9 T.C. 943 (1947)

When determining the allowable gift tax exclusion for a gift of a present interest in trust income, the potential reduction of the trust corpus due to permissible trustee encroachment must be considered, thereby reducing the value of the present interest.

Summary

William Harry Kniep created a trust for several beneficiaries, granting the trustees the power to encroach on the principal up to $1,000 per beneficiary per year. The IRS argued that the potential encroachment reduced the value of the beneficiaries' present interest in the trust income, thereby limiting the allowable gift tax exclusions. The Tax Court agreed with the IRS, holding that the value of the present interests must be reduced by the potential corpus encroachments. This decision highlights the importance of carefully considering trustee powers when valuing gifts of present interests for gift tax purposes.

Facts

Kniep established a trust on March 12, 1943, benefiting five nephews and nieces, and a relative of his deceased wife. The trust provided for quarterly income distributions to the beneficiaries until they reached age sixty, at which point they would receive their proportionate share of the corpus. The trust agreement authorized the trustees to encroach on the principal for the beneficiaries' maintenance, support, or in case of emergencies, up to $1,000 per beneficiary per year. Kniep transferred shares of stock to the trust in 1943 and 1944. He also made small cash gifts directly to the beneficiaries in 1943.

Procedural History

The Commissioner of Internal Revenue determined gift tax deficiencies for 1943 and 1944. Kniep challenged the Commissioner's assessment in the Tax Court, disputing the method of calculating allowable exclusions for the gifts of present interests in the trust income.

Issue(s)

Whether, in computing the present value of gifts of trust income, the trust corpus should be reduced each year by the amounts the trustees were authorized to withdraw for the beneficiaries' use, thereby reducing the value of the "present interests" against which the statutory exclusion applies.

Holding

Yes, because the gifts of trust income were capable of valuation, and therefore subject to the statutory exclusion, only to the extent to which they were not exhaustible by the exercise of the right of the trustees to encroach upon the trust corpus.

Court's Reasoning

The Tax Court relied on its prior decisions in *Margaret A.C. Riter, 3 T.C. 301*, and *Andrew Geller, 9 T.C. 484*, which held that gifts of trust income could not be ascribed any value where the trustees had the power to distribute all of the trust corpus. The court stated that the rule in those cases is applicable here where the trustees were empowered to distribute up to $1,000 of trust corpus to each beneficiary in each year. The Court reasoned that the gifts of trust income were subject to the statutory exclusion, only to the extent to which they were not exhaustible by the trustee's ability to encroach on the trust corpus. Judge Murdock dissented, arguing that the group of beneficiaries was bound to get either all income from the entire corpus or the more valuable corpus itself. "The problem is to discover the value of present interests in gifts…The present case differs to this extent, that property was placed in trust and an equal part of the income was to be paid to each member of a group during his life, while corpus, not to exceed a certain amount, could be paid to members of the group during that period."

Practical Implications

This case demonstrates that when drafting trust agreements for gift tax purposes, the power granted to trustees to encroach on the trust corpus can significantly impact the valuation of present interests. Attorneys must carefully consider the scope of such powers and their potential effect on the availability of gift tax exclusions. The decision requires legal practitioners to reduce the calculated value of present interest gifts by the amount of potential corpus encroachment. Later cases applying or distinguishing this ruling typically involve scrutiny of the trustee's discretionary powers and the likelihood of corpus invasion. Practitioners should advise clients that broad discretionary powers may diminish the value of present interest gifts.