OBTAINING THE GIFT TAX EXCLUSION ON GIFTS IN TRUST: DRAFTING AND LEGISLATIVE SUGGESTIONS

Zolman Cavitch
Member of the Ohio Bar

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No prospect is more appealing to the modern taxpayer than the possibility of getting something for nothing. Of the few such remaining possibilities, one of the most attractive is the federal gift tax annual exclusion. Indeed, by taking full advantage of the $3,000 ($6,000 for married donors) exclusion for annual gifts to each of several donees, a donor might succeed in transferring several hundred thousand dollars—thus effecting both estate and income tax savings—without any gift tax cost. Unfortunately, however, this apparent free ride is not so readily available when the donor makes his gifts by means of the inter vivos trust.

Although recent developments in the field of federal gift taxation have increased the attractiveness of making lifetime gifts, they have also highlighted the extremely technical pitfalls which face the donor who contemplates obtaining annual gift tax exclusions on gifts made in trust. These divergent developments have produced an unhappy impasse—many tax conscious clients virtually demand that their gift tax program be so arranged as to permit recurring annual gifts free of gift taxes, while cautious and well-informed attorneys are understandably reluctant to start their clients on a gift plan which must skirt so many pitfalls in order to be successful.

Prior to 1950, the donor whose gift program was motivated in whole or in part by a desire to decrease or eliminate his taxable estate for federal estate tax purposes was necessarily haunted by the very real possibility that his gifts might be held to have been made in contemplation...
of death, and therefore includible in his taxable estate. Since 1950, however, the Internal Revenue Code has provided that no gift made more than three years before the death of the donor will be considered as made in contemplation of death. Accordingly, gift planning is now substantially more attractive than heretofore.

The increased attractiveness of making lifetime gifts has undoubtedly stimulated interest in the use of the inter vivos trust. The inter vivos trust offers many advantages that cannot be obtained by outright gifts. Thus, the donor will often wish to vest management of the donated property in others than the beneficiary, perhaps in himself. The beneficiary may be a minor or incompetent, making outright gifts impractical for a variety of reasons. Often the donor will be impressed with the high degree of flexibility as to income and principal distributions that is afforded by the trust device. In addition, the donor might wish to use the trust device in order to avoid the inclusion of the gift property in the taxable estate of the beneficiary.

Relatively recent cases, however, have more than justified the estate planner’s reluctance to use the inter vivos trust when one of the donor’s principal objectives is to obtain the annual exclusion. This reluctance on the part of the estate planner stems from the surprisingly little understood requirement that a gift must be a “present interest” in order to qualify for the exclusion. A gift of a “future interest,” no matter how small in amount, must be reported for gift tax purposes. The difficulty, perhaps indeed the impossibility, of drafting an inter vivos trust which will qualify gifts as a “present interest,” is a very real one.

The purposes of this article are to outline the “future interest” pitfalls in the use of various conventional trust provisions, to explore remedial drafting possibilities even under the present law, and to suggest a statutory amendment which will eliminate the fundamental defects of the present poorly-drafted law.

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8 A substantial motive to avoid estate tax is persuasive of a transfer made in contemplation of death. Rickenberg v. Commissioner, (9th Cir. 1949) 177 F. (2d) 114, cert. den. 338 U.S. 949 (1950); Farmers Loan & Trust Co. v. Bowers, (2d Cir. 1938) 98 F. (2d) 794, cert. den. 306 U.S. 648 (1939); Vanderlip v. Commissioner, (2d Cir. 1946) 155 F. (2d) 152.

4 I.R.C., §811(c), as effective prior to September 24, 1950.

5 I.R.C., §811(1).


7 I.R.C., §1003(b)(3).
DEFINITION OF "PRESENT INTEREST"

The Regulations define "future interests" as any interests "whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." A "present interest" must therefore be an interest or estate, whether vested or contingent, which is limited to commence in possession or enjoyment immediately. Obviously, the common law concept of a vested interest is entirely irrelevant. So also is any consideration of when legal or equitable ownership begins. To constitute a present interest the donee must have the right to the present possession or enjoyment of the property. "The question is of time, not when title vests, but when enjoyment begins."

This much can be gleaned from a reading of the definition advanced by Congress and the Commissioner. The actual task, however, of drafting a trust which will give the beneficiary a present interest faces many pitfalls which are not apparent from the mere reading of definitions.

DRAFTING PITFALLS

1. Accumulation of income. The cases are clear that a gift to a trust which directs that the income be accumulated for a term of years is a gift of a future interest and, accordingly, is not entitled to the annual exclusion.

2. Discretionary power over income. Equally well settled is the proposition that a discretionary power in the trustee to distribute income to or for the benefit of the beneficiary or to withhold and accumulate such income results in a future interest, thereby making the exclusion unavailable. This result obtains whether the discretionary

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9 Fondren v. United States, 324 U.S. 18, 65 S.Ct. 499 (1945); Commissioner v. Wells, (6th Cir. 1942) 132 F. (2d) 405; Commissioner v. Glos, (7th Cir. 1941) 123 F. (2d) 548; Welch v. Paine, (1st Cir. 1941) 120 F. (2d) 141.
11 Id. at 20.
12 United States v. Pelzer, 312 U.S. 399, 61 S.Ct. 659 (1941); Welch v. Paine, (1st Cir. 1941) 120 F. (2d) 141; Commissioner v. Glos, (7th Cir. 1941) 123 F. (2d) 548.
power is subject to a standard, presumably enforceable by a court of equity,\textsuperscript{14} or whether the power is subject to no standard at all.\textsuperscript{15} So, also, is the exclusion denied where all of the income \textit{must} be distributed but where the trustee has the power to change the relative amounts which each of several beneficiaries will receive.\textsuperscript{16} In each case, the gift is a future interest because the beneficiary has no absolute right to the enjoyment of an ascertainable amount of income commencing immediately and continuing for life or for a definite number of years.\textsuperscript{17}

The relatively large number of cases\textsuperscript{18} holding that gifts to a discretionary trust are gifts of a future interest suggests that attorneys have been extremely reluctant to accept this result. This reluctance probably stems from the fact that the beneficiary of the discretionary trust is usually a minor child and, consequently, a mandatory direction to distribute income would ordinarily be unrealistic and unwise. Furthermore, in view of the legal restrictions imposed upon guardians in the use of a ward's property,\textsuperscript{19} the compelling argument has been made that a discretionary trust for a minor, authorizing distributions of income pursuant to a broad standard and providing for termination when the beneficiary attains majority, gives the minor at least as much assurance of obtaining present enjoyment of the income as would a gift outright to him or to his legal or natural guardian.\textsuperscript{20} Any hope that at-


\textsuperscript{15} French v. Commissioner, (8th Cir. 1943) 138 F. (2d) 254; Hutchings v. Commissioner, (5th Cir. 1944) 141 F. (2d) 422.

\textsuperscript{16} Helvering v. Blair, (2d Cir. 1941) 121 F. (2d) 945; Vogel v. United States, (D.C. Mass. 1941) 42 F. Supp. 103.

\textsuperscript{17} If it can be established that the beneficiary has a need for funds at the time that the gift in trust is made, and the trustee is therefore under a duty to distribute income to him and the trust instrument or the circumstances indicate that some ascertainable amount of income will continue to be distributed in the future, then the income interest should qualify as a present interest. See Commissioner v. Disston, 325 U.S. 442, 65 S.Ct. 1328 (1945). In short, it must be shown that despite the words of the trust instrument, the trustee actually has no right to withhold income and will not have such right in the future. One early case seems to have met this heavy burden. Smith v. Commissioner, (8th Cir. 1942) 131 F. (2d) 254. The Smith case, however, has been criticized by the Tax Court, in Simon Guggenheim, 1 T.C. 845 (1943).

\textsuperscript{18} See note 13 supra.

\textsuperscript{19} See note 6 supra.

Attorneys may have entertained for eventual success with this argument was dispelled in 1945 by the Supreme Court cases of *Fondren v. United States*\(^\text{21}\) and *Commissioner v. Disston*,\(^\text{22}\) which established conclusively that gifts to a discretionary trust, even though for the benefit of a minor beneficiary,\(^\text{23}\) give rise to a future interest.

Conversely, a gift in trust which requires that the income be distributed currently to the beneficiary will give rise to a present interest.\(^\text{24}\) It is essential to point out, however, even though we thereby digress for a moment, that only the present value of the income interest is a present interest—the value of the corpus (the remainder interest) is a future interest, its distribution being postponed to some future date.\(^\text{25}\) Thus, a gift in trust providing for the periodic (annual or more often) distribution of income to the beneficiary until he attains the age of 25 and the outright distribution of principal at age 25 would result in the availability of the exclusion to the extent of the present value of the income to age 25\(^\text{26}\) and an includible gift for gift tax purposes to the extent of the excess value.

A moment's reflection will indicate that the allowance of an exclusion only to the extent of the present value of the income interest results in certain absurdities. We would probably all agree that the payment of income in the future is no more a present interest than is the payment of principal in the future. It is clear, for example, that if a gift in trust were made on January 1, 1952, and the trust instru-

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\(^\text{21}\) 324 U.S. 18, 65 S.Ct. 499 (1945).

\(^\text{22}\) 325 U.S. 442, 65 S.Ct. 1328 (1945).

\(^\text{23}\) "The statute in this respect purports to make no distinction between gifts to minors and gifts to adults. If there is deferment in either case, the exemption is denied." *Fondren v. United States*, 324 U.S. 18 at 28 (1945).

\(^\text{24}\) Payment of income to the beneficiary once a year is sufficient to qualify as a present interest, even though the income may thereby be withheld for as long as one year. *Fisher v. Commissioner*, (9th Cir. 1942) 132 F. (2d) 383. But cf. *Hessenbruch v. Commissioner*, (1st Cir. 1950) 178 F. (2d) 785, which held that a gift in trust for the benefit of a person 20 years and 9 months of age was a future interest because the income was not required to be paid out until the beneficiary attained 21.


\(^\text{26}\) The value of the income interest is computed on the basis of its duration until the beneficiary attains 25 and not on the life expectancy of the beneficiary even though he will continue presumably to receive the income after the outright distribution of principal to him. *Fisher v. Commissioner*, (9th Cir. 1942) 132 F. (2d) 383.
ment provided that the first payment of income were to be made on December 31, 1953, the entire gift would be a future interest. Yet if the trust instrument were altered to provide that the first payment of income should be made on December 31, 1952, not only would the first payment (for the current year) be a present interest, but in addition the second payment, on December 31, 1953, would be transformed into a present interest. If the trust instrument were further altered to provide that in addition to the income payments at the end of the years 1952 and 1953, one-half of the principal were to be paid out on July 1, 1954, it is equally clear that the payment of principal in 1954 would be classified as a future interest. The payment of income in 1953 qualifies as a present interest because it is part of an unbroken series of income payments which starts presently even though it embraces payments which will not be made within the current income period. Yet from any logical viewpoint, the second payment of income, in 1953, is no more a present interest than is the payment of principal in 1954. Perhaps the answer should be that all payments in the future, whether of income or principal, are future interests. Such answer would have at least the virtue of logical consistency. The accepted answer, although not quite so harsh on donors, sacrifices both logic and simplicity.

A related absurdity is the fact that the value of the present interest often increases as the beneficiary's interest in the trust estate decreases. Suppose, for example, that the trust instrument provides that income is to be paid to the beneficiary for five years and at the end of five years the principal is to be distributed outright to the beneficiary. A gift to such a trust would be a present interest to the extent of the present value of the income for five years. The exclusion, accordingly, would be limited to that amount. If, however, the income were to be paid to the beneficiary for his lifetime and at his death the principal distributed to designated remaindermen, the value of the present interest would be the present value of the income for the period corresponding to the beneficiary's life expectancy. In the latter case the gift tax ex-

27 Cases cited in note 12 supra.
28 Cases cited in note 25 supra.
29 It would also have the blessing of Judge Wyzanski who, in his very discerning opinion in Charles v. Hassett, (D.C. Mass. 1942) 43 F. Supp. 432, pointed out the inconsistency and expressed his preference for the conclusion that all future payments should be future interests.
30 Fisher v. Commissioner, (9th Cir. 1942) 132 F. (2d) 383; Charles v. Hassett, (D.C. Mass. 1942) 43 F. Supp. 432. Even if the remainder had to be distributed to the income beneficiary or his estate, it still would not qualify for the exclusion.
clusion might be many times greater than in the first case, despite the fact that the beneficiary in the latter case received something of less value.  

3. Power to invade principal. Suppose a transfer in trust which provides that income must be distributed annually to the beneficiary for twenty years, at the end of which time the trust is to terminate and the principal is to be distributed outright to the beneficiary. We have seen that such transfer would give rise to an exclusion to the extent of the present value of the income for a twenty-year period. Suppose, however, that in addition to the above provisions, the trustee has the power to distribute to the beneficiary from time to time such amounts of principal as the trustee deems necessary or appropriate for the beneficiary's health, support, comfort and maintenance. The possibility that the beneficiary may receive some or all of the principal prior to the expiration of twenty years is of course a future interest. Accordingly, few lawyers would expect the value of the present interest in income to be increased by the added provision for principal invasions. On the other hand, without the benefit of recent cases, few lawyers would expect that the addition of a power to invade principal would defeat the exclusion otherwise obtainable to the extent of the present interest in income. Yet the latter result seems to be clearly established.

The development of the rule has not been free of substantial doubt. As late as 1947, a memorandum decision of the Tax Court allowed an exclusion for the present value of an income interest despite the existence of a discretionary power to invade principal for the benefit of the income beneficiaries. And as late as 1949, the government conceded, under similar facts, the availability of an exclusion to the extent of the income interest. However, as early as 1943 the Tax Court held that where the income was required to be paid out at the inception of the trust but where the trustees had the power to sell the real estate forming the corpus of the trust and thereafter to distribute the

32 A power in the trustee to invade principal, whether subject to a broad or limited standard or to no standard at all, is wisely considered by most draftsmen to be one of the most essential attributes of a good trust instrument.
33 "... the right to receive principal through the power of the trustees to invade it is future interest..." Kniep v. Commissioner, (8th Cir. 1949) 172 F. (2d) 755 at 757.
35 Louise L. McCoy, 6 T.C.M. 1097 (1947).
36 Jesse S. Phillips, 12 T.C. 216 (1949).
income and principal in their (the trustees') discretion, the present interest was incapable of valuation because the right to the income had no definite life. Accordingly, no exclusion was allowed.\(^{37}\) A year later the Tax Court disallowed the exclusion in a case where the trustee could distribute principal to the income beneficiary or to the beneficiary's son.\(^{38}\) Both of these cases, however, although anticipating the present rule, were distinguishable from our hypothetical case. In the first of the two cases, the beneficiaries' unqualified right to income would be extinguished by the subsequent sale of the corpus of the trust, whereas in our hypothetical case, the beneficiary would presumably receive the income on any principal distributed outright to him. In the second of the two cases, the principal could be distributed to someone other than the income beneficiary,\(^{39}\) in which event the income beneficiary would be deprived of both income and principal, whereas in our hypothetical case the exercise of the power to invade principal would result in the income beneficiary receiving the principal as well as the income.

As a result of three recent cases, however, the rule seems clearly to be that a power to invade principal will eliminate any exclusion even though the principal must be distributed to the income beneficiary.\(^{40}\) In \textit{Kniep v. Commissioner},\(^{41}\) a gift was made in trust, providing for the equal distribution of the income to six beneficiaries until each attained sixty years of age at which time a proportionate part of the principal was to be distributed outright. In addition, the trustee had the discretionary power to invade principal but not in excess of $1,000 per year for each beneficiary. Any principal invasion was to be considered an advance on the principal ultimately distributable to such beneficiary, but was not to affect his right to equal income distributions in the interim. Both the Tax Court\(^{42}\) and the Court of Appeals for the Eighth Circuit held that the value of the income interest must be computed on the assumption that the maximum invasions, $6,000 per year, would be made. If, however, principal invasions solely for the benefit of the income beneficiary do not decrease the value of the present interest, the court should have held (if the question was raised) that the value

\(^{38}\) Margaret A. C. Riter, 3 T.C. 301 (1944).
\(^{39}\) A similar element was present in Andrew Geller, 9 T.C. 484 (1947).
\(^{40}\) Kniep v. Commissioner, (8th Cir. 1949) 172 F. (2d) 755; Evans v. Commissioner, (3d Cir. 1952) 52-2 U.S.T.C., ¶10,862.
\(^{41}\) (8th Cir. 1949) 172 F. (2d) 755.
\(^{42}\) William Harry Kniep, 9 T.C. 943 (1947).
of the present interest must be computed on the assumption that principal invasions of $5,000 would be made. This is so because the most that any one beneficiary could be deprived of each year was his proportionate share of the income on $5,000 of principal. Since the court assumed a decline in principal of $6,000 per year, instead of $5,000, the decision perhaps stands for the proposition that the value of a beneficiary's income right must be reduced on account of principal invasions which may be made solely to him.43

In *Evans v. Commissioner*,44 the taxpayer made a gift in trust for the equal benefit of each of six children. The trust instrument directed the trustee to distribute the income of each beneficiary's share to the respective beneficiary for life. In addition, the trustee could distribute to the beneficiary such amounts of principal as the trustee deemed necessary for the education, comfort and support of the beneficiary or his spouse or children. The Court of Appeals for the Third Circuit held that the present interest in income was incapable of valuation because the corpus of the trust could be exhausted at any time and therefore disallowed any exclusion. In the course of its opinion the court made it clear that the fact that payments of principal could be made only to the income beneficiary was unimportant since the difficulty was one of valuing the income interest.

The taxpayer in the *Evans* case argued that the distribution of principal to the income beneficiary, pursuant to the trustee's discretionary power of invasion, would not cut down the beneficiary's interest but rather would augment his beneficial interest in the gift. Although the court denied the availability of the exclusion, it is not likely that it disagreed with the taxpayer's premise that the presence of a power of invasion which can be exercised only for the income beneficiary augments the beneficiary's interest in the subject of the gift. The beneficiary's interest is augmented, however, only because the power to invade principal makes possible the receipt of principal in the future—a future interest—and thereby makes impossible the determination of the amount of future income payments—the only present interest. If we start with the rule that the income interest must be computed separately from the principal interest, the result obtained

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43 The Kniep case is weak authority for this proposition, however, because the opinion does not indicate that the question of whether the decline in principal should be $5,000 or $6,000 was in issue.

44 (3d Cir. 1952) 52-2 U.S.T.C. ¶10,862.
in the *Evans* case is perhaps inevitable.\(^\text{45}\) Disallowing the exclusion, however, on a ground which means a greater beneficial interest was given to the donee, seems to be nothing short of absurd.

4. **Power to pay debts and incumbrances out of income.** In order for the donor to obtain the gift tax exclusion, the beneficiary of a gift in trust must have the right to the immediate enjoyment of an ascertainable portion of the trust income *for life or for a certain number of years*. Suppose that the trust instrument authorizes the trustee to borrow and permits, either expressly or impliedly, the trustee to repay the debt out of income. Can the government successfully argue that the duration of the beneficiary’s right to the income is uncertain and that therefore the present interest in the income cannot be valued? Although no case has unequivocally so held, the government would very likely prevail with this argument.

In *Bristol v. Welch*\(^\text{46}\) the taxpayer created a funded life insurance trust which provided that any income not used for payment of insurance premiums, and for taxes and liens on real estate, was to be distributed to the beneficiaries. In subsequent years, the taxpayer made additional gifts of insurance policies and encumbered real estate to the trust. The district court held that the subsequent gifts were gifts of future interests and stated:

> "Such a power [to pay premiums on insurance policies out of income] vested in the trustees is not compatible with the existence of a present interest . . . . Further, . . . the trust agreement allowed the trustees before computing the net distributable income to pay off any taxes and liens due or to become due on the real estate. *This power must be considered in conjunction with the right of the trustees to add property to the trust.*"\(^\text{47}\)

It is quite likely that, in the *Bristol* case, the immediate premium charges plus the amortizing payments on encumbrances existing at the time of the gifts were at least as great as the currently available income and that therefore no income was immediately distributable to the beneficiaries. If that was indeed the fact, the *Bristol* case falls in the same category as the cases disallowing the exclusion because the

\(^{45}\) It is interesting to note that the Court of Appeals for the Third Circuit relied, for its decision in the *Evans* case, not on the Kniep case, but on the cases of Sensenbrenner *v.* Commissioner, (7th Cir. 1943) 134 F. (2d) 883 and Fisher *v.* Commissioner, (9th Cir. 1942) 132 F. (2d) 383, which held that the principal interest must be valued separately from the income interest.


\(^{47}\) Id. at 678. Italics added.
income was to be accumulated and added to principal. The emphasized portions of the quotation from the opinion indicate, however, that the bare power to divert income in the future from the immediate use of the beneficiaries in order to build up the corpus of the trust is incompatible with a present interest.

In *Howe v. Commissioner* the taxpayer conveyed real estate in trust for his seven children, giving the trustee broad powers to improve, subdivide and sell the land. Any income not needed to create a reserve for taxes and other obligations was to be distributed to the beneficiaries. The Court of Appeals for the Seventh Circuit held that a future interest was created to the full extent of the property transferred, relying on the facts that (1) the beneficiaries had no right to the income because the trustee could use it for improving the land and (2) the trustee had broad discretionary powers to create a reserve out of income. Thus, the court's refusal to allow an exclusion was based, at least in part, on the power of the trustee to use the income in the future in such a way as to deprive the beneficiaries temporarily of its enjoyment.

In the *Bristol* case, there was probably an immediate requirement that the income, in effect, be accumulated. In the *Howe* case the circumstances indicated that accumulation was the immediate and primary purpose of the trust. In both the *Bristol* and *Howe* cases, it is probable that no present interest was ever created since there may have been no income available for the beneficiaries even at the inception of the trust. In our hypothetical case, a present interest is created because the income is currently payable to the beneficiary. It is impossible, however, to value that present interest since the trustee can at any time terminate the beneficiary's right to the income simply by borrowing money and repaying such loan out of income. Thus, no convincing distinction can be drawn between the *Evans* case, in which the trustee could terminate the steady flow of income to the beneficiary by distributing principal to him and our hypothetical case, where the trustee has a like power by borrowing money. The valuation of the present interest would seem to be equally impossible in both cases since the duration of the present interest is entirely conjectural.

5. *Spendthrift clause.* Most trust draftsmen usually prefer to include in the trust instrument a provision commonly referred to as a

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49 (7th Cir. 1944) 142 F. (2d) 310, cert. den. 324 U.S. 841 (1945).
50 The same factor was present in Mary R. Nelson, 46 B.T.A. 653 (1942).
“spendthrift clause.” The purpose of the spendthrift clause is to prohibit the voluntary assignment by the beneficiary, or the forced assignment by some type of creditors’ process, of the income or principal of the trust while it is still in the hands of the trustee. The restrictive type of spendthrift clause simply prohibits the beneficiary from assigning his interest by way of anticipation and purports to make such interest free of execution by creditors. The more complex forfeiture type of spendthrift clause goes on to provide that in case of attempted alienation or execution all interest of the beneficiary in the trust shall cease, but usually adds that in such event the trustee may in his discretion pay out income and/or principal to or for the benefit of the former beneficiary.

Despite the fact that no case has squarely so held, it is fairly clear that the restrictive type of spendthrift clause will not prevent an exclusion for a present income interest. The restriction on the beneficiary or his creditors to assign his rights to future income or principal in no wise impairs the guarantee that he will receive the current income for life or a stated number of years. Indeed, the restriction increases the assurance that he will receive such income. Accordingly, the restrictive type spendthrift clause can be used without fear of endangering the allowance of the exclusion.

The use of the forfeiture type of clause, however, raises some doubt. If the beneficiary, or his creditors, attempt any of the prohibited acts, the beneficiary’s right to the income ceases; any subsequent receipt of income by him through the exercise by the trustee of his discretion to distribute income in spite of the forfeiture will not be by way of a present interest. Thus, the beneficiary’s right to the income is of indeterminate duration and accordingly, so the argument would go, the present interest is incapable of valuation.

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51 For an authoritative discussion of the spendthrift trust, its effect and its validity in various jurisdictions, see Griswold, Spendthrift Trusts, 2d ed. (1947).
52 Although the forfeiture clause does not create a true spendthrift trust, its purpose and effect are substantially the same. For the sake of convenience, the forfeiture clause will be referred to in this article as a type of spendthrift clause. Where the validity of the restrictive type clause is doubtful, the forfeiture type clause is the only safe spendthrift provision. See Griswold, Spendthrift Trusts, 2d ed., §§ 12 and 574 (1947).
53 In Charles v. Hassett, (D.C. Mass. 1942) 43 F. Supp. 432, the court stated that the presence of a spendthrift clause was irrelevant to the exclusion question. In at least three cases, a restrictive type spendthrift clause was contained in the trust instrument but was ignored in the opinion. The Commissioner, however, may not have raised the question. Fisher v. Commissioner, (9th Cir. 1942) 132 F. (2d) 383; Smith v. Commissioner, (8th Cir. 1942) 131 F. (2d) 254; Hutchings v. Commissioner, (5th Cir. 1944) 141 F. (2d) 422.
It is impossible to state with any reasonable assurance whether the courts would or would not accept this argument if it were urged by the Commissioner. Unlike the situation where the trustee has the discretionary power to invade principal or to borrow money, the use of the forfeiture type spendthrift clause does not give the 

*trustee* the discretionary power to terminate the beneficiary's present income interest. Indeed, to the extent that the invoking of the spendthrift clause is dependent on the beneficiary's voluntary act, the beneficiary himself has the power to determine whether his present income interest will be terminated. And even to the extent that the invoking of the clause is dependent on the acts of the beneficiary's creditor, the beneficiary nevertheless may have a large measure of control.

On the other hand, we have no assurance that control in the beneficiary is a relevant factor in valuing the present income interest. Consider, for example, a gift in trust providing for the distribution of income to the beneficiary for twenty years, with the added provision that at any time after the expiration of ten years the 

*beneficiary* may terminate the trust and receive the principal outright. We may guess that despite the complete control in the beneficiary to permit the trust to last for twenty years the present income interest would be valued on the basis of its duration for ten years.

6. **Power to acquire non-productive property.** Most modern trust agreements provide that the trustee shall have broad powers of sale and investment without regard to the rules of equity or chancery courts. So broad a power will usually include the power to acquire non-productive property. Can it not be argued, however, that a power in the trustee to make the trust non-income-producing makes the valuation of the present income interest impossible?

Ordinarily, the value of a present income interest is computed on the basis of a hypothetical annuity of three and one-half per cent per annum,\(^5\) even though the *amount* of income that will be received cannot be forecast with any reasonable degree of accuracy.\(^5\) Although it would thus appear that a power in the trustee to convert the trust corpus to non-income-producing property is thereby tacitly approved, it may be that the three and one-half per cent valuation rule is appli-

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\(^5\) U.S. Treas. Reg. 108, §86.19, as amended by T.D. 5902 on May 27, 1952. For gifts made prior to January 1, 1952, a factor of 4 per cent is used. Id.

\(^5\) Commissioner v. Lowden, (7th Cir. 1942) 131 F. (2d) 127; Pauline W. Tidemann, 1 T.C. 968 (1943).
cable only when the receipt of at least some amount of income can be reasonably predicted.

The cases bearing most closely on this question are divided. In Commissioner v. Kempner, the Court of Appeals for the Fifth Circuit, relying solely on the dispositive provisions of the trust instrument, allowed an exclusion despite the fact that the corpus of the trust was non-interest bearing notes. If the Kempner case is correct in holding that the exclusion is available even though the very subject of the gift in trust was non-productive property, then it should of course follow that a mere power in the trustee to convert productive property to non-productive property will not preclude obtaining the exclusion.

However, in Elizabeth H. Polk, the Tax Court denied an exclusion for a gift in trust, stating:

"The record establishes that the trust corpus had a market value of $9,000, but there is no evidence that the right to receive the trust income had any value. . . . Furthermore, it may be noted that the record shows that from 1928 until the date of trial in this proceeding only one dividend had been paid on the . . . stock and no dividends had been paid since the creation of the trust. The taxpayer has not sustained her burden of proving that the gift of income had value and the amount thereof."

If the Polk case is correct in holding that an exclusion cannot be obtained when the gift in trust is of non-productive property, it should logically follow that a power in the trustee to convert productive property to non-productive property precludes obtaining the exclusion. Surely the possibility that the trustee will exercise such power, and thereby terminate the present income interest, is substantial enough to make the valuation of the present interest impossible.

**DRAFTING REMEDIES**

It is entirely possible for the trust draftsman to draft a trust which would eliminate all of the pitfalls discussed above. Thus, he could

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56 (5th Cir. 1942) 126 F. (2d) 853.

57 In John M. Smyth, 2 T.C.M. 4 at 6 (1943), the Tax Court stated: "The fact that the properties produced no income is not determinative. The question is the right to receive the income if produced."

The court nevertheless denied the exclusion, relying partly on the fact that the rental value of the trusteed real estate was not shown. It is impossible to weigh intelligently the effect of the Smyth case on this question.

58 2 T.C.M. 357 (1946).

59 Id. at 359. The weight of the opinion is somewhat lessened by the fact that the same result might have been reached on other grounds. Accord: Jesse S. Phillips, 12 T.C. 216 (1949). See Commissioner v. Boeing, (5th Cir. 1941) 123 F. (2d) 86; Andrew Geller, 9 T.C. 484 (1947).
avoid the pitfalls of the power to accumulate income and the discretionary power to distribute or withhold income simply by making it mandatory that the income be distributed currently. He could avoid the power to invade principal pitfall simply by eliminating it. He could avoid the pitfall created by a power to repay loans out of income by not giving the trustee such power or by expressly requiring that any such repayment be made out of principal. He could avoid any doubts as to the effect of the spendthrift clause on the availability of the exclusion simply by eliminating it or by using the restrictive type clause and, in jurisdictions where the validity of such clause is in doubt, taking the calculated risk that an effective spendthrift trust is thereby created. The broad investment power pitfall could be avoided by limiting the trustee’s power of investment to productive property. These simple and obvious remedies are clearly available.

Drafting a trust, however, which contains none of the pitfalls would be, in almost every conceivable case, extremely unwise from every standpoint except gift tax saving. Many of those pitfalls are occasioned by the use of trust provisions that are important, and often essential, in most situations which call for the use of the trust device. Sacrificing any one of those provisions for the tax saving which might be effected would be a drastic and usually unwise step. When we consider further that even after making such a sacrifice, the remainder interest would still not qualify for the exclusion, the lure of tax saving becomes even more senseless.

The desire to avoid taxes being what it is, however, it is not surprising that the ingenuity of lawyers has been called upon to draft a trust which would retain the conventional trust safeguards while at the same time obtain the annual gift tax exclusion. Indeed, several cases have involved trusts which have accomplished the seemingly impossible task of obtaining the exclusion for the \textit{full value} of the property transferred without sacrificing many of the traditional trust safeguards.

In \textit{Strekalovsky v. Delaney}, a gift was made in trust for the benefit of three minor children. As each child attained the age of twenty-one he was to receive his share of the trust estate outright. Until such time, the trustee could pay any part of the child’s share to or for the benefit of the child for any purpose whatsoever “in accordance with
the needs and best interest of said child, as if the interest of each said child were held by the trustee herein as guardian for said child and as if the trustee were making payments and distributions in that capacity for the benefit of each child respectively.”

Ordinarily, giving the trustee discretionary power over income or principal, even though subject to an enforceable standard, precludes the allowance of any exclusion. The district court in the Strekalovsky case held, however, that an exclusion should be allowed for the full value of the gift, relying on the fact that the trust instrument clearly disclosed the donor's intention to give the beneficiaries the same interest they would have obtained by an outright gift.

Even though the standards regulating the trustee's exercise of discretion in Strekalovsky were the same standards imposed by law on a legal guardian for a minor child, the rationale of the court seems to be clearly wrong. If the trust had not analogized the trustee's function to that of a guardian but instead had recited the identical standards which guided legal guardians under local law, the gift clearly would have been a future interest. The fact is that by the terms of the trust instrument itself the beneficiaries were not entitled to the immediate use or enjoyment of the income or principal. Reliance on the Strekalovsky case and the similar case of Cannon v. Robertson would be dangerous.

A far more interesting possibility was disclosed in Kieckhefer v. Commissioner. In that case, a gift was made in trust for the benefit of a one-month-old beneficiary. The trustee was given the discretionary power to distribute income or principal for the education, comfort and support of the beneficiary and was directed to accumulate any

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61 Cases cited in notes 14 and 15 supra.
62 The same result was obtained on substantially similar facts in Cannon v. Robertson, (D.C. N.C. 1951) 98 F. Supp. 331.
63 The trust instrument also contained a provision giving the legal guardian of each beneficiary the right to terminate the trust as to the beneficiary's share. This provision, entirely ignored by the court, may make the decision right (see infra page 637), but leaves the opinion nevertheless wrong. No such provision appeared in Cannon v. Robertson, supra note 62.
64 Cases cited in note 14 supra.
67 (7th Cir. 1951) 189 F. (2d) 118; noted, 65 Harv. L. Rev. 703 (1952); 46 Ill. L. Rev. 636 (1951).
income not so expended. The trust was to terminate when the beneficiary attained twenty-one years of age. In the interim, the beneficiary or his legally appointed guardian had the right at any time to draw down all or any part of the trust estate. No guardian was ever appointed for the beneficiary.

Clearly the trust would have given rise to a future interest but for the presence of the power in the beneficiary or his guardian to draw down the corpus. The Tax Court felt that the power of termination did not change the result otherwise obtained because it was absurd to expect the infant beneficiary to exercise the power and no guardian was appointed who could exercise the power for him. Accordingly the Tax Court denied the exclusion. The Court of Appeals for the Seventh Circuit, however, reversed the Tax Court and allowed the exclusion on the full value of the property transferred, relying on the fact that the infant beneficiary had the unqualified right to draw down the corpus and any barrier that existed to his exercise of that right was a barrier imposed by law and not by the donor.

The Tax Court and the Second Circuit, however, have refused to follow the decision of the Seventh Circuit in the Kieckhefer case. In Stifel v. Commissioner, the facts were substantially the same as the facts in the Kieckhefer case except that instead of one beneficiary one month old there were three separate trusts for three beneficiaries, aged four, seven and eleven, respectively. Also, there was some doubt, from a reading of the trust instrument in Stifel, whether the minor beneficiaries had the right to demand trust corpus or whether their guardians alone could make such demand. (As in Kieckhefer, no guardian was appointed.) The Court of Appeals for the Second Circuit resolved this doubt in favor of the taxpayer by assuming that the trust instrument gave the minor beneficiaries directly, as well as their guardians, the right to terminate the trusts. Nevertheless both the Tax Court and the Second Circuit held that the gifts made to such trusts were gifts of future interests.

The Tax Court reasoned that there was no guardian in existence who could exercise the right to terminate the trusts and, in addition, the donor must have anticipated that a substantial period of time would

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69 (2d Cir. 1952) 52-1 U.S.T.C., ¶10,855, affirming 17 T.C. 647 (1951).
elapse before any occasion arose for terminating the trust. Under these circumstances, concluded the court, "His [the donor's] real intent as shown by the instrument and the surrounding circumstances controls." It is difficult to accept this reasoning by the Tax Court. Surely the determination of whether or not a present interest has been created must depend upon an analysis of the exact interest that was actually given, and not upon whether the donor anticipated that the donated interest would be fully used by the beneficiary.

The Court of Appeals for the Second Circuit based its affirmance of Stifel, not on the subjective intent of the donor, but on an inquiry into the capacity of the minor beneficiaries to exercise their right of termination. Since, the court reasoned, no guardian was in existence who could exercise such right for the beneficiaries and since the minor beneficiaries themselves could not exercise such right, the gift was one of a future interest.

A critical appraisal of the Kieckhefer and Stifel cases requires that we first determine whether an outright gift to a minor qualifies as a present interest. If it does not, then it would necessarily follow that a right in a minor beneficiary of a trust to terminate the trust and thereby to acquire outright ownership could not give rise to a present interest. If, however, an outright gift to a minor does qualify as a present interest, then a right of termination in a minor beneficiary of a trust might or might not give rise to a present interest, depending perhaps upon whether such right of termination in a minor can be equated with outright ownership.

In recent years the argument has been advanced that no gift to a minor, whether outright to him, to a guardian for him, or in trust for his benefit, can qualify for the annual gift tax exclusion. The argument, very briefly, is that since the minor is disabled, either by his extreme youth or by legal restrictions, from exercising actual physical dominion over the subject of the gift, and since a gift to a guardian

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70 17 T.C. 647 at 650 (1951).
71 See note, 7 Tax L. Rev. 500 (1952). This same erroneous use of the donor's state of mind was made by a district court in Strekalovsky v. Delaney, (D.C. Mass. 1948) 78 F. Supp. 556, in holding that a present interest was created. See pages 635-636 supra.
72 The court suggested that the guardian might be appointed by the trust instrument itself. It is doubtful, however, whether the laws of most states would recognize the appointment of a guardian by so informal a process.
73 Fleming, "Gifts for the Benefit of Minors," 49 Mich. L. Rev. 529 (1951); see, also, notes: 7 Tax L. Rev. 84 and 89 (1951); 7 Tax L. Rev. 500 (1952).
or a trustee necessarily means that actual physical dominion over the subject of the gift will be postponed, every gift to or for the benefit of a minor is a gift of a future interest. The argument, although interesting, seems clearly to be rebutted by the cases. At least two cases have held that an outright gift to a minor gave rise to a present interest, even though no guardian had been appointed for the donee. In addition, several cases have held that a direction to pay income to or for the benefit of the trust beneficiary gave rise to a present interest in income even though the trust beneficiary was a minor. It is not likely that these authorities will be overruled.

There can be little question, also, but that an unqualified right to acquire outright ownership will ordinarily be equated for tax purposes with outright ownership. If, for example, an adult beneficiary of a trust were to have the unqualified right to terminate the trust and acquire outright ownership of the corpus, even the Second Circuit would apparently agree that a gift to such a trust would give rise to a present interest. Does the minority of the beneficiary, however, so qualify the right of termination that a different result should obtain?

The Court of Appeals for the Second Circuit, in Stifel, apparently felt that the right of termination, although unqualified by the terms of the trust instrument, was nevertheless qualified by the fact that a minor is incapable of exercising such a right. The court’s apparent assumption, however, that a minor is incapable of exercising a power of termination is difficult to understand. Did it mean that state law would prohibit a minor’s exercise of such right? Did it mean that a court would not compel a trustee to honor a minor’s request for termination of the trust? Or did the court mean that a minor was physically and mentally incapable of performing the necessary acts?

It is extremely doubtful that the law of any state prohibits a minor beneficiary from exercising a power of termination expressly granted to him by the terms of the trust. Ordinarily the so-called “disabilities”

74 Charles F. Roesser, 2 T.C. 298 (1943); John E. Daniels, 10 T.C.M. 147 (1951).
75 Commissioner v. Sharp, (9th Cir. 1946) 153 F. (2d) 163; Fisher v. Commissioner, (9th Cir. 1942) 132 F. (2d) 383; Jesse S. Phillips, 12 T.C. 216 (1949); Louise L. McCoy, 6 T.C.M. 1097 (1947). The issue of the income beneficiary’s minority, however, was probably not raised by the Commissioner. See Frances M. Rassas, 17 T.C. 160 (1951), affd. (7th Cir. 1952) 196 F. (2d) 611.
76 “If an adult had been the beneficiary of each of these trusts, of course the gifts would not have been of future interests...” Stifel v. Commissioner, (2d Cir. 1952) 52-1 U.S.T.C., ¶10,855.
of minority are not really disabilities at all but rather are privileges. Thus, under certain circumstances a person may disaffirm purchases, sales, and contractual obligations made by him while a minor. Although the law may thus cast an onerous burden on the parties with whom a minor deals, it rarely prevents the minor from acting. It is difficult to believe that the Court of Appeals for the Second Circuit, in the Stifel case, was thinking in terms of an imagined legal disability on the part of the minor.

If a minor is under no legal disability to act, and if the trust instrument gives the trustee no discretionary authority to refuse to honor the beneficiary's request for termination, it would seem inevitably to follow that a court would compel compliance by the trustee. Suppose, however, that the beneficiary exercising such power is two years of age, barely old enough to voice his request and surely too young to appreciate the consequences of his request. Would a court nevertheless compel compliance by the trustee? If an affirmative answer seems ridiculous, suppose further that the trust instrument was very explicit that the trustee must honor any request for termination, regardless of the age of the beneficiary and regardless of the probable consequences. On what possible basis could a court then refuse to compel compliance? Or suppose, as the other extreme, that the beneficiary possessing the power was twenty years and eleven months of age. Is it even conceivable that a court would refuse to enforce the clear command of the trust instrument on the ground that the beneficiary was one month too young? It is difficult to interpret the broad language of the Second Circuit as indicating that the court was thinking in terms of a state court's probable action in this kind of situation.

It is likely that the court based its decision on the assumed physical and mental incapacity of the minor beneficiaries to perform the acts necessary to effect a termination of the trust.\footnote{Such, at any rate, was apparently the view of the Tax Court in John W. Kieckhefer, 15 T.C. 111 (1950).} If so, it may be doubted whether an eleven-year-old, or even a seven-year-old, child might not have sufficient ability to form a desire to acquire the trust corpus and to make an effective demand upon the trustee. In any event, the apparent rationale of the court's decision should require that in each case where a minor beneficiary has a power to terminate the
trust the court must inquire into the intelligence of the minor beneficiary. The practical difficulty of administering such a rule, and the open invitation to controversy and litigation that it affords, are sufficient reasons alone to make the Stifel decision undesirable.

It must of course be conceded that a child who has not attained a certain minimum level of intelligence will not and, indeed, cannot himself obtain the actual physical use and possession of any part of the trust corpus. If so personal a dominion by the beneficiary over the trust corpus is required, then the result in the Stifel case may be correct. There is no convincing reason, however, for narrowing the concept of present interest to mean actual physical dominion. Just as outright ownership of property by a minor qualifies as a present interest despite the fact that the minor's effective dominion over the property depends upon his having attained a certain minimum level of intelligence, so also the rule should be that if a minor has the unqualified right to draw down the trust corpus and the only barrier to his exercise of that right is a barrier imposed by the beneficiary's tender age, but not by the terms of the donor's gift, then the gift is one of a present interest.

What, then, is the present status of the "Kieckhefer clause"? First of all, it is clear that the Kieckhefer clause will give rise to a present interest if the beneficiary of the trust is an adult. Also, the Stifel case suggests that the Kieckhefer clause would have given rise to a present interest despite the minority of the beneficiaries if a guardian who was not under the control of the donor had been appointed. Where the beneficiary of the trust is a minor, however, and a guardian for such beneficiary is not in existence at the time the gift in trust is made, the use of the Kieckhefer clause in order to qualify gifts in trust for the annual gift tax exclusion will entail a very definite risk.

78 The court might properly have inquired whether one or more of the beneficiaries, aged four, seven and eleven, respectively, had attained that minimum level of intelligence.

79 Judging from present analogous authority, the court's suggestion seems eminently sound. An outright gift to a minor through his legal guardian probably gives rise to an exclusion. Commissioner v. Sharp, (9th Cir. 1946) 153 F. (2d) 163; Edward J. Kelly, 1952 CCH T.C. Rep., Dec. No. 19,241. See Strekalovsky v. Delaney, (D.C. Mass. 1948) 78 F. Supp. 556; John E. Daniels, 10 T.C.M. 147 (1951). If the exercise of ownership rights by a legal guardian is imputed to the minor ward for the purpose of obtaining an exclusion on an outright gift, it should follow that the present power of an existing legal guardian to exercise a minor's right of termination be considered the minor's power for the purpose of obtaining an exclusion on a gift in trust.
Nevertheless, one may hazard the guess that many trust draftsmen are using the Kieckhefer clause despite the uncertainty as to its effectiveness. The benefits that may be obtained if the Kieckhefer clause is eventually upheld are a strong temptation to tax-conscious donors. Thus, by using the Kieckhefer clause, the full value of a gift in trust may qualify for the exclusion even though the income will be accumulated or distributed in the trustee's discretion (except as the Kieckhefer clause may be invoked), even though the trustee may invade principal in his discretion, and even though the trustee is given very broad powers to borrow and repay such debt out of income, and to sell productive property and to invest in non-productive property.\(^8^0\)

Indeed, one may venture the second guess that the Kieckhefer clause may be used indiscriminately and without adequate consideration of its full implications. The donor and the draftsman alike must recognize that giving the beneficiary a power to terminate the trust may subvert every purpose, other than gift tax saving, that the donor may have for using the trust device. The indiscriminate use of the Kieckhefer clause may often result in the beneficiary having a complete command of the entire trust property in a situation where the donor might more wisely protect the beneficiary from himself.\(^8^1\)

A second caveat to the use of the Kieckhefer clause is the fact that the unlimited power in the beneficiary to terminate the trust constitutes a taxable power of appointment for federal estate tax purposes.\(^8^2\) Even if the beneficiary does not exercise the power, the trust corpus will be includible in his taxable estate if he should die during the term of the trust.\(^8^3\)

In order to avoid the possibility of the entire corpus of the trust being includible in the taxable estate of the beneficiary and in order to lessen the temptation to the beneficiary to exercise the power of termination, the power of termination should be limited to the amount

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\(^{80}\) The cautious draftsman may refrain, however, from qualifying the Kieckhefer clause by any type of spendthrift clause. If the spendthrift clause were an effective qualification of the Kieckhefer clause, the Commissioner might argue that the beneficiary's command over the trust property was thereby fettered and accordingly the exclusion was unavailable.


\(^{82}\) I.R.C., §§811(f)(2) and (3).

\(^{83}\) Even in the absence of a Kieckhefer clause, the trust corpus will be includible in the beneficiary's taxable estate if the corpus is payable to his estate at his death. I.R.C., §811(a); see Estate of Kinney v. Commissioner, (9th Cir. 1935) 80 F. (2d) 568.
of the gift made to the trust during the calendar year in which the termination power is exercised. With such a limited termination power, the beneficiary at his death would have no power of appointment over property given to the trust in prior years. Also, if the beneficiary’s only reward for exercising his power of termination is the amount of the current gift, he may well persuade himself to abide by the donor’s plan.

Such a limited Kieckhefer clause might be the magic formula so long sought by many estate planners. It must be pointed out, however, that the failure of the beneficiary or his guardian to exercise his power to draw down the current-year gift, with the consequent loss of that power as to the particular gift, may constitute a “lapse of a power of appointment” within the meaning of sections 811(f)(5) and 1000(c)(5) of the Internal Revenue Code. Under those sections of the Internal Revenue Code, a lapse of a power of appointment is equated with a release of such power to the extent that the property subject to the power exceeds the greater of $5,000 or 5 percent of the value of the assets out of which the exercise of the power could be satisfied. For gift tax purposes, a release of a power of appointment is considered a transfer of property by the individual possessing the power. For estate tax purposes, the release of a power of appointment makes the property subject to the power includible in the beneficiary’s taxable estate if the release is made by a “disposition which is of such nature that if it were a transfer of property owned by the . . . [beneficiary], such property would be includible in the . . . [beneficiary’s] gross estate under subsection . . . 811(c) or (d).” If the beneficiary dies during the term of the trust, the release would seem clearly to have been a disposition of such nature as to make the property includible in the beneficiary’s taxable estate, on the theory that the beneficiary made a transfer reserving the life interest.

84 Both sections were added to the Code in 1951.
85 I.R.C., §1000(c)(2). Presumably the transfer would be of a future interest, and therefore not subject to the benefit of the annual exclusion, if the ultimate recipient of the property subject to the lapsed power is the remainderman of a trust. Also, there is a question of the extent of the gift. For example, if the lapsing beneficiary is himself the beneficiary of a mandatory income distribution provision, then to the extent of his own income interest in the lapsed property he has made no gift.
86 I.R.C., §811(f)(2).
87 I.R.C., §811(c).
Briefly, then, if the annual gift to the limited Kieckhefer trust exceeds $5,000, the failure of the beneficiary to exercise his power of termination will almost certainly result in the beneficiary's incurring gift tax liability or cutting into his lifetime exemption, and is very likely to result in increased estate tax liability at the time of the beneficiary's death. Under the present status of the law the only certain method of avoiding lapsed power of appointment problems is for the donor to limit his gifts to the limited Kieckhefer trust to $5,000 per year.

Thus, although the Kieckhefer clause may turn out to be an important addition to the trust designed to obtain the gift tax exclusion, its use may result in the beneficiary having both a taxable power of appointment for estate tax purposes and, tax considerations aside, too extensive control over the trustee property. Perhaps its most effective use can be made by limiting the power of termination to the amount of the current gift. Where so limited, however, the donor should be cautioned to limit his gifts to the trust to $5,000 per year, else needless gift and estate tax liability may be unwittingly incurred.

A Proposed Legislative Remedy

The large volume of exclusion cases has produced a mass of pitfalls, technicalities and absurdities as an incident of the present interest requirements. Under the present status of the law, it is doubtful whether any gift in trust can obtain the benefit of the annual exclusion without sacrificing many of the salutary and necessary provisions of a well-drafted trust. Even if the Supreme Court should eventually give its approval to the Kieckhefer clause, its use will require a hyper-technical knowledge of tax pitfalls on the part of the trust draftsman. The ironic fact is that the entire present interest requirement is an unnecessary appendage to the gift tax law—seemingly adopted without adequate thought and retained through sheer inertia. It is an unnecessary appendage, not merely from the standpoint of donors (whose own private interests should not determine the incidence of the gift tax), but also from the broad standpoint of government fiscal need and desirability.

88 There are, as yet, no reported cases interpreting new §§811(f)(5) and 1000(c)(5) of the Internal Revenue Code.
The Committee Reports which accompanied the introduction of the present interest requirement explain the reason for that requirement as follows:

"The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts."\(^{90}\)

Admittedly, the problem anticipated by Congress was a real one. Suppose, for example, a gift in trust providing for the accumulation of income for ten years and providing further that after the expiration of ten years the trust estate be distributed equally among the donor's then living children. In this, and countless similar situations, there is no way of determining the number of donees, the value of each donee's gift and, consequently, the number and extent of the allowable exclusions. The resulting evil, absent some statutory corrective, might be that a donor could obtain several exclusions on what was essentially a gift to one donee. The future interest prohibition admittedly solves this problem. It does so, however, by imposing an unnecessarily broad restriction\(^{91}\) that either confines the trust draftsman to a drafting straitjacket or lures him to a distortion of the trust device.

The difficulty anticipated by Congress can be satisfactorily met without the ambiguous and unnecessarily harsh present interest requirement. It can be met by allowing the exclusion only to the extent of the minimum value of the interest of a living ascertained beneficiary, provided that such a minimum value is susceptible of actuarial determination. Such a modified requirement would avoid the necessity of speculating as to the number of donees, since that number would be limited to the number of donees who are actually in being and identified at the time of the gift. Similarly, no problem in valuation would exist since, in order to qualify for the exclusion, the gift would have to have a minimum value that could be actuarially computed. The particular virtue of the suggested "minimum value" test is that it would give the trust draftsman a degree of flexibility not now

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\(^{91}\) See Welch v. Paine, (1st Cir. 1941) 120 F. (2d) 141; Sensenbrenner v. Commissioner, (7th Cir. 1943) 134 F. (2d) 883; Commissioner v. Glos, (7th Cir. 1941) 123 F. (2d) 548.
available, while at the same time meet the difficulty anticipated by Congress.

The following illustrations will indicate how the minimum value test would be applied:

1. Suppose a gift in trust which provided that the income be paid to A for ten years and then the corpus be paid to A if living, otherwise to B or his estate, and A and B are persons in being at the time of the gift.

Under the minimum value test, an exclusion would be allowed to the extent of A's income interest plus A's contingent remainder and an exclusion would also be allowed to the extent of B's contingent remainder interest. The possibility that neither A nor B might come into the actual possession of the trust corpus is immaterial. It is sufficient, in order to meet the problem anticipated by Congress, that both A and B are in being at the time of the gift and receive interests in title (and not necessarily in enjoyment or possession) which are capable of actuarial valuation. Thus, the value of B's interest would not be diminished by the possibility that B's estate rather than B might take the remainder in possession.

2. Suppose the facts are the same as in illustration 1, except that during the term of A's income interest, the trustee has the discretionary power to invade principal for A's benefit.

The exclusion would be allowed to the extent of A's income interest (valued without regard to the power to invade principal) plus his contingent remainder, that being the minimum actuarial value of his interest. Although the power to invade principal for the benefit of A makes the valuation of his income interest impossible, the valuation of A's aggregate interest presents no problem under the suggested minimum value test, since the exercise of the power to invade principal would increase the value of A's interest in the principal in an amount more than offsetting the decreased income interest. The minimum value of A's combined interest in income and principal would remain the same. No exclusion, however, would be allowed to the extent of B's contingent remainder interest, since there is no way of actuarially computing its value.

3. Suppose the facts are the same as in illustration 1, except that during the term of A's income interest, the trustee has the discretionary power to invade principal for either or both of A and B.
No exclusion whatever would be allowed under the suggested mini­
mum value test because none of the interests thus created can be
actuarially valued. Since, however, the only evil at which the sug­
gested statute is directed is the possibility of obtaining more exclusions
than the number of donees warrants, it would be possible to modify the
minimum value requirement so as to permit an exclusion, or a partial
exclusion, even in this illustration. Thus, the statute might provide
that even though no single interest is created which can be actuarially
valued, where one or more of several living, ascertained persons must
eventually take, one exclusion will be allowed, limited, however, to
the smallest amount by which the donor has not obtained the full
exclusion on gifts to any of such possible beneficiaries during the same
year. For example, in our illustration, if the donor had made other
gifts during the same year totaling $1,000 to A and $2,000 to B, and
such gifts qualified for the exclusion, the donor (if he were unmarried)
would be allowed an exclusion of $1,000 on the hypothetical gift, that
being the smallest amount by which the donor had not obtained a full
exclusion on gifts to either A or B.

4. Suppose a gift in trust which provides that the income be
distributed to A or withheld from him in the trustee’s sole discre­
tion, but upon A’s attaining 30 years of age, the corpus and any
accumulated income be distributed to him; if A dies before attain­
ing 30 years of age, then to B or his estate. Both A and B are
living at the time of the gift.

An exclusion would be allowed to the extent of the value of A’s con­
tingent right to receive the income at age 30 (assuming for this pur­
pose that he will receive none of the income before that age) plus the
value of his contingent remainder interest in the corpus; an exclusion
would also be allowed to the extent of B’s contingent remainder interest
in the corpus (assuming for the purpose of valuing B’s interest, that
all of the income will have been currently distributed to A). Even
though the income might be withheld from A unless and until he
attained 30 years of age, the likelihood of his receiving such income at
age 30, A’s minimum income interest, can be actuarially valued. B’s
contingent interest in the income, however, cannot be so valued, and,
accordingly, such interest cannot increase the amount of the exclusion
otherwise obtainable on the gift to B.

The above examples indicate that the suggested minimum value
test would permit the trustee of a gift in trust to have considerable dis-
cretion as to income distributions and principal invasions without needlessly depriving the donor of the benefits of the gift tax exclusion. The suggested test does not, however, provide a remedy for the pitfalls which exist in the power to repay indebtedness out of income, the power to invest in non-productive property, and the forfeiture type spendthrift clause. The manner in which these latter pitfalls should be eliminated can be best explained by the following illustrations:

5. Suppose a gift in trust which provides that the income be paid to A for ten years and then the corpus be paid to A if living, otherwise to B or his estate and A and B are both living at the time of the gift. The trust instrument also provides, however, that the trustee shall have broad powers of investment and reinvestment, including the power to invest in non-productive property.

The exclusions should be allowed as in illustration 1, without regard to the trustee's broad power of investment. 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,\(^\text{92}\) the statute should make it clear that such valuation applies without regard to the fact that the gift property is non-productive or that the trust corpus may in the future become non-productive.\(^\text{93}\)

6. Suppose the facts are the same as in illustration 5, except that instead of having a broad power to invest in non-productive property, the trustee has the power to borrow and to repay the resulting indebtedness out of income.


\(^{93}\) It is recognized that the suggested disregard of the productiveness of the trust corpus could conceivably result in a situation where a donor receives two exclusions on what is essentially a gift to one donee. For example, suppose a gift of non-productive property in trust, income to A for ten years and then corpus to B or his estate, and the trust agreement or extrinsic circumstances indicate that the trust will never be productive. The situation is realistically no different from what it would be if there had been no intervening "gift" of income to A, yet in the illustration two exclusions would be allowed because of the arbitrary income factor of three and one-half per cent. It is extremely unlikely, however, that any donor would postpone the receipt of property by his intended donee or would compel the maintenance of unproductive property in an unproductive state simply to obtain the additional gift tax benefits which might result. The practical advantage of having a workable rule far outweighs the improbable "evil" outlined above.
This latter power should be treated as the equivalent of a discretional power in the trustee to distribute or accumulate income. Since the accumulation of income, rather than its outright distribution, does not lessen the value of an income interest (provided that the beneficiary from whom the income was withheld will eventually receive the accumulated income plus the additional income earned on such accumulation), an exclusion would be allowed to the full extent of A's income and principal interest, discounted only to reflect the possibility of his death before the expiration of ten years. An exclusion would also be allowed to the extent of B's contingent remainder interest in the corpus; as in illustration 4, no value can be placed on B's contingent interest in the income.

7. Suppose the facts are the same as in illustration 5, except that the trust instrument contains a forfeiture type spendthrift clause.

The exclusions should be allowed as in illustration 5, without regard to the spendthrift clause. Although it is true that the operation of the forfeiture type spendthrift clause would decrease the value of the interest affected, the statute should expressly make such operation irrelevant to the exclusion problem. Since the likelihood of the forfeiture type spendthrift clause being invoked is remote, the trustee having no power to invoke it and the beneficiary's interest being opposed to its invocation, there is no persuasive reason for penalizing the donor for using such clause.

Although the above examples are by no means exhaustive, they indicate that many of the present restrictions on obtaining the exclusion can be eliminated, thus making available without gift tax disadvantages some of the practical advantages of trusteeing gifts, and at the same time the Treasury position of not giving more than one exclusion on gifts to one donee can be safeguarded.

**Summary and Recommendations**

When Congress added the future interest prohibition to the gift tax law it undoubtedly did not anticipate the necessity of a large volume of cases to interpret that prohibition. Extensive litigation, however, has demonstrated the existence of a set of pitfalls, technicalities and absurdities that are entirely unnecessary to meet the difficulties anticipated by Congress.
Although the limited Kieckhefer clause may provide an acceptable drafting remedy in certain instances where the beneficiary is an adult, its availability for obtaining the exclusion on gifts to minors is still in doubt. Even if that doubt be eventually resolved in favor of the taxpayer, however, the limited Kieckhefer clause will be far from an ideal remedy.

The difficulty is one that can be satisfactorily eliminated only by Congress. The problem that bothered Congress and the Treasury Department—the difficulty of ascertaining the number of donees and, consequently, the number and extent of the available exclusions—can be met by allowing the exclusion to the extent of the minimum actuarial value of the interest of a living, ascertained beneficiary. Such a requirement, with appropriate refinements, would also accord the trust draftsman a degree of desirable flexibility not now available.

The one conclusion that is strikingly clear is that it is up to Congress to make the law conform to the dictates of wise trust draftsman-ship so long as government fiscal policy is not thereby adversely affected.