GIFTS UNDER 2503(b): HOW TO VALUE THE PRESENT INTEREST OF AN INCOME BENEFICIARY WHEN THE TRUSTEE HAS DISCRETIONARY INVESTMENT POWER

Section 2503(b) of the Gift Tax Code provides that the first $3,000 of gifts, other than gifts of future interests, may be excluded from the total gifts made to any person during the calendar year.[1] The remaining gifts made during that calendar year are subject to gift tax.[2] The purpose of the exclusion was to eliminate the donor's inconvenience of reporting small gifts, such as Christmas gifts.[3] Estate planners, however, have used this provision to lower estate taxes upon death, by reducing the size of the estate during the donor's life, and at the same time avoid gift taxes upon the transfer by limiting the size of the gift to the amount of the annual exclusion. The donee of a gift in trust is the beneficiary, not the trust itself.[4] Frequently, a grantor makes an annual gift valued at $3,000, or less, to a trust fund where these annual gifts are accumulated as principal. The earnings from the principal are paid to the beneficiary as income.

The grantor (settlor) is entitled to the annual exclusion only if two requirements are met: first, the trust instrument must grant the beneficiary an unrestricted right to the immediate use, possession or enjoyment of a certain share of trust income;[5] second, that right must have a reasonably ascertainable value on the date of the gift, or in the present situation, the date the trust was created.[6] If the first requirement

1. The section provides as follows:

> In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1955 and subsequent calendar years, the first $3,000 of such gifts to such person shall not . . . be included in the total amount of gifts made during such year.

26 C.F.R. § 25.2503(b) (1969).

2. 26 C.F.R. § 25.2503-1 (1969).

3. H. Rep. No. 708, 72d Cong., 1st Sess. 29 (1932), 1939-1 C.B. 478 (Part 2); S. Rep. No. 665, 72d Cong., 1st Sess. 41 (1932), 1939-1 C.B. 525-26 (Part 2).

4. 26 C.F.R. § 25.2503-2 (1969).

5. *See, e.g.*, Chanin v. United States, 393 F.2d 972 (U.S. Ct. Cl. 1968); Jolley v. United States, 259 F. Supp. 315 (D.S.C. 1966); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 708 (2d ed. 1962).

6. Van Den Wymelenberg v. United States, 272 F. Supp. 571, 574 (E.D. Wis. 1967); *see* Commissioner v. Brandegee, 123 F.2d 58, 61 (1st Cir. 1941); Commissioner v. Gardner, 127 F.2d 929 (7th Cir. 1942); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 709 (2d ed. 1962).

is met, the beneficiary's interest is traditionally called a present interest.[7]

Since these requirements are theoretically independent of each other, it is possible to have a present interest which is incapable of valuation.[8] Generally, before the recent case of *Rosen v. Commissioner*,[9] the courts relied on this concept, a present interest incapable of valuation, to disallow the annual exclusion in two instances: (1) when the corpus was unproductive at the time the trust was created;[10] and, (2) when a productive corpus could be rendered unproductive because the trustee had discretionary power to reinvest or alter the trust corpus.[11] The decision in *Rosen* significantly changed the law applicable to the situation in which the trust corpus is initially unproductive.[12]

In *Rosen*, the beneficiaries were given a present interest, and the trustee had discretionary power to reinvest the corpus, which was unproductive.[13] The grantor argued that the present interest could be

---

7 *See, e.g.*, 26 C.F.R. § 25.2503-3(b) (1969); Shefner v. Knox, 131 F. Supp. 936 (D. Minn. 1955); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 708 (2d ed. 1962).

8 *See, e.g.*, Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); Andrew Geller, 9 T.C. 484 (1947); C. LOWNDES & R. KRAMER, FEDERAL ESTATE AND GIFT TAXES 709 (2d ed. 1962).

9 397 F.2d 245 (4th Cir. 1968).

10 *See, e.g.*, William Hamm, 30 P-H Tax Ct. Mem. 1983 (1961); Martha F. Mason, 46 B.T.A. 682 (1942). *But cf.*, Commissioner v. Kempner, 126 F.2d 853 (5th Cir. 1942), where the trust corpus consisted of noninterest-bearing secured notes which were due within a five-year period from the date of the gift. The court held that the exclusion was available, and never reached the valuation question after deciding that the gift was a present interest. The probability that the beneficiary will receive income is especially important where the beneficiary is a charity. *See* 26 C.F.R. § 25.2522(a)-2(b) (1969).

11. *See, e.g.*, Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); Van Den Wymelenberg v. United States, 272 F. Supp. 571 (E.D. Wis. 1967). Prior to the enactment of the 1954 Code, the courts disallowed the annual exclusion on the rationale that the beneficiary had a present interest which was incapable of valuation whenever the trustee held discretionary power to distribute corpus during the term of the beneficiary's income interest. *E.g.*, Kniep v. Commissioner, 172 F.2d 755 (8th Cir. 1949); Evans v. Commissioner, 198 F.2d 435 (3d Cir. 1952). The 1954 Code has repudiated this rationale in cases where the trustee can distribute corpus to only the income beneficiary during the term of the income beneficiary's interest. 26 C.F.R. § 25.2503(b) (1969). An example of this situation is found in the regulations:

> Under the terms of a trust the net income is to be paid to *F* for life, with the remainder payable to *G* on *F's* death. The trustee has the uncontrolled power to pay over the corpus to *F* at any time. Although *F's present right* to receive the income may be terminated, no other person has the right to such income interest. Accordingly, the power in the trustee is *disregarded* in determining the *value* of *F's present interest*.

26 C.F.R. § 25.2503-3(c)(4) (1969) (emphasis added). "The power would *not* be disregarded to the extent that the trustee during *F's* life could distribute the corpus to persons *other than F*." *Id.* (emphasis added).

12 Although Rev. Rul. 69-344, discussed *infra*, stated that the Internal Revenue Service would not follow the decision in *Rosen*, the holding of the Rev. Rul. was concerned with the trustee's discretionary power to reinvest or alter the trust assets, rather than the initial status of the corpus.

13. The corpus consisted of shares of stock in a corporation which had never paid dividends. Further, there was no likelihood that dividends would be paid in the future.

valued by use of the actuarial tables contained in the regulations.[14] The government conceded that the interest given to the beneficiaries was a present interest, but contended that the interests were incapable of valuation since use of the tables would produce an unreasonable result.[15] The circuit court, reversing the tax court, stated that it was near fatal for the commissioner to concede that the interest was a present interest, and then argue that it was incapable of valuation. Following this reasoning, the court held that present interests, by definition, have value and can be valued by use of the actuarial tables in the regulations, regardless of whether income is actually produced.[16]

With reference to the two requirements which must be met to obtain the exclusion, the practical result of *Rosen* is that whenever the first requirement is met, the second is automatically met. This consequence raises problems in the situation where the trustee is given discretionary power to reinvest or alter the trust corpus.[17] In order to deny the annual exclusion in those cases, the courts argued that the possibility that the trustee would invest in non-productive property, and thereby terminate

14. 26 C.F.R. § 25.2512-5(c) (1969) provides as follows:

> If the interest to be valued is the right of a person for his life, or for the life of another person, to receive the income of certain property or to use nonincome-producing property, the value of the interest is the value of the property multiplied by the figure in column 3 of Table I opposite the number of years nearest to the actual age of the measuring life.

Table I is found at 26 C.F.R. § 25.2512-5(f) (1969).

15. The critical issue in the case was whether the tables could be used to value the present interest. In previous cases, the issue was the more general problem of whether the value of the gift could be determined with reasonable certainty. *See, e.g.*, Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961) (Commissioner conceded that the interests were present interests; the court held that, since the trustees could divert the income from the beneficiaries by making investments which did not produce income, "the present interests could not be valued with reasonable certainty." *Id.* at 578); Van Den Wymelenberg v. United States, 272 F. Supp. 571 (E.D. Wis. 1967) (The court held that the interest was a present interest, but denied the exclusion because the gift was not reasonably certain at the time of the trust's creation. The court stated that the trustee's powers "could significantly affect the income available to the beneficiaries." *Id.* at 574).

16. It is interesting to note that, rather than contend that the trustee's power to reinvest the corpus would render the present interest incapable of valuation, the court stressed the trustee's power to reinvest to support its holding. A. CASNER, ESTATE PLANNING 343 (3d ed., Supp. 1969). It should further be observed that the income beneficiary would receive the corpus if he attained a specified age. As a result, the trustees did not have to convert the corpus in order for the beneficiary to derive benefit from the trust. Although this factor is not relevant to the valuation issue, Mr. Casner has suggested the possibility that the beneficiary's future interest in the corpus influenced the courts decision. *Id.*

17. Apparently no problems have arisen in the situation where the trustee has discretionary power to distribute the trust corpus during the life of the beneficiary's income interest. Problems may arise, however, since these cases are supported by similar rationale. *See, e.g.*, Evans v. Commissioner, 198 F.2d 435 (3d Cir. 1952); Kniep v. Commissioner, 172 F.2d 755 (8th Cir. 1949).

the flow of income to the beneficiary, was substantial enough to make valuation impossible.[18] After the decision in *Rosen*, however, it makes no difference that the flow of income to the beneficiary is interrupted so long as the first requirement is met.

The Internal Revenue Service responded to this problem in Rev. Rul. 69-344.[19] The result of this ruling is that a beneficiary's unrestricted right to the immediate use, possession or enjoyment of a certain share of trust income is no longer a present interest if the trustee has discretionary power to reinvest the trust corpus.[20] In order to reach this result, the Service relied heavily on the grantor's intention to create a future interest. The Service stated that this intent was indicated by trust indenture provisions which gave the trustee discretionary investment powers,[21] and by the provisions authorizing the purchase of life

18. Cavitch, *Obtaining the Gift Tax Exclusion on Gifts in Trust: Drafting and Legislative Suggestions*, 51 MICH. L. REV. 621, 634 (1953) [hereinafter cited as CAVITCH]; Fischer v. Commissioner, 288 F.2d 574 (3d Cir. 1961); Van Den Wymelenberg v. United States, 272 F. Supp. 571 (E.D. WIS. 1967). Generally, the problem is not presented by the uncertainty of the amount of income the beneficiary will receive. CAVITCH at 634; *cf.*, Gilmore v. Commissioner, 213 F.2d 520, 522 (6th Cir. 1954); Commissioner v. Lowden, 131 F.2d 127 (7th Cir. 1942). As in the cases involving the initial status of the corpus, the concern is the likelihood that the beneficiary will not receive income. *Cf.* cases cited note 10 *supra*.

19 I.R.B. No. 1969-25 at 21 (June 23, 1969). Although the beneficiary may have been a minor under the facts, such fact is irrelevant to this discussion. Since the beneficiary is given a life estate, he does not qualify for treatment under Section 2503 (c) of the Code, which deals with gifts to minors. Under the regulations, a gift to a minor which does not qualify for treatment under 2503(c) is considered a present or future interest under the same provisions which are the subject of this paper. 26 C.F.R. §§ 25.2503(c), 25.2503-4(c), 25.2503-3 (1969).

20. One of the consequences of *Rosen* is that the previous distinction between present interests capable of valuation and present interests incapable of valuation is gone. Apparently, the Service felt that the only way to avoid the direct result of *Rosen* was to redefine the interest.

21. "The above-quoted language from the indenture of trust indicates an intention of the grantor that the trustees pursue an investment policy that results in a future increase in the value of the trust, rather than an investment policy to provide current income to the trust beneficiaries." Rev. Rul. 69-344, 1969-1 CUM. BULL. 225 at 226. The part of the trust indenture quoted in the opinion provides as follows:

> The Grantor hereby authorizes the Trustees to invest, from time to time, in such securities and property as the Trustees may think most advantageous to any trust created hereunder, without responsibility for the exercise of their discretion in so doing. The Trustees are not to be limited in the selection of securities and property, but may, in their discretion, invest, reinvest and change investments in such stocks, bonds, shares, securities and obligations of any corporations, governmental bodies or agencies, unincorporated associations or partnerships, trusts, investment companies, investment trusts, or in a common trust fund without giving notice to any beneficiary, or in any other kind of real or personal property domestic or foreign, wasting or non-wasting, productive or non-productive, as may, in their opinion, result in a future increase in the value or yield of any trust, notwithstanding the fact that any or all of the investments made or retained are of a character or size which but for this express authority would not be considered proper for Trustees.
>
> The Trustees are hereby authorized to exercise any and all options, rights, and privileges

insurance.[22] The Service's conclusion does not necessarily follow from these premises.

The power of reinvestment is a sound, and essential, estate planning device. The power to reinvest the trust corpus does not necessarily indicate an intent on the donor's part to increase the future value of the trust fund. It may just as well indicate an intent to preserve the present yield payable to the income beneficiary.[23] For example, if the corpus consisted of shares of stock paying quarterly dividends, and the value of the stock fell to a point where dividends were not paid, the trustee would need the power of reinvestment in order to preserve the productivity of the corpus and maintain a steady flow of income for the beneficiary.

Providing for the purchase of life insurance is likewise a sound estate planning technique. It may be true that life insurance policies are generally purchased to provide future benefits,[24] but it does not necessarily follow that a beneficiary cannot derive immediate benefit from them. For example, a common type of life insurance policy provides for the payment of dividends, which may be paid to the beneficiary or invested in additional insurance. If the dividends are paid to the beneficiary, the result is a steady flow of an ascertainable amount

contained in any life insurance policy, or endowment contract or contracts which may become an asset owned by any trust created hereunder, including by way of illustration and not by way of limitation, the right to leave any sum on deposit with any life insurance company at interest for any length of time, to revoke any optional mode of settlement, to obtain the cash surrender value, or to convert any such policy to paid up insurance, or extended term insurance, and the Grantor further hereby authorizes the Trustees to take out and/or continue in force and to pay the premiums on any life insurance, annuity (regardless of whether such annuity may be wholly wasting asset) or endowment contract or contracts. which they may deem desirable to purchase upon the life of any beneficiary of any trust created hereunder or upon the life of any issue of such beneficiary, for any purpose whatsoever, including, by way of illustration but not by way of limitation, the purpose of providing cash for the payment of taxes upon the death of such beneficiary. All details of any such contract shall be within the direction of the Trustees.

Rev. Rul. 69-344, 1969-1 CUM. BULL. 225. The provisions regarding the purchase of life insurance are discussed later in the opinion. Therefore, it is reasonable to assume that, by "above-quoted language from the indenture of trust," the opinion was referring to the power of the trustees to reinvest and alter the trust corpus.

22. "The purchase of life insurance policies authorized by the indenture further indicates an intention that future rather than present interests be created for life insurance policies are generally purchased for future rather than immediate use and enjoyment." Rev. Rul. 69-344, 1969-1 CUM. BULL. 226.

23. "If the original corpus of a trust is income producing in nature, it would appear that a grant to a fiduciary of a power to sell and reinvest may be desirable in the event of changed circumstances in the future." Comment, 51 MARQ. L. REV. 332, 340 (1967-68).

24. *See* footnote 22 *supra*.

of income.[25] In each case, it is necessary to examine the type of insurance policy involved.

The use of an intent test in gift tax law is not new,[26] and has been criticized by some authorities.[27] An intent test forces the grantor to take his chances in making a gift, and taking advantage of the exclusion, even though he has conformed with all the requirements in the regulations. Uncertainty of this type would make the annual exclusion provision virtually unworkable.

The rule in *Rosen*, however, is also unrealistic because the actuarial tables are used in all situations. The tables show the present worth of these interests, based upon an interest rate of 3½% per year, compounded annually.[28] When the probable yield is significantly greater or significantly less than the 3½% annual yield assumed by the tables, or so uncertain that any concept of average yield is meaningless, the value of the interest should be determined by the facts of the particular case under consideration.[29]

The practical result of Rev. Rul. 69-344 is that the annual exclusion will be denied in every situation where the trustee is given discretionary investment powers, even though the beneficiary has an unrestricted right to the immediate use, possession or enjoyment of any income produced by the trust. The practical result of *Rosen* is that the annual exclusion will be allowed in all such cases, regardless of whether the beneficiary actually receives income. Neither result is desirable.

In order to develop a new method for determining the availability of

---

25. The inability to definitely determine, in advance, the exact amount of dividends from a life insurance policy does not make it impossible to value the right to receive them. Guggenheim v. Rasquin, 312 U.S. 254 (1941); Pauline Wilkins Todemann, 1 T.C. 968 (1943); *cf.* Martha F. Mason, 46 B.T.A. 682, 686 (1942).

26 *See, e.g.*, Martha F. Mason, 46 B.T.A. 682, 687 (1942); Strekalovsky v. Delaney, 78 F. Supp. 556 (D.C. Mass. 1948); Arthur C. Stifel, Jr., 17 T.C. 647 (1951), *aff'd sub. nom* Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952) (different rationale).

27 "Where possible, the intent rule should be rejected in tax cases." Comment, 7 TAX L. REV. 500, 502 (1952). *See* CAVITCH at 636, 638. *But see* Albright v. United States, 308 F.2d 739 (5th Cir. 1962); Munger v. United States, 154 F. Supp. 417 (M.D. Ala. 1957).

28. 26 C.F.R. § 25.2512-5 (1969).

29 William Hamm, 30 P-H Tax Ct. Mem. 1983, 2014 n.16 (1961); Hanley v. United States, 63 F. Supp 73, 81 (Ct. Claims 1945); Irma Green, 22 T.C. 728, 732 (1954). *Contra*,

> There is no convincing reason for inquiring into the productiveness of the trust corpus. Indeed, expediency alone would dictate that the impossible burden of speculating as to the existence and amount of future income be avoided. Since the Gift Tax Regulations presently provide for the valuation of income and remainder interests on the basis of a hypothetical annuity of three and one half per cent, the statute should make it clear that such valuation applies without regard to the fact that the gift property is nonproductive.

CAVITCH at 648.

the annual exclusion, it is necessary to remember that the goal of the service is to disallow the exclusion in cases where the flow of income to the beneficiary will be interrupted. If the service really is concerned with the actual receipt of income by the income beneficiary, it should be willing to allow the exemption whenever the grantor can offer satisfactory proof that the beneficiary actually received income during the years in question.

The real solution to the problem is to determine the availability of the exclusion when the $3,000 limit is reached, or at the termination of the income interest, whichever occurs first. This "wait-and-see" test would allow the grantor a refund of the tax on the income received during the term of the income interest, or the tax on $3,000, whichever is less. This solution, however, would discourage the grantor from making gifts of income because he would have to pay the tax, then "wait-and-see" if he is permitted a refund. An "alternate wait-and-see" test would permit the grantor to value the income interest by use of the tables, or otherwise, at the date of the gift. He would be able to take an exclusion on the basis of that valuation. He would then be permitted to keep the exclusion if the income received is equal to, or greater than, the exclusion, where the exclusion is $3,000. Where the exclusion is less than $3,000, however, and the income received is greater than the exclusion, the grantor should receive a tax refund on the difference between the exclusion and the income, up to the $3,000 limit, with interest.[30] If the income received is less than the exclusion, or $3,000, the grantor must pay tax on the difference between the income and the exclusion, with interest.

Because both the "wait-and-see" test and the "alternate wait-and-see" test would be difficult to administer, the "compromise" test is proposed. The "compromise" test would value the gift at the end of the fiscal year in which the gift was made, but tax would be paid at the usual time. The grantor would receive a refund of the tax on the income received in one year, or the tax on $3,000, whichever is less.

The "compromise" test is comparable to § 2032(a)(3) of the Estate Tax Code which provides that an executor may elect to value estate assets at either the date of the decedent's death or the date one year after the decedent's death in order to account for fluctuating market values of the estate assets.[31] Further, the "compromise" test offers the advantages

30. An argument can be made that the grantor should be bound by the original exclusion. The grantor should not be permitted to derive unexpected benefits, because he alone determines valuation.

31. 26 C.F.R. § 20.2032(a)(3) (1969).

of certainty and ease of administration. By providing for an alternate valuation date, it accomplishes the result desired by the Service since no exclusion would be allowed when no income was produced during the first year of the gift. Finally, the "compromise" test avoids the unrealistic consequences of both *Rosen* and Rev. Rul. 69-344.

It should be emphasized that the "compromise" test is not a solution to the problem of prospective valuation of income interests. It is designed solely to give the grantor some benefit under the annual exclusion provision when he otherwise would receive none.[32]

---

32 Before *Rosen* and Rev. Rul. 69-344, the annual exclusion was allowed if the trustee's power to reinvest, or distribute, the trust corpus was limited to an ascertainable standard, and if the possibility of encroachment being made, according to that standard, was so remote as to be negligible. *E.g.*, Van Den Wymelenberg v. United States, 272 F. Supp. 571, 574 (E.D. Wis. 1967); Hugh McK. Jones, 29 T.C. 200 (1957). It is suggested, therefore, that the problem discussed in this paper may be *avoided* by some drafting changes. A provision which authorizes the trustee to reinvest or alter the trust corpus *only* to preserve or increase the productivity of the principal would give the trustee the desired reinvestment power without severely limiting his discretion. *See* Comment, 51 MARQ. L. REV. 332, 340 (1967-68); Krassner, *The Trouble Spots of the Gift Tax: A Haunting Ground for the Tax Planner*, 22 J. TAX. 346, 347 (1965). Further, if a provision for the purchase of life insurance is desired, the indenture should require that the life insurance policy be purchased, or maintained, be of the type which pays dividends, and that the dividends be paid at least annually to the income beneficiary.