioner*, 14
- General Motors Corp., Hainline v.*, 439
- General Motors Corp., Parrish v.*, 439
- Genesee Merchants Bank & Trust Co. v. United States*, 84

- Getty v. Commissioner, 122  
 Gildersleeve's Estate, In re, 72  
 Gilman, Charles, Estate of, 272  
 Glenshaw Glass Company, Commissioner v., 14  
 Goff, In re, 9  
 Goforth v. Commissioner, 14–15  
 Goldsby v. Commissioner, 84  
*Goodwyn, Hilton W., Estate of*, 269–273  
 Gordon, Helvering v., 322  
 Gordon v. Keene, 310  
 Gould v. Gould, 18  
 Government of the Virgin Islands, Hop-  
 per v., 192  
 Grace's Estate,, 80  
 Grace, Estate of, United States v., 299  
 Graham v. Miller, 161  
 Grant v. Commissioner, 174–175  
 Gray v. United States, 4  
 Gregory v. Helvering, 356, 381  
 Grey v. Commissioner, 92  
 Griffiths v. Commissioner, 355  
 Grill v. United States, 412, 445, 456  
 Grimm v. Commissioner, 29  
 Grosvenor, Commissioner v., 260  
 Guaranty Trust Co. of New York, 29  
 Guggenheim, Burnet v., 248, 252  
  
 Hainline v. General Motors Corp., 439  
 Hale v. Anglim, 166  
 Hale v. Dominion Nat. Bank, 356  
 Halliday v. United States, 430, 436, 439,  
 442  
 Hamill, Estate of, In re, 382  
 Hamilton, A. Magnano Co. v., 118  
 Hansberry v. All, 440  
 Hanson v. Commissioner, 376  
 Hardy v. Mayhew, 18  
 Hargis, J.F., Estate of, 219  
*Harkness v. United States*, 111–121, 208,  
 340  
 Harmel, Burnet v., 233  
 Harrelson, Crooks v., 18  
 Harris v. United States, 194  
 Harrison, James Max, Estate of, 162  
 Harrison v. Northern Trust Co., 82  
 Harrison, Sarah Helen, 306  
*Harrison v. Schaffner*, 254–256, 272, 321,  
 373  
  
 Hart v. Commissioner, 14  
 Harte v. United States, 122  
*Hartwick College v. United States*, 77–84  
 Harvard College v. Amory, 45  
 Hassett, Jones v., 31  
 Hassett, Saltonstall v., 172  
 Hawaiian Trust Company v. Kanne, 12,  
 256  
 Hawley, King v., 12, 15  
*Hay v. United States*, 87–92, 104, 181  
 Hayward v. Hayward, 155  
 Healy v. Commissioner, 189  
 Hedges, Ralph E., 168, 219  
 Heiner, Arrott v., 29  
 Heiner v. Donnan, 120  
 Heining, Commissioner v., 34–36  
 Heintz v. Commissioner, 293  
 Held v. Commissioner, 393  
 Helfrich's Estate v. Commissioner, 350  
 Helvering v. \_\_\_\_\_. See taxpayer's  
 name.  
 Henderson's Estate v. Commissioner, 29  
 Hensley, Fleenor v., 271  
 Herbert, Charlotte Leviton, 220  
 Herberts, Curtis A., 268  
 Herbst, Cynthia K., 69  
 Hess v. Commissioner, 440  
 Hickman v. Commissioner, 383  
 Higgins v. Commissioner, 68  
 Higgins v. Smith, 382–383, 389  
 Higginson, United States v., 162, 165, 170  
 Hill v. Estate of Richards, 213  
 Hill, Jr., Horace Greeley, 166–167  
 Hillman v. Commissioner, 376  
 Hirschman v. United States, 18  
 Hoepfer v. Tax Commission, 248  
 Hoey, Lyeth v., 130  
 Holdeen v. Commissioner, 279, 281  
 Holland, First National Bank of Rich-  
 mond v., 217  
 Holloway, Will of, In re, 212–214  
 Holloway's Estate, In re, 212–214  
 Holman v. United States, 376  
 Holt v. United States, 263, 454  
 Hopkins, Burk-Waggoner Oil Ass'n v., 22  
 Hopper v. Government of the Virgin  
 Islands, 192  
 Hormel v. Helvering, 255–256, 431

- Horst, Helvering v.*, 11, 250–255, 272, 373, 404  
 Horvat v. Commissioner, 370  
 Horwitz's Estate v. Commissioner, 442  
 Houston, Burnet v., 350, 389  
 Howard v. United States, 25  
 Hudson County Water Co. v. McCarter, 110  
 Hudspeth v. United States, 422  
 Humphrey v. Commissioner, 296, 298  
 Humphrey v. United States, 298  
 Hunt Trust, Samuel P. v. United States, 76  
 Huntington National Bank v. Commissioner, 356  
  
 Igoe, Alma, 196  
 Igoe, Andrew J., Estate of, 191, 196  
 Igoe v. Commissioner, 194  
 INDOPCO, Inc. v. Commissioner, 45  
 Industrial Aggregate Co. v. United States, 49  
 Interlochen Co. v. Commissioner, 350  
 Internal Revenue Service, Crestar Bank v., 75  
 Interstate Transit Lines v. Commissioner, 45  
 Investment Research Associates, Ltd. v. Commissioner, 269, 274, 281  
 Irish v. Commissioner, 12  
 Irving Trust Co. v. United States, 82  
*Irwin v. Gavit*, 109–111, 122, 199, 249, 256  
 Izrastzoff v. Commissioner, 157  
  
 James, United States v., 122, 157, 340  
 Jamison, William H., 69  
 Jenn v. United States, 308  
 Jergens v. Commissioner, 12  
 Johnson, Bingler v., 361  
 Johnson v. Commissioner, 262, 308, 373  
 Johnson v. United States, 454  
*Johnson, Estate of, v. Commissioner*, 193–195, 219  
 Jones v. Hassett, 31  
 Jones' Will, In re, 80  
 Jones v. Whittington, 28  
 Joplin, In re, 9  
  
 Kanne, Hawaiian Trust Company v., 12, 256  
 Kanter, Estate of v. Commissioner, 269, 274, 281  
 Kaufmann v. United States, 67  
 Keck, George W., 424  
*Keck v. Commissioner*, 416–419, 422, 424–425, 427, 429–430, 436, 439, 445  
 Keefover v. Commissioner, 376  
 Keene, Gordon v., 310  
 Keitel, Estate of, v. Commissioner, 102  
 Keith, David, 306  
 Kelly, Fidelity Union Trust Co. v., 356  
*Kenan v. Commissioner*, 230–233, 235  
 Kerbaugh-Empire Co., Bowers v., 251  
 Khalaf v. Khalaf, 316  
*Kincaid, Estate of, v. Commissioner*, 469–472, 475  
 King v. Hawley, 12, 15  
 Kinsey v. Commissioner, 422  
 Kirby, In re, 9  
 Kirby Lumber Co., United States v., 232, 251  
 Kitch v. Commissioner, 157, 229, 457  
 Knetsch v. United States, 350  
*Knight v. Commissioner*, 40–46  
 Koffman v. United States, 219, 328  
 Kohtz Family Trust, 349  
 Kooyers v. Commissioner, 377  
 Kornhauser v. United States, 34–36  
 Koshland v. Helvering, 361  
 Krakowski v. Commissioner, 457  
 Krall, United States v., 377  
 Krause, Adolph K., 299  
*Krause, Victor W.*, 302–307  
 Kushner v. Commissioner, 274  
  
 Lacomble v. United States, 440  
*LaFargue v. Commissioner*, 288  
 Laflin v. Commissioner, 92  
 Laganas v. Commissioner, 268  
 Lambert Tree Trust Estate, 93, 100  
*Lamkin v. United States*, 97–99  
 Landsberger, United States v. 377  
 Lane v. United States, 191  
 Langford Investment Co. v. Commissioner, 356  
 Langley v. Commissioner, 260  
 Latendresse v. Commissioner, 442

- Laughlin v. Commissioner, 372  
 Laughlin's Estate v. Commissioner, 157  
 Legg, A.W., , 335  
 Leighton v. Nash, 310  
 Leininger, Burnet v., 248, 250, 252, 254, 259  
 Lemle v. United States, 121, 123  
 Letts v. Commissioner, 166, 175  
 Levin v. Commissioner, 91  
 Levin v. United States, 404, 412  
 Levy, Lou, 168  
 Lewis v. Commissioner, 49, 68  
 Lewis, United States v., 189  
 Lewis v. White, 260  
 Linde, Commissioner v., 395–396, 412, 415, 421, 424–425, 430, 434  
 Lindley v. United States, 181  
 Linn, Blair v., 248  
 Little, Estate of, v. Commissioner, 90  
 Lockhart, Black v., 442  
 Lonergan Trust, Thomas, 154, 202  
 Long, Coolidge v., 120  
 Looman v. Rockingham National Bank, 217  
 Love Charitable Foundation, John Allan, v. United States, 85  
 Lowenstein, Estate of, 85  
 Lowry, St. Marks Episcopal Church v., 91  
 Loyd v. United States, 49, 51  
*Lucas v. Earl*, 245–246, 248, 250, 252, 254–255, 259, 272, 321, 372  
 Luehrmann, Estate of, v. Commissioner, 83  
 Luman v. Commissioner, 376  
 Lumpkin, Bowers v., 49  
 Lund v. Commissioner, 376  
 Lundry v. Commissioner, 376  
 Luscomb v. Fintzelberg, 10  
 Lyeth v. Hoey, 130  
 Lynchburg Trust & Savings Bank v. Commissioner, 181, 356  
  
 Machat, Estate of, 440  
 MacManus v. Commissioner, 356  
 Macomber, Eisner v., 110, 117  
 Madorin v. Commissioner, 345  
 Magnano Co., A., v. Hamilton, 118  
 Mahler v. Commissioner, 122  
 Mairs v. Reynolds, 314  
  
 Makransky, Commissioner v., 294, 300  
 Makransky, Harry, 172  
 Malat v. Riddell, 416  
 Malcolm, United States v., 246  
 Malcom, Thalia W., 165  
 Malley, Woolley v., 28, 191  
 Mallinckrodt, Edward, Jr., 69, 72  
*Mallinckrodt v. Nunan* 11–12, 304, 317–322  
*Manufacturers Hanover Trust Co. v. United States*, 47–57, 61, 63, 69, 72, 115, 176, 192, 200  
*Maresca Trust, Peter J., v. Commissioner*, 215–218  
 Maring v. Commissioner, 124  
 Markle, Jr., George B., 331  
 Markosian v. Commissioner, 376  
 Marquis v. United States, 84  
 Marx, Leonard, 221  
 Mau v. United States, 281  
 Mayhew, Hardy v., 18  
 McCarter, Hudson County Water Co. v., 110  
 McCauley v. United States, 219  
 McClung, Hu L., 84  
 McCoy, Lawrence R., Estate of, 158, 340  
 McDonald, Commissioner v., 68  
 McDonald v. Commissioner, 35  
 McDonald Trust, D.G., 306  
 McGinley v. Commissioner, 356  
 McGinnis v. Commissioner, 254, 264, 274  
 McHarg v. Fitzpatrick, 349, 356  
 McIlvaine, Commissioner v., 349  
 McIlvaine, Helvering v., 356  
 McKenzie v. Commissioner, 376  
 McKenzie, Dick H., Family Estate v. Commissioner, 377  
 McRitchie, Lee, 8, 15  
 McWilliams v. Commissioner, 387  
 Meek v. Commissioner, 269, 384  
 Meeker v. Durey, 7  
 Meissner, George N., 69  
 Mellon, William L., 181  
 Mellon Bank, N.A. v. United States, 42, 44  
 Mellott v. United States, 149, 331  
 Mercer, Myrtle, 18  
 Merchants' Funds Ass'n, Appeal of, 136

- Merchants' Loan & Trust Co. v. Patterson, 249  
 Merriam, United States v., 18  
 Merrill, United States v., 29  
 Mesker v. United States, 327  
 Metairie Cemetery Association, 156  
 Middleton v. United States, 84  
 Midland Mutual Life Insurance Co., Helvering v., 258  
 Miller, A. T., 219  
 Miller, Emerson R., 274  
 Miller, Graham v., 161  
 Miller Trust, Carl T. v. Commissioner, 29  
 Miller Trust, Prudence, 4  
 Miller v. Commissioner, 376, 388  
 Miller v. United States, 440  
 Minor v. Commissioner, 4  
 Moline Properties v. Commissioner, 354  
 Moody Trust, Robert L., 358  
 Moore, Genevieve F., 302  
 Moore v. Commissioner, 126  
 Moreell v. United States, 40, 159  
 Morgan, Annette S., Estate of, 306–307  
 Morgan v. Commissioner, 130  
*Morrill v. United States*, 309–311, 315  
*Morris Trusts, Estelle*, 347–356, 359–360, 362  
*Morrissey v. Commissioner*, 14, 20–24  
*Mott v. United States*, 154, 198–204, 340  
 Muhich v. Commissioner, 376  
 Muller v. United States, 453  
 Musser's Estate, In re, 45  
 Myers v. Commissioner, 172  
 Myra, John E., Estate of, 76  
  
 Napolitano, Estate of, v. Commissioner, 428  
 Nash, Leighton v., 310  
 Nat Harrison Associates, Inc., 467  
 National City Bank, United States v., 19  
 Neave, Charles F., 222  
 Neely v. United States, 376  
*Nemser, Alan*, 221–223  
 Netcher, Commissioner v., 89–90, 94  
 Neuman, Simon S., 219  
 Newburgh v. Arrigo, 315  
 Newbury v. United States, 90, 92, 94  
 New Colonial Ice Co. v. Helvering, 124, 126  
  
 New York Trust Co., Helvering v., 471  
 Nichols v. United States, 393  
 Nilssen, Estate of, v. United States, 422, 440  
 Nissen, Estate of, 98, 100  
 Nissen, In re, 98  
 North American Oil Consolidated v. Burnet, 11, 189  
 Northern Pac. Ry. Co. v. United States, 389  
 Northern Trust Co., Harrison v., 82  
 Northampton Nat'l Bank, Bartholomew v., 284  
*Nunan, Mallinckrodt v.*, 11–12, 304, 317–322  
  
 Oakes, Alden B., 354  
*O'Bryan v. Commissioner*, 125–127, 224–229  
*O'Connor, Estate of*, 335–344  
 O'Connor, Estate of, v. Commissioner, 8, 70, 85, 192, 204  
 O'Daniel's Estate v. Commissioner, 395, 412, 415, 422, 424, 440  
 O'Donnell v. Commissioner, 378  
 Old Colony Trust Co. v. Commissioner, 75, 85, 248, 250–251  
 Old Virginia Brick Co. v. Commissioner, 216–217  
 O'Neil, Estate of, In re, 195  
 O'Neill, William J., Jr., Irrevocable Trust v. Commissioner, 42  
 Owens, Commissioner v., 14, 168  
  
 Pardee, Marvin L., Estate of, 350  
 Parker v. Commissioner, 268  
 Parrish v. General Motors Corp., 439  
 Partington v. Attorney-General, 18  
 Patsey v. United States, 281  
 Patterson, Merchants' Loan & Trust Co. v. Patton v. United States, 219  
 Paxton, Estate of, v. Commissioner, 262  
 Paxton, Floyd G., 262  
 Pearson, Commissioner v., 172  
 Penn Mutual Life Insurance Co., Willcox v., 246  
 Perry v. United States, 396  
 Peterson, Edwin M., , 219



- Peterson, Estate of, v. Commissioner*, 428–434, 436, 438
- Petschek, Estate of, v. Commissioner*, 173
- Pfaff v. Commissioner*, 404
- Pfluger v. Commissioner*, 378
- Pickard v. Commissioner*, 338
- Pierce Estates, Inc. v. Commissioner*, 217
- Plant, Commissioner v.*, 39, 155
- Plant, H.B.*, 159
- Plunkett v. Commissioner*, 171
- Poe v. Seaborn*, 246, 248
- Pollock v. Farmers' Loan & Trust Co.*, 117
- Polt v. Commissioner*, 165, 170
- Poorbaugh v. United States*, 457
- Potter v. Bowers*, 86
- Pozzo di Borgo, Valerie Norrie*, 69
- Prather, Adams v.*, 10
- Preston v. Commissioner*, 376
- Proctor v. White*, 192
- Pullen v. United States*, 204
- Quick's Trust v. Commissioner*, 442
- Ramos v. Commissioner*, 51
- Rand Trust, Frank C.*, 356, 358
- Ratfield, United States v.*, 377
- Redding v. Commissioner*, 374
- Reid, Daniel G., Estate of*, 157
- Reynolds, Mairs v.*, 314
- Richards, Estate of, Hill v.*, 213
- Richardson v. Commissioner*, 12
- Richardson v. United States*, 9, 399
- Riddell, Malat v.*, 416
- Riegelman v. Commissioner*, 395, 412, 415, 442
- Riggs National Bank v. United States*, 204
- Rixey's Ex'rs v. Commonwealth*, 218
- Robbins, United States v.*, 246
- Roberts v. Commissioner*, 289
- Robinson v. United States*, 19
- Rockingham National Bank, Looman v.*, 217
- Rockland Oil Co.*, 76
- Roe, Mabel C.*, 405
- Rollert Residuary Trust, Edward D., v. Commissioner*, 198, 419, 434–440
- Rolston's Estate, In re*, 462
- Rosenthal v. Rosenthal*, 316
- Ross, Trust Co. of Georgia v.*, 407–416, 418, 421, 423–424, 426, 429, 434, 436, 445
- Roth, Matter of*, 460
- Rothstein v. United States*, 282–290, 345
- Routzahn, Aluminum Castings Co. v.*, 251
- Rubin v. Commissioner*, 372
- Rudkin Testamentary Trust v. Commissioner*, 41
- Ruoff v. Commissioner*, 49
- Rusoff, Irving I.*, 332
- Russell, Stella Porter*, 219
- Safety Tube Corp. v. Commissioner*, 49
- St. Joe Paper Co., United States v.*, 49
- St. Marks Episcopal Church v. Lowry*, 91
- Sakovits v. Sakovits*, 316
- Saltonstall, Commissioner v.*, 90
- Saltonstall v. Hassett*, 172
- Samoset Associates, In re*, 9
- Sampson v. Commissioner*, 376
- Samuel v. Commissioner*, 295
- San Diego Trust & Savings Bank v. United States*, 356, 359
- Sargent, Agness, v. United States*, 149
- Saunders v. Saunders*, 310
- Schaefer v. Commissioner*, 130, 158
- Schaefer, Matter of Trust, Estate of*, 130
- Schaffner v. Chemical Bank*, 205
- Schaffner, Harrison v.*, 254–256, 272, 321, 373
- Schall v. United States*, 359
- Scheft, William*, 332
- Scheft v. Commissioner*, 127
- Schilder v. United States*, 9
- Schimberg v. United States*, 173
- Schlesinger v. Wisconsin*, 120
- Schmidt Liberty Irrevocable Trust v. United States*, 377
- Schulz v. Commissioner*, 370–376
- Schwan v. United States*, 31, 37, 157
- Schweitzer, Helvering v.*, 248, 310
- Scott v. United States*, 42
- Scully v. United States*, 384–390
- Seaborn, Poe v.*, 246, 248
- Security-First National Bank v. United States*, 19
- Seligson v. Commissioner*, 159–161

- Sence v. United States, 354  
 Senior v. Braden, 249  
 Shanley v. Bowers, 249  
 Shea v. Commissioner, 15  
 Sheaffer, Craig R., Estate of, 305–306  
 Sid W. Richardson Foundation v. United States  
*Sidles, Harry B., Estate of*, 419–425, 430, 433, 445, 471  
 Skellenger v. England, 18  
 Sletteland, Gregg P., 30, 223, 340, 459  
 Slocum, Bowers v., 76  
 Slocum, Edwards v., 82  
 Smietanka v. First Trust & Savings Bank, 14, 17  
 Smith, Fred W., 350  
 Smith, Higgins v., 382–383, 389  
 Smith, United States v., 377  
 Smith v. United States, 12  
 Smith v. Westover, 119  
 Smith's Estate v. Commissioner 28, 166, 191  
 Smither v. United States, 12, 18  
 Smither, United States v., 12  
 Smythe, Estate of, 11  
 Snively v. Commissioner, 381  
 SoRelle v. Commissioner, 396  
 South Texas Lumber Co., Commissioner v., 91, 202, 340, 361  
 Spero, Trust of, v. Commissioner, 51  
 Spies v. United States, 12  
 Springer v. United States, 335  
 Staley, Sr., Estate of, A.E., 305  
 Stanley v. Commissioner, 453  
 State Savings Loan & Trust Co. v. Commissioner, 349, 356  
 Stearns v. Burnet, 194  
 Stearns, Commissioner v., 190, 194  
 Steck, In re, 9  
 Steingold v. Commissioner, 172  
*Stephenson Trust, Edward L., v. Commissioner*, 359–368  
 Sternberger, Estate of, Commissioner v., 82–83  
 Stevens, Estate of, v. Commissioner, 4  
 Stevens v. Commissioner, 60  
 Stewart v. Commissioner, 219  
 Stinson v. Bridges, 310  
 Stokes, Helvering v., 248, 310  
 Stone v. Commissioner, 316  
 Straight Trust, M.T., v. Commissioner, 356  
 Street, Estate of, v. Commissioner, 102  
 Stuart, Helvering v., 310, 322  
 Studebaker, George M., 331  
 Stussy v. Commissioner, 332  
 Suisman v. Eaton, 231–232, 235, 237  
*Sun First National Bank v. United States*, 345, 443–452, 473  
 Superior Court, Feldmeier v., 165, 167  
 Swanson v. Commissioner, 342–343  
*Swanson, W. Clark, Jr., 1950 Trust*, 267–268  
 Swayze v. Commissioner, 376  
 Swoboda v. United States, 221  
 Taft v. Bowers, 117  
 Tax Commission, Hoepfer v., 248  
 Taylor, Williams v., 42  
 Temple v. Commissioner, 247  
 Terriberry v. United States, 343  
 Thompson Estate, 382  
 Thompson, Estate of, v. Commissioner, 82  
 Thompson v. Commissioner, 262  
 Thompson v. United States, 265, 274  
 Tibbits, William B.J., 317  
 Totten, In re, 293  
 Tower, Commissioner v., 354–355  
 Transport Mfg. & Equipment Co. of Delaware v. Commissioner, 381  
 Treat v. White, 18  
*Trust Co. of Georgia v. Ross*, 407–416, 418, 421, 423–424, 426, 429, 434, 436, 445  
 Trust No. 3 v. Commissioner, 327  
*Tucker v. Commissioner*, 60–63, 72, 129, 210  
 Tucker, Marcia Brady, 176  
 Turner, Richard H., 306  
 Ungar, George, 350  
 Union Trust Co. of Butler v. Commissioner, 356  
 United California Bank v. United States, 473  
 United States Trust Co. v. Commissioner, 348, 356  
 United States Trust Co. v. Internal Revenue Service, 204



- United States v. \_\_\_\_\_. See taxpayer's name.
- Upton v. Commissioner, 89–90, 92, 94
- Van Buren v. Commissioner*, 129, 205–211
- Vercio v. Commissioner, 376
- Virgin Islands, Government of the, *Hopper v.*, 192
- Vnuk v. Commissioner, 373, 376
- Vogel Fertilizer Co., *United States v.*, 361
- Vreeland, George W., 331
- Walet, Eugene H., Jr., 39
- Walker, John, Trust of, 85
- Wanamaker, John, Trustees Common Stock, Commissioner v., 155
- Wanamaker Trust, Rodman, 155
- Washington, State of, v. Commissioner, 361
- Water Resource Control v. Commissioner, 25, 263
- Weber v. Commissioner, 29
- Weil, Elsie, Estate of, 69
- Weil, Joseph, 302
- Weil v. *United States*, 13–14, 19
- Weir Foundation, Ernest and Mary Hayward, v. *United States*, 85, 338
- Welch, Abbot v., 29
- Welch v. Helvering, 160
- Welch, Wellman v., 76
- Wellman v. Welch, 76
- Wells, Burnet v., 11, 248, 250–251
- Wenz v. Commissioner, 376
- Wesenberg v. Commissioner, 277, 373, 376
- West v. *United States*, 18
- Westover, Smith v., 119
- Westphal, Mary C., 229
- Westvaco Corp. v. *United States*, 389
- White, Lewis v., 260
- White, Proctor v., 192
- White, Treat v., 18
- Whitehead, J.B., Estate of, 86
- Whitehouse v. Commissioner, 25, 263
- Whitfield v. Commissioner, 191
- Whittemore v. United States*, 64–69, 73
- Whittington, Jones v., 28
- Wichita Terminal Elevator Co., 125
- Wickwire v. *United States*, 382
- Widener v. Commissioner, 388, 390
- Widener Trust, Joseph E., v. Commissioner*, 378–383
- Wiener, Fernandez v., 118
- Wiles, Jack, 308
- Willcox v. Penn Mutual Life Insurance Co., 246
- Willcuts v. Bunn, 68
- Willcuts, Douglas v., 248, 251, 310
- Williams v. Taylor, 42
- Williams v. *United States*, 9, 85
- Wilshire Oil Co., *Helvering v.*, 92
- Wilson, Anderson v., 29
- Winmill, *Helvering v.*, 366
- Wisconsin, Schlesinger v., 120
- W.K. Frank Trust v. Commissioner
- Wood, *Helvering v.*, 259
- Woodhall v. Commissioner, 442
- Woodward, Bessie A., Estate of, 29
- Woolley v. Malley, 28, 191
- Wrenn v. Daniels, 217
- Wright v. Commissioner, 442
- Wright, Estate of, v. *United States*, 82, 84
- Wyche v. United States*, 311–315
- Wylie v. *United States*, 219
- Wyly v. Commissioner, 383
- Wysong v. Commissioner, 274
- Yetter, Orville A., Estate of*, 101–102
- Zand v. Commissioner, 291
- Zmuda v. Commissioner, 376



# Table of Revenue Rulings

---

Revenue Rulings that have been reproduced are in italics.

54-143:	400–401	58-567:	265
55-2:	253	59-15:	84
55-34:	265	59-30:	7
55-38:	256	59-32:	103
55-92:	85	59-64:	441
55-117:	233	59-99:	20
55-229:	441	59-162:	442
55-278:	400-401	59-346:	173
55-356:	401	59-357:	4
55-410:	308	59-375:	29
55-463:	456	60-68:	447
55-469:	4	60-87:	238–240
55-655:	403	60-227:	395, 422, 454–456
55-726:	29	60-370:	256, 332
56-222:	381, 383	61-20:	148–149
56-270:	238-240	61-86:	32
56-449:	102	61-102:	19
56-484:	4, 313	61-211:	100
56-496:	396	61-223:	264
56-601:	265	62-147:	162, 168, 170
57-8:	293	62-148:	292–293
57-31:	223–224	63-27:	72–73
57-133:	29, 76	64-62:	175
57-214:	196–197, 344	64-101:	158
57-363:	298	64-104:	403–404
57-390:	332	64-240:	308
57-544:	454–456, 465	64-253:	76
57-554:	395	64-289:	397–399
57-564:	307	64-308:	405
58-19:	263	64-314:	158, 241
58-65:	4	65-217:	440
58-69:	458	66-160:	236
58-190:	7	66-161:	293, 301
58-242:	300–301	66-170:	263
58-337:	253–254	66-207:	235–237
58-435:	399–402	66-259:	75
58-436:	397, 399	66-278:	100

66-313:	301	73-565:	63-64
66-348:	456	73-584:	344
66-367:	76	74-94:	317
67-70:	335	74-175:	459
67-74:	234	74-178:	30
67-117:	179-180	74-257:	175-176
67-167:	335	74-299:	182-184
67-241:	322-323, 325	74-410:	76
67-242:	462-465, 468, 470-472	74-530:	100
67-268:	327	74-613:	334, 344, 448
67-304:	103, 157	75-61:	5, 29
68-47:	3-4	75-68:	162
68-48:	9, 154	75-79:	441
68-49:	197-198	75-124:	158
68-145:	404	75-257:	175-176, 376
68-195:	198, 442	75-258:	376
68-392:	140-142, 144-145, 147	75-267:	301
68-440:	76	75-278:	333
68-506:	453	75-307:	333
68-666:	29	76-23:	219
68-667:	75, 202, 204	76-100:	334, 448, 453
69-70:	329	76-486:	5-7
69-300:	9	76-498:	345, 459-462
69-402:	462	76-530:	334
69-432:	241	77-260:	8
69-450:	344	77-355:	62-64
69-486:	242-243	77-402:	345, 448
70-361:	102	77-439:	381
70-467:	404	77-466:	73
70-567:	9	78-24:	75, 181
71-50:	381	78-32:	426-427
71-119:	8	78-203:	476
71-167:	28, 158	78-292:	457
71-180:	220	79-84:	448
71-285:	75	79-223:	274, 301, 332
71-335:	189-190	79-335:	406
71-422:	459, 461	79-340:	404
71-423:	459, 461	80-165:	64
71-507:	442	81-6:	326-327
72-295:	236	81-98:	253, 335
72-387:	9	81-287:	102
72-396:	190	82-1:	427
73-94:	9	82-4:	236-238
73-95:	76	82-95:	308
73-251:	265	82-196:	441
73-322:	31, 156	83-25:	268
73-327:	440	83-75:	234, 308
73-366:	80	84-14:	299
73-397:	220	85-13:	291, 345

85-116:	169–171
86-32:	265
86-72:	453
86-82:	281
86-105:	236, 241
87-61:	344
87-97:	156
90-82:	94–97
90-55:	332–333
95-71:	404
2003-123:	75, 204
2004-5:	85
2005-30:	405–407
2006-19:	378
2007-13:	343, 345
2007-48:	184

## Table of Revenue Procedures

---

2008-3:	86, 219
---------	---------



# Table of Private Letter Rulings

---

Private letter rulings that have been reproduced are in italics.

7737025:	383
7809057:	205
8341005:	158
<i>8429005:</i>	145-148
<i>8501011:</i>	211-214
8506005:	192
<i>8545076:</i>	323-324
<i>8728001:</i>	142-145, 148
8738007:	175, 204
8810006:	86, 192, 204
9023012:	427
9031022:	107
9043068:	457
9147022:	196
9326043:	456
9535026:	291
9547004:	26
9549023:	456
9552039:	269
9625020:	243
9811036:	142
9811037:	142
9831005:	269
9840025:	86
200004030:	198
200142011:	86
<i>200222035:</i>	324-326
200226031:	219
200228019:	343
200316008:	465, 473
200334030:	243
<i>200618003:</i>	184-186
200636086:	343
200733023:	107
200744001:	428





# Preface

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This book began as a set of course materials prepared by Professor Ascher when he first went into teaching in 1982. Now in its third edition, the book has a new co-author, along with new cases, problems, and other materials; the essential approach of the book, however, remains the same. Over the years the book has profited from comments and criticisms of numerous classes taught by the authors at the University of Arizona, the University of Miami, the University of Missouri, New York University, the University of Texas, and Washington and Lee University, as well as from the suggestions of our faculty colleagues at other schools. To all those who have contributed to the success of this book, we extend our warmest thanks.

But publication of this book is not solely for the relatively few instructors who presently teach classes on subchapter J. The earth-shattering changes in the federal wealth transfer taxes (particularly with respect to the unified credit) that began with the Tax Reform Act of 1976 and blossomed in the Economic Recovery Tax Act of 1981 have as a central feature a congressional intention to make those taxes applicable to fewer and fewer taxpayers. Twenty years later the Economic Growth and Tax Relief Reconciliation Act of 2001 implemented a phased-in increase of the estate tax exclusion to \$3,500,000, followed by a repeal of the tax with respect to estates of decedents dying after December 31, 2009 (although, under EGTRRA, the tax is reinstated as of January 1, 2011). As of the date of publication of this edition, permanent repeal of the estate tax seems unlikely; more likely is a permanent increase of the exclusion to \$3,500,000 or more. But whatever action Congress ultimately takes, it is apparent that the estate tax will continue to apply to a decreasing number of estates.

Yet the federal income tax rolls merrily along. We all know that the income tax applies to trusts and estates. Still, almost all of us—even the I.R.S.—have frequently underestimated the importance of income tax considerations in both our practices and our teaching. Section 1(e) of the Code subjects trusts and estates to an onerously compressed rate schedule; one therefore ignores at one's peril such topics as the distribution deduction and the grantor trust rules—mechanisms designed to shift tax liability from an estate or trust to individuals, who are typically taxed at lower rates. Teachers in the wealth transfer area thus face a challenge. They can continue to focus exclusively on the decreasingly relevant taxes on gratuitous transfers, or they broaden their teaching packages to include the subjects of this course.

This course is not easy to teach. However, we really do believe that this book takes student and teacher alike firmly enough in hand that any teacher reasonably well-grounded in the basics of federal income taxation can successfully survive a first run through the course. A teacher's manual is available from the publisher. For those who wish to do additional reading, we recommend the following:

B. Abbin, *Income Taxation of Fiduciaries and Beneficiaries* (2007).

J. Blattmachr, A. Michaelson & L. Boyle, *Income Taxation of Estates and Trusts* (15th ed. 2007).

M. Ferguson, J. Freeland & M. Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries* (3d ed. 1998, supplemented annually).

H. Zaritsky, N. Lane & R. Danforth, *Federal Income Taxation of Estates and Trusts* (3d ed. 2001, supplemented semi-annually).

J. Peschel & E. Spurgeon, *Federal Taxation of Trusts, Grantors and Beneficiaries* (3d ed. 1997, supplemented annually).

We also recommend an article that nicely attempts to summarize subchapter J: Sherman, *All You Really Need to Know About Subchapter J You Learned from This Article*, 63 Mo. L. Rev. 1 (1998).

Unless otherwise indicated, all section references are to the Internal Revenue Code. In a deliberate effort to force students to deal directly with the Code, we have deleted from the reproduced materials almost all quotations of Code provisions. Students must, therefore, possess and be willing frequently to refer to a current version of the Code. References to obsolete Code provisions are, unfortunately, unavoidable, but we have tried hard to identify such references for the reader. We have tried to indicate all omissions, except footnotes, in reproduced materials. The remaining footnotes retain their original numbering. The Uniform Principal and Income Act (1997), our standard authority for questions of state law, appears as an appendix.

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May 2008

# Introduction

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This book examines federal income taxation of trusts and estates. It does not deal with federal estate and gift taxation. The federal estate and gift taxes are excise taxes on the transfer of property at death or by gift. They are imposed by chapter 11 (sections 2001 to 2210) and chapter 12 (sections 2501 to 2524) of subtitle B (“Estate and Gift Taxes”) of the Internal Revenue Code. The estate and gift taxes have little to do with how the income of trusts and estates is taxed. They are taxes on gratuitous transfers of property, not on income generated by that property.

Trusts and estates pay income taxes much as the rest of us do. Each year we add up what we take in, subtract out various exclusions and deductions, and pay a percentage of the remainder to the federal government. The basic system for taxing the income of trusts and estates is the same as that for taxing the income of individuals. Section 641(b) makes this very clear: “The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.” Thus, everything the student (may have) learned in the basic course on individual income taxation, which generally deals almost exclusively with chapter 1 (sections 1 to 1400T) of subtitle A (“Income Taxes”) of the Internal Revenue Code, is potentially relevant.

This book is not, however, a review of the basic course on individual income taxation (although it is possible to view chapter 2 that way). More than anything else, it is an examination of the ways in which the income taxation of trusts and estates differs from that of individuals. Section 641(b) acknowledges these differences when it refers to “this part.” That reference is to part I (“Estates, Trusts, and Beneficiaries”), which consists of sections 641 to 685. Part I, along with the two sections (691 and 692) of part II (“Income in Respect of Decedents”), make up subchapter J (“Estates, Trusts, Beneficiaries, and Decedents”). Thus, subchapter J is the primary focus of this book. Like it or not, an alternative title for the book would have been “Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code.”

Individuals bear the full tax consequences of their income. Thus, they are pure taxpayers. Partnerships and S corporations, on the other hand, generally pay no taxes on their income; the Code shifts their income to the partners or shareholders for taxation. Partnerships and S corporations, then, are pure conduits. Subchapter J blends these two, distinct modes of taxation into a unique system for taxing the income of trusts and estates. Such entities are, simultaneously, both taxpayers and conduits. They are taxpayers insofar as section 641(b) treats them as individuals. But part I of subchapter J allows trusts and estates a deduction for distributions to beneficiaries. This is the mechanism by which such entities also serve as conduits.

There is another major wrinkle. Subchapter J directs that some trusts, because of interests or powers retained by their grantors, are not treated as taxpayers at all. Their items of income, deductions, and credit are attributed directly to their grantors. These trusts are commonly referred to as “grantor trusts.”

This book very deliberately follows the organization of subchapter J. Thus, one, fairly accurate, way of visualizing the book is:

- Chapter 1 Section 641(a)
- Chapter 2 Sections 641(b), 642
- Chapter 3 Sections 643, 651–663
- Chapter 4 Sections 671–678
- Chapter 6 Section 691

Strong pedagogical and thematic concerns are, however, also present in the book's organization. Chapter 1 asks the logically first question, "Which entities are subject to income taxation under subchapter J?" Chapter 2 examines the entity as taxpayer, i.e., how the familiar principles of basic income taxation apply to entities. Chapter 3 then examines the entity as conduit, i.e., how the distribution deduction works to shift some of the income taxation of entities to their beneficiaries. Chapter 4 inquires into when the entity is to be ignored, either under assignment-of-income principles or the grantor trust rules. Chapter 5 provides the student with an opportunity to reconsider the complete picture in the context of manipulative and, arguably, abusive use of entities. Chapter 6, which deals with income and deductions in respect of decedents, mars the organization of the book, just as it does that of subchapter J, but contains obviously important material that fits better in this course than in any other.

The provisions of subchapter J are the core of this book. Its overwhelming first priority is understanding of those provisions and how they work. Likely criticisms are the book's detail and attention to mechanics. But, clearly, such is stuff tax lawyers are made of. Those who wish to pursue tax policy more thoroughly than the book at first seems to must start somewhere. This book can be that springboard. Even the most unabashed would-be technical expert ought to be willing to pause over the concept of "distributable net income" after reading *Irwin v. Gavit* alongside *Harkness* (ch. 3, sec. A). Three series of cases, far longer than the would-be technical expert needs, are not included just to acquaint students with the anguish of the common law or even with the interaction of judicial and legislative lawmaking. These series are included primarily to force the student to ask tough "why" questions. (In tax law "why" questions are especially tough for many students (and teachers) to ask because they often have only "because" for an answer.) The *Manufacturers Hanover Trust Co.-Tucker-Whittemore-Fabens* series (ch.2, sec. B(3)(b)) ought to stimulate questions about why entities are not taxed exactly as individuals are. It also ought to focus attention on why distributable net income occupies the role it does in subchapter J. The *Trust Company of Georgia-Keck-Sidles-Peterson* series (ch. 6, sec. A(2)) should force analysis of whether there is a need for a concept similar to "income in respect of a decedent" and whether the current concept either fills that need or is worth the candle. Moreover, it should prompt students to question the soundness of section 1014. *Estelle Morris* and *Stephenson* (ch. 5, sec. A) have survived the Tax Reform Act of 1984 not only to illustrate the potential operation and flaws of section 643(f), but also to necessitate analysis of whether there remains a need for section 643(f) after the Tax Reform Act of 1986. Most importantly, however, *Estelle Morris* and *Stephenson* should force each student to ask the central policy question of a course on the income taxation of trusts and estates: Should trusts and estates have separate income tax existences?

We offer the following suggestions for coming to terms with these challenging materials:

1. Your starting point should always be the words of the Internal Revenue Code.

2. Use the Treasury Regulations as your primary tool for understanding the Code.
3. Use the cases, the rulings, the Illustrative Material, and the problems strictly as tools to understand the Code and regulations.
4. Ask whether the regulations, cases, etc. fairly and accurately interpret the Code.
5. Ask whether the Code makes sense and, if not, whether there is a better alternative.