17 T.C. 206 (1951)

A gift tax exclusion is not allowable for the present interest in the income of a trust if the trust agreement permits the total exhaustion of the trust corpus, rendering the income interest incapable of valuation.

Summary

Sylvia H. Evans created trusts for her six children, funding them in 1945 and 1946. The trust allowed the corporate trustee to distribute income and, at its discretion, principal for the beneficiaries' education, comfort, and support. Evans claimed gift tax exclusions for these transfers. The Commissioner of Internal Revenue disallowed the exclusions, arguing the income interests were not susceptible to valuation because the trust corpus could be entirely depleted. The Tax Court agreed with the Commissioner, holding that because the trustee had the power to exhaust the entire corpus, the income interest was not capable of valuation, and the gift tax exclusion was not applicable. The court also disallowed an additional exclusion claimed for one beneficiary who had the right to withdraw principal, finding it a future interest.

Facts

Sylvia H. Evans created a trust on December 31, 1945, for the benefit of her six children, allocating a separate trust for each. The trust deed stipulated that trustees were to pay the net income to each child in installments. Additionally, the corporate trustee had the discretion to distribute principal for the education, comfort, and support of each child, or their spouse or children. One child, Sylvia E. Taylor, was over 30 and had the right to withdraw up to $1,000 of principal each year. In 1945, Evans contributed $2,500 to each child's trust and made other direct gifts. In 1946, she added $5,000 to each trust and made additional direct gifts. The trust income was distributed currently, but no principal was withdrawn.

Procedural History

The Commissioner of Internal Revenue determined gift tax deficiencies for 1945 and 1946, disallowing gift tax exclusions claimed by Evans for transfers to the trusts. Evans petitioned the Tax Court for a redetermination of the deficiencies. The Tax Court upheld the Commissioner's disallowance of the exclusions, with a minor adjustment to be calculated under Rule 50 regarding Evans' specific exemption.

Issue(s)

1. Whether the petitioner is entitled to gift tax exclusions for transfers made to trusts where the trustee has the discretion to distribute principal, potentially exhausting the entire corpus.

2. Whether the petitioner is entitled to an additional gift tax exclusion in 1946 for a transfer to a trust where the beneficiary already had a right to withdraw principal.

Holding

1. No, because the trustee's power to invade the trust corpus for the beneficiaries' education, comfort, and support made the income interest incapable of valuation, precluding the gift tax exclusion.

2. No, because the beneficiary already possessed the right to withdraw principal, making the additional transfer a gift of a future interest.

Court's Reasoning

The Tax Court relied on the precedent set in *William Harry Kniep, 9 T.C. 943*, which held that gifts of trust income are only eligible for the statutory exclusion to the extent that they are not exhaustible by the trustee's right to encroach upon the trust corpus. The court reasoned that, similar to *Kniep*, the trustee's power to distribute principal for the beneficiaries' education, comfort, and support made the corpus entirely exhaustible, rendering the income interest incapable of valuation. The court emphasized that the focus is on valuing the present interest of each beneficiary at the time of the gift. As the Court of Appeals said in the *Kniep* case, "the only certainty as of the time of the gifts is that the beneficiaries will receive trust income from the corpus, reduced annually by the maximum extent permitted under * * * the trust agreement." Because the trust agreement allowed for complete exhaustion, the present interests were not valuated. The court also denied the additional exclusion claimed for the transfer to Sylvia E. Taylor's trust in 1946. It determined that because Sylvia already had the right to withdraw $1,000 per year, the additional transfer did not confer any new present right and was, therefore, a gift of a future interest.

Practical Implications

This case underscores the importance of carefully drafting trust agreements to ensure that income interests are capable of valuation if the grantor intends to claim gift tax exclusions. The *Evans* decision, along with *Kniep*, establishes that if a trustee has broad discretion to invade the trust corpus, potentially exhausting it entirely, the income interest will likely be deemed incapable of valuation, thus precluding the gift tax exclusion. Attorneys drafting trust documents should consider limiting the trustee's power to invade the corpus if the grantor wishes to secure the gift tax exclusion for the present income interest. Later cases citing *Evans* often involve similar trust provisions and reinforce the principle that the ability to value the income stream with reasonable certainty is critical for claiming the exclusion. This case also illustrates that simply adding to a trust where a beneficiary already has withdrawal rights may not qualify for an additional exclusion if it is deemed a future interest.