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Recommended Citation
Mortimer Caplin, Trusts For Minors, 13 Wash. & Lee L. Rev. 145 (1956), https://scholarlycommons.law.wlu.edu/wlulr/vol13/iss2/3

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TRUSTS FOR MINORS

MORTIMER CAPLIN*

INTRODUCTION

The years 1954 and 1955 have witnessed a sharp clarification of the tax effects of various forms of gifts to minors.1

Outright Gift

The Internal Revenue Service led the way when it announced in Revenue Ruling 54-400 that, for purposes of the annual gift tax exclusion, an "unqualified and unrestricted gift to a minor, with or without the appointment of a legal guardian, is a gift of a present interest." By ending the uncertainty as to the availability of the annual gift tax exclusion where no legal guardian has been appointed, this ruling serves to encourage plans for income tax and estate tax savings through outright transfers to minors of income-producing properties.

Gifts of Life Insurance

More recently, the Service gave additional assurances concerning the annual exclusion when it ruled that gifts of life insurance policies having no immediate cash value, as well as subsequent payments of premiums thereon, constituted gifts of present interest under the new Code.3 This result will prevail so long as (a) the donee becomes the absolute owner of the policies, (b) he has the "usual incidents of ownership" including the rights to change the beneficiary and to surrender the policy for its cash value, if any, and (c) neither he nor his guardian is restricted in any manner in the exercise of all of the legal incidents of ownership in the policies.4 The cloud previously formed by

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4Id. at 33.
Nashville Trust Co.\textsuperscript{5} seems to have been dissipated by this single pronouncement.

Use of Nominee

The income tax consequences resulting from the use of nominees have also been given needed clarification. Thus, where a donor, intending to make a gift to a minor, registers the gift property in the name of an adult nominee, it is now settled that the income from this property will be taxed to the infant donee.\textsuperscript{6} A trust will not be deemed to have been created; nor will the nominee be subjected to income tax so long as the gift is bona fide and unequivocal.

Gifts of Securities to Minors Act

We have also seen, under the auspices of the New York Stock Exchange, a partial solution of some of the practical problems involved in outright transfers of securities to minors. A "Gifts of Securities to Minors Act" has been drafted and adopted by eleven states—California, Colorado, Connecticut, Georgia, New Jersey, New York, North Carolina, Ohio, South Carolina, Virginia and Wisconsin. This act provides a simple legal procedure whereby an adult may make an irrevocable gift of securities to a minor by simply having the securities registered in the name of a "custodian," who may be the donor himself or a close adult relative of the child. Thereafter, by virtue of mere reference on the stock certificate to the state statutory provision, the custodian is empowered to retain the securities or to sell them, and to reinvest the proceeds or to hold them in a savings account. In making investments, he must be guided by the "prudent man rule." While he may be reimbursed for expenses, he may not be otherwise compensated, except where he is the legal guardian of the property of the minor.\textsuperscript{7}

Widespread adoption of this sensible legislation would eliminate the unnecessary costs and cumbersome legal procedures which so frequently characterize this type of gift. However, the coverage of this act is limited to "securities," thus leaving unanswered the many problems raised by gifts to minors of realty, other types of personality,
cash, and the like. Futhermore, within its limited scope, the statute applies only to outright transfers and does not leave room for more flexible plans which may be accomplished through other methods of transferring property.

INCOME TAX SAVINGS

Variations in the manner of disposing of property are most satisfactorily accomplished during a donor's lifetime through gifts made to irrevocable inter vivos trusts. Almost every type of property lends itself to this form of gift; and, where minor beneficiaries are involved, the trust provides a ready solution to the many practical problems to be faced.

General Patterns for Income Tax Savings

To the extent that a trust is recognized as a separate taxpayer, it acts as a convenient method for spreading the family income. Each trust, as a separate taxpayer, has the potential of being in a lower tax bracket than the person who is primarily responsible for the family income. And as the number of trusts is expanded, the likelihood of securing lower surtax rates is obviously increased.

The mere availability of additional related taxpayers enlarges the potential for shifting and minimizing the total income tax impact. This is particularly applicable in the trust area whenever an unrelated and independent trustee has been appointed. For it then becomes possible to strive for tax savings through a variety of business transactions between the grantor and the trustee, or between the bene-

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6The creation of multiple trusts serves to subdivide further any accumulated trust income. Where the same instrument provides for the holding of property in trust, a question of fact often arises as to whether one trust or several trusts have been created. See United States Trust Co. v. Comm'r, 296 U. S. 481 (1936); McHarg v. Fitzpatrick, 210 F. (2d) 792 (C. A. 2nd, 1954); Mary E. Fennerty Testamentary Trust, 13 TCM 831 (1954). But cf. IRC § 663(c), treating separate shares as separate trusts for the sole purpose of determining the amount of "distributable net income" in the application of IRC §§ 661 and 662. For a general consideration of the multiple trust problem, see Paul, The Background of the Revenue Act of 1937 (1937) 5 U. of Chi. L. Rev. 41, 71-75; Tremper, Single v. Multiple Trusts (1939) 17 Taxes 463; Note, Multiple Trusts and the Minimization of Federal Taxes (1940) 40 Col. L. Rev. 309.

7The multiple trust pattern can prove disadvantageous where one trust operates at a loss while another produces a gain. See Fred W. Smith, 25 TC No. 22 (1955) (same creator, same trustee and same beneficiary of two separate trusts; held, single consolidated return may not be filed); cf. Reg. 118 § 39.142-3.
iciary and the trustee—such as sales of depreciable property, co-
ownership arrangements, family partnerships, leasebacks and other leasing agreements.

An annual income tax deduction of $300 is allowed for each currently distributable trust, while all other trusts are limited to a $100 deduction. In turn, the income beneficiary of the trust is allowed a personal exemption of $600 on his individual return; and, regardless

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1IRC § 1239 will not prevent capital gain treatment in a sale of depreciable property by a grantor or beneficiary to his trust. Hence, where the seller is willing to pay the tax on his capital gain, the trust will obtain “two-for-one” treatment by securing a stepped-up basis for depreciation purposes. In contrast, IRC § 267 denies recognition of any loss in transactions between grantor and trustee, between beneficiary and trustee, as well as in other similar types of transactions.

2Under co-ownership arrangements, income is usually taxable to the parties in proportion to their respective interests in the property. E.g., H. D. Webster, 4 TC 1169 (1954), acq. (joint tenancy and tenancy by entirety); Alfred Hafner, 31 BTA 398 (1934), acq. (tenancy in common). However, the co-ownership must be bona fide. See Lannan v. Kelm, 221 F. (2d) 725, 735-736 (C. A. 8th, 1955). And where losses are realized, the deduction must be similarly shared. Oren C. White, 18 TC 385 (1952).

3See IRC § 704(e) and Proposed Reg. § 1.704-1(e)(vii); also, Comm'r v. Culbertson, 337 U. S. 733, 741 (1949). Where a discretionary trust is recognized to be a partner, a question may arise whether the income is taxable to the trustee or to the beneficiary. Cf. Grant v. Nicholas, 127 F. Supp. 236 (D. C. Colo. 1955). On the other hand, though the partnership is disregarded, income may still be taxable to the trustee under the co-ownership principle. See Wofford v. Comm'r, 207 F. (2d) 749 (C. A. 5th, 1953).


5Leasing arrangements involving business realty or equipment may permit advantageous income tax deductions for the lessee. However, the courts will often inquire into whether “the parties in good faith actually intended to enter into a lease contract,” or whether the party claiming the deduction was “taking title” to the property or had acquired an “equity” therein. Compare Benton v. Comm'r, 197 F. (2d) 745, 752 (C. A. 5th, 1952) (valid lease), with Oesterreich v. Comm'r, 55-2 USTC 9733 (C. A. 9th, 1955) (contract of sale). For a recent statement of the Commissioner’s views as to leases of business equipment, see Rev. Rul. 55-546, 1955-35 IRB 9; Rev. Rul. 55-541, id. at 6; Rev. Rul. 55-543, id. at 14. Also, cf. Lukins, Tax Treatment of the Lease With Option to Purchase: Is Allocation the Answer? (1955) 11 Tax L. Rev. 65; Kirby, Considerations in Business Lease Arrangements (1956) 34 Taxes 94.

6IRC § 642(b).

7IRC § 151(b).
of the amount of his gross income, he may, if he is under 19 years of age or is a "student," also be claimed by his parent for a $600 dependency exemption.18

Discretionary Trusts

Maximum flexibility in the control of the family's aggregate income tax bill is attained by granting the trustee the discretion to accumulate trust income. In this way, a comparison can be made between the projected income tax brackets of the trust and of the beneficiaries, with the trustee determining the optimum point for the division or accumulation of trust income.

"Combination" Trusts

If the donor is anxious to have the beneficiary receive some fixed portion of the income each year, he may prefer to establish a "combination" trust providing for a two-way treatment of the trust income: part to be paid or applied for the beneficiary, and part to be distributed in the trustee's discretion. Or, if the donor does not want to rely upon the trustee's discretion he might provide for a specific part of the income to be paid or applied, and the balance to be accumulated. Either of these arrangements would establish an automatic procedure for dividing income between the trustee and the beneficiary. In addition, as to that part of the corpus requiring annual payment or application of income, a partial gift tax exclusion would be available in the year of the transfer in trust.19

Accumulation Trusts

The income tax sections of the Code encourage trust provisions which permit or require accumulations of income for a minor. For example, the income beneficiary of a trust is freed from the application of the 5-year throwback rule where there is a distribution to him of income accumulated prior to his 21st birthday.20 Again, the Clifford provisions of the Code do not penalize the grantor of the trust when, without the approval or consent of an "adverse party," income may or must be accumulated during the minority of the income beneficiary.21

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18IRC § 151(e)(1)(B).
19See notes 84-88, infra.
20IRC § 674(b)(6).
21IRC § 674(b)(7)(B). Under this provision, it is not necessary that the accumulations be paid to the beneficiary from whom the income was withheld. Compare IRC § 674(b)(6), which, as to all accumulations, establishes strict rules as to the distribution pattern. Also, see Greenberger, Changes in the Income Taxation of Clifford Type Trusts, Proc. N. Y. U. 13th Ann. Inst. on Fed. Taxation 165, 177 (1955).
It should be noted, however, that the price to be paid for an accumulation provision, at least where it is of a mandatory nature, is the probable loss of the gift tax exclusion. And, if the donor is also a trustee of the trust, his reservation of a discretionary accumulation power will carry with it estate tax consequences should he die before the trust terminates.

Check List of Income Tax Pitfalls

The Code and the cases are replete with concepts aimed at blocking tax avoidance plans which lack tax substance. If the donor is not willing to cut himself off entirely from the gift property—where he retains strings attached to the aggregate bundle of rights comprising "ownership" in the tax sense, or where he attempts to make the gift property available for his personal use—he may find his well-laid plan going askew.

In brief, before embarking on a program of gifts in trust, the donor would be advised to keep in mind the following check-list of income tax pitfalls:

(1) *Anticipatory assignment of income:* If the transaction is considered no more than a mere anticipatory assignment of income, the donor still will be taxable on this income under the broad sweep of Section 61(a), despite a prior legal transfer and a continuing flow of income to the trustee.\(^{22}\)

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\(^{22}\)See notes 113-115, infra.


\(^{24}\)IRC § 671 indicates that Subpart E of the Code (§§ 671-678) is intended to be the sole arbiter of the issue of taxability on the grounds of "dominion and control" over the trust. "However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust." S. Rep. No. 1622, 85rd Cong. 2d Sess. 565 (1954). Thus IRC § 61(a) will still apply in situations involving assignment to a trust of the future income of the assignor. Cf. Rev. Rul. 55-38, 1955-4 IRB 24; Hogle v. Comm’r, 132 F. (2d) 66 (C. C. A. 10th, 1942). Compare Lum v. Comm’r, 147 F. (2d) 356 (C. C. A. 3rd, 1945) (lessee-owner assignment of entire lease), with Arthur T. Galt, 19 TC 892 (1953), aff’d 216 F. (2d) 41 (C. A. 7th, 1954), cert. den. 348 U. S. 951 (1955) (assignment of percentage of rentals), and Wareham C. Seaman, TC Memo 1955-292, 14 TCM—(1955) (gift of all rent of month-to-month
(2) Short-term trust: Where the corpus or income "will or may reasonably be expected" to revert to him within 10 years, he may find that this alone has subjected him to taxation.\(^\text{26}\) Exceptions to this rule are made only for trusts for a designated charity and for trusts continuing until the death of the income beneficiary.\(^\text{27}\)

(3) Dispositive controls: Again, he may be taxed where the beneficial enjoyment of the corpus or income is subject to a "power of disposition" by himself or by a nonadverse party, or both, without the approval or consent of an adverse party.\(^\text{28}\)

(4) Administrative controls: The retention of certain specified administrative powers by the donor or a nonadverse party, or both, may also result in taxation to him.\(^\text{29}\)

(5) Revocable trusts: He may be taxed when the power to revest in him title to any portion of the corpus is exercisable by him or a nonadverse party, or both.\(^\text{30}\)

(6) Income for donor's benefit: Taxation may similarly follow where income, without the approval of an adverse party, is or, in the discretion of the donor or a nonadverse party or both, may be (a) distributed to the donor, or (b) held or accumulated for future distribution to him.\(^\text{31}\)

\(^{\text{26}}\) IRC § 673(a) and (d).

\(^{\text{27}}\) The grantor is not taxable under IRC § 673(a) in the following two specific situations: (i) under IRC § 673(b), where the trust income is irrevocably payable for a period of at least two years to "a designated beneficiary" which is of a type described in IRC § 170(b)(1)(A) (i), (ii) or (iii); and (2) under IRC § 673(c), where his reversionary interest is not to take effect until the death of the income beneficiary. If the corpus will revert to the grantor's estate upon his death, the grantor is taxable upon the trust income where his life expectancy is less than 10 years. Cf. Rev. Rul. 55-34, 1955-4 IRB 9.

\(^{\text{28}}\) See IRC § 674. Also, see Mannheimer, Wheeler and Friedman, How to Use Sprinkling Trusts (1955) 33 Taxes 532.

\(^{\text{29}}\) IRC § 675.

\(^{\text{30}}\) IRC § 676. For a consideration of the predecessor § 166 of the 1939 Code, see Caplin, Protecting a Grantor of a Short-Term Trust Against Income Taxation (1940) 18 Taxes 677. The 1954 Code added IRC § 676(b), which answers a constitutional problem raised in Helvering v. Dunning, 118 F. (2d) 241, 245 (C. C. A. 4th, 1941), cert. den. 314 U. S. 631 (1941).

\(^{\text{31}}\) IRC § 677 (a)(1) and (2); cf. Rev. Rul. 54-516, 1954-2 CB 54, 56 (stating that, if grantor remains liable in any capacity, other than as trustee, for mortgage on realty transferred to trust, he is taxable on any income used to pay principal or interest). But cf. Hays' Estate v. Comm'r, 181 F. (2d) 169, 171 (C. A. 5th, 1950) (estate tax); Edwards v. Greenwald, 217 F. (2d) 632 (C. A. 5th, 1954) (income tax). Income which is actually distributed or required to be distributed to the grantor is now
(7) **Support trusts:** He may be subject to taxation if, in the discretion of (a) another person or (b) the trustee or (c) the donor acting as trustee or co-trustee, income may be applied or distributed for the support or maintenance of a beneficiary whom the donor is legally obligated to support. The donor would here be taxed only to the extent income was actually so applied or distributed. However, should he reserve the power to himself in a nonfiduciary capacity, he would find that he would be taxable on all of the trust income regardless of its application or distribution. In contrast, where trust income is required to be distributed to a person to whom the donor owes a legal obligation of support, taxation of the donor will hinge upon the determination of his intention—i.e., whether or not he intended to have this obligation satisfied through the use of trust income.

(8) **Insurance trusts:** The donor will also be taxable where the income (a) without the approval of an adverse party, is applied, or (b) in the discretion of the donor or a nonadverse party, or both, may be applied, to the payment of premiums on policies of insurance on the donor's life. However, taxation will be limited to that portion of income specifically covered by IRC § 677(a), whereas in the past it was necessary to lean upon Section 22(a) of the 1939 Code. Cf. Douglas v. Willcuts, 296 U. S. 1 (1935); S. Rep. No. 1622, 86th Cong. 2nd Sess. 371 (1954).

IRC § 677(b). For estate tax purposes, the grantor will be deemed to have retained "the possession or enjoyment of, or the right to the income from, the property" where the trust income is required to be distributed to discharge the grantor's legal obligation of support or maintenance. See IRC § 2036(a)(1) and cf. Reg. 105 § 81.18; Comm'r v. Dwight's Estate, 205 F. (2d) 298 (C. A. 2nd, 1953); Helvering v. Mercantile-Commerce Bank & Trust Co., 111 F. (2d) 224 (C. A. 8th, 1949), cert. den. 310 U. S. 694 (1940). But there is no estate tax imposed upon the donor where a trustee other than himself has the discretion to use the income. See Comm'r v. Douglass Estate, 143 F. (2d) 961 (C. C. A. 3rd, 1944), aff'd 2 TC 487 (1941), acq.; McCullough v. Granger, 128 F. Supp. 611 (W. D. Pa. 1955); Estate of Alexander K. Sessoms, 8 TCM 1056 (1949). Where the grantor was the trustee, the retention of a discretionary power to apply income for the education and maintenance of a minor resulted in the corpus being includable in the grantor's estate. Townsend v. Thompson, 50-2 USTC paragraph 10, 780 (E. D. Ark. 1950). Also, compare Estate of Clayton William Sherman, 9 TC 594 (1947), non-acq., noted (1948) 48 Col. L. Rev. 293 (non-taxable), with Helfrich's Estate v. Comm'r, 143 F. (2d) 42 (C. C. A. 7th, 1944) (taxable). The grantor's intent as to the use of the trust income seems to have determined the results in the last two cases.

the trust income necessary to pay premiums on the policies in the trust which were in existence during the tax year.35

(9) "Grandfather" trusts: Even where someone other than the taxpayer has created and funded the trust, he must still be aware of income tax dangers inherent in the granting to him of certain powers. For example, he would be taxable if he were granted the power exercisable "solely by himself" to vest corpus or income in himself.36 Yet if this power were limited to income alone, he would escape taxation if, under Sections 671 through 677, the grantor himself were otherwise treated as the owner.37

(10) "Grandfather" support trusts: Where the power granted to the taxpayer under a "grandfather" trust was merely to apply income to the support of a person whom he was obligated to support, and where he was granted this power "in the capacity of trustee or co-trustee," then he would be taxable only to the extent that the income was so applied.38 In turn, if the power were exercisable by him in a nonfiduciary capacity, all of the trust income would be taxable to him, regardless of its application. On the other hand, if the trust required another person to join with him in the exercise of this power, he should not be taxable at all—whether he had been granted this power as a fiduciary or not.39 And, although the result is not free of doubt,40 he should not be taxable under the present form of the statute41 when another person alone has the discretion, or when the

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35Frank C. Rand, 40 BTA 233 (1959), aff'd, 116 F. (2d) 939 (C. C. A. 8th, 1941), cert. den. 315 U. S. 594 (1941). Also, see Joseph Weil, 3 TC 579, 584 (1944), aff'd. Genevieve F. Moore, 39 BTA 808, 812-813 (1939), aff'd.
36IRC § 678(a)(1), adopting the rule of Richardson v. Comm'r, 121 F. (2d) 1 (C. C. A. 2nd, 1941), cert. den. 314 U. S. 684 (1941), and Mallinckrodt v. Nunan, 146 F. (2d) 1 (C. C. A. 8th, 1945), cert. den. 324 U. S. 871 (1945).
37IRC § 678(b).
38IRC § 678(c).
39The reference to "co-trustee" in IRC § 678(c) has been the cause of some concern among tax commentators. See Stern, A Tax Trap for the Family Trustee (1955) 33 Taxes 594. Compare Casner, The Internal Revenue Code of 1954: Estate Planning (1955) 68 Harv. L. Rev. 433, 460-461 (co-trustee is taxable), with Kamin, Surrey and Warren, The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries (1954) 54 Col. L. Rev. 1237, 1263 (not taxable). In coordinating the various provisions of IRC § 678, it would appear that the words "solely by himself" contained in IRC § 678(a)(1) are intended to be read into IRC § 678(c) in the following fashion: "... which enables such person [solely by himself], in the capacity of trustee or co-trustee...", etc.
41IRC §§ 61(a), 677 and 678. As to the interplay of IRC §§ 61(a) and 671, see note 25, supra.
trust instrument itself requires the use of income, to discharge his support obligations.\textsuperscript{42}

(ii) Substitution of trustee: As a final word of precaution, consideration should be given to the advisability of reserving to the donor the power to substitute trustees. If the power is unlimited—permitting the donor to remove trustees without cause and to replace them—the donor may be vulnerable to both income and estate taxation.\textsuperscript{43} Under the 1939 Code, the donor's possession of such unlimited power could subject him to income taxation under the Clifford doctrine. Through this incident of dominion and control, the donor was deemed to possess all of the powers initially granted to the trustee; and, where the actual possession of such powers by the donor would have resulted in his being taxable, then this constructive possession similarly brought taxation.\textsuperscript{44}

Whether income taxation will follow under the 1954 Code is controversial—in view of the failure of Congress to cover this situation specifically and in view of the exclusive scope given to Subpart E in the Clifford area.\textsuperscript{45} In Section 672, Congress adopted almost verbatim, with one exception, Section X851 of the American Law Institute Federal Income Tax Statute.\textsuperscript{46} The unexplained exception is ALI Section X851(d), which provides: "If the grantor or a related or subordinate party has the power to remove a trustee without cause, the grantor shall be treated as possessing the powers of that trustee."\textsuperscript{47} While some solace may be found in this omission, yet it can hardly be recommended that the unlimited right of substitution be reserved.

However, the reservation of a power to appoint a substitute


\textsuperscript{43}For estate tax purposes, a trustee's power to alter or amend a trust was attributed to a decedent because of his reservation of the power to remove and substitute the trustee. Loughridge's Estate v. Comm'r, 183 F. (2d) 294 (C. A. 10th, 1950), cert. den. 340 U. S. 830 (1950). Cf. Rev. Rul. 55-393, 1955-25 IRB 19, 20 (mere power to fill vacancy not taxable).


\textsuperscript{45}IRC § 671, discussed in note 25, supra.


\textsuperscript{47}Id. at 198.
TRUSTS FOR MINORS

trustee only in the event of a vacancy should not result in estate taxation48 or income taxation. The exercise of such a power would be contingent in nature—depending upon the resignation, death or disqualification of the original trustee—and consequently, would not seem to constitute a degree of control sufficient to attribute to the donor the powers granted to the trustee.49

GIFT TAX EXCLUSIONS FOR TRANSFERS IN TRUST

When the donor has been competently advised, the trust instrument which he is prepared to execute either will avoid adverse income and estate tax consequences, or will be drawn with a complete understanding and the acceptance of these consequences. At the same time, he will have given consideration to the gift tax results of his proposed transfers in trust.

The donor will, of course, be told of his $30,000 specific exemption from the gift tax available during his lifetime;50 and of the doubling of this exemption from a practical standpoint where his wife signifies her consent that his gift be considered as made one-half by her.51 He will also be told that this lifetime exemption will be available whether the gifts are considered "future interests" or present interests.

But when he turns to his annual gift tax exclusion of $3,000 per donee—or $6,000 per donee where his wife consents to gift-splitting—the question of "future interests" assumes special importance, inasmuch as the exclusion will be denied unless a gift of a present interest is involved.52 The availability of the annual exclusion for gifts in trust cannot be dismissed as inconsequential, for trusts of this type are often of the "open-end" variety, permitting periodic additions of principal either by the donor or by some other person. Consequently, through an annual gift program during the minority of a child, there

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50IRC § 2513. For explanation of the requirements for filing gift tax returns where spouses split gifts, see Rev. Rul. 54-252, 1945-9 CB 322. As to the interplay between the lifetime specific exemption and the gifts-splitting provisions, see Rev. Rul. 54-30, 1954-1 CB 207. Also, cf. Matthew P. Whittall, 24 TC No. 91 (1955) (gift-splitting privilege denied where part of gift in trust was made to spouse, and where the court was unable to ascertain that part of the gift made to third parties).
51IRC § 2503(b). A gift to husband and wife jointly, with right of survivorship, is regarded as a gift to the individuals, and is not treated as a separate gift to the estate of tenants by the entireties. Estate of G. A. Buder, 25 TC No. 112 (1956).
is a potential of shifting some $126,000 of principal from the donor to a child without any gift tax impact. This result is even more striking in the light of the accretion to the fund which follows from compounding the annual net income remaining in the trust after deducting taxes at the trust's comparatively low rate. As it was recently suggested:

"It would be interesting to calculate the result, say at a 4 per cent rate, and compare it with what could be left to the child at age 21 if the father had retained his $6,000 per annum and invested and compounded the income at the same rate, after his high taxes. The comparison would have to take into account, of course, that the trust method would pass the aggregate ultimate fund without gift or estate tax, while the retention method would be subject either to an immediate gift tax or an eventual estate tax."

For the donor of more modest means, the tax savings can still be substantial when the trustee accumulates all of the income and principal for the infant beneficiary.

Statutory Boiler-Plate Trust

If the donor is bargaining for the full exclusion, Section 2503(c) supplies him with a complete answer, provided he is willing to meet the strict statutory requirements. The section expressly states that no part of a gift to a minor shall be considered a gift of a future interest if both the property and the income therefrom may be expended by or for the benefit of the minor before his attaining the age of 21, and will to the extent not so expended (a) pass to the minor on his attaining the age of 21, and (b) in the event he should die before attaining the age of 21, be payable to his estate or as he may appoint under a general power of appointment as defined in Section 2514(c).

Regulations under Section 2503(c) have not yet been proposed. Accordingly, until we have official guides, it is suggested that draftsmen who seek to qualify trusts under this section give consideration to the following points:

(1) Discretionary accumulation: It is not necessary that the income be actually expended by or for the benefit of the minor during his minority; however, the trust must allow for such an expenditure

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54 For an analysis and criticism of IRC § 2503(c), see Caplin, supra note 1, at 214-221.
or distribution. It would seem, therefore, that a provision for discretionary accumulation would satisfy the statute, while a provision for mandatory accumulation would not.

(2) Discretionary invasion: Corpus, too, need not be actually expended for or distributed to the minor during his minority, although the trust instrument must make provision for the availability of all of the corpus. Here, it would seem sufficient if a discretionary power of invasion were included. If the trust required mandatory invasion as to part of the corpus, there should also be a provision for discretionary invasion as to the balance.\(^{57}\)

(3) Unlimited discretion: The discretion as to accumulation and invasion should extend to all of the undistributed income and principal. Moreover, it would seem advisable not to place any limitation upon the exercise of this discretion.\(^{58}\) Even the insertion of some standard—such as support, maintenance, education, health, emergency, etc.—to act as a guide in the exercise of the discretion, should be discouraged at this time.

(4) Discretion in fiduciary: Section 2503(c) does not designate the person who is to exercise the discretion as to accumulation and invasion. Literally, the statute would be satisfied if anyone possessed the power—the donor, a parent, a friend, a legal guardian, or the minor himself, or even if different discretions were granted to different persons.\(^{59}\) Nevertheless, it would seem advisable at present to grant the discretion to a trustee or trustees, and to have the discretion exercisable only in a fiduciary capacity. This would certainly be the usual means of having the discretion exercised, and would fit into a pattern consistent with the use of the trust arrangement.

(5) Distribution at 21: Provision should be made for a complete distribution to the beneficiary of both corpus and accumulations upon his reaching 21. If the trust is to continue after such date, it is doubtful whether the property would be regarded as “passing” to the bene-

\(^{56}\) Ibid.

\(^{57}\) As to other reasons for using a “combination” trust see p. 149, supra.

\(^{58}\) Under IRC § 2503(c)(1), it is sufficient “if the property and the income therefrom . . . may be expended by, or for the benefit of, the donee” [italics supplied]. It could be argued, of course, that the statute is technically satisfied if there is any reasonable possibility that the property and income could be so used. However, in the light of the history of the judicial development of the definition of “future interests,” which led to the adoption of IRC § 2503(c), this interpretation of the statute would appear to be unsound.

\(^{59}\) Ibid.
ficiary at age 21, even though it were made subject to the absolute demand of the beneficiary on and after his 21st birthday.60

(6) Distribution at death: The statute requires that, in the event of the minor's death before age 21, the property and income be payable to his estate or as he may appoint under a general power of appointment.61 And it is clear, under the Senate Finance Committee Report, that "the general power of appointment need not be limited to one exercisable by will."62 To avoid any possible conflict in interpretation, it is recommended that the trust provide for payment directly to the estate of the minor. Or, if greater flexibility is desired, provision can be made for payment in accordance with the minor's exercise of a general power of appointment; but, to the extent that there be a default in such exercise, the trust should provide for ultimate payment to his estate.63 In other words, there should be no-takers in default other than the minor's estate.64

(7) Spendthrift clause: Where a trust otherwise qualifies under Section 2503(c), a spendthrift provision should not defeat the availability of the full gift tax exclusion. Under the 1939 Code, the Internal Revenue Service had ruled that a "gift of the present right to enjoy the income from a trust corpus for a period of years or for life will not be held to be one of a future interest in property solely because of the inclusion of a provision or clause which prohibits the income beneficiary from alienating, assigning or otherwise anticipating such income."65 This disregard of the relevance of a spendthrift provision should similarly follow under Section 2503(c).

(8) Trust res: Section 2503(c) states that no part of a gift to a minor "shall be considered a gift of a future interest in property" if the property and income therefrom are held, administered and disposed of in accordance with the provisions of the section. Nothing is said about the character of the gift property; consequently, the statute would seem to be satisfied whether the gift property were income pro-

60For an analysis of IRC § 2503(c)(2), see Caplin, supra note 1, at 216-218.
61IRC § 2503(c)(2)(B).
63The validity of the minor's attempted exercise of a general power of appointment would obviously be first tested under local law.
64"Section X1009(a)(1) of the American Law Institute Federal Gift Tax Statute, which is based upon IRC § 2503(c), specifically provides that the property shall be payable, "in default of the exercise of that power [of appointment], to his estate." See Tentative Draft No. 10, American Law Institute Federal Income, Estate and Gift Tax Statute 10-11 (April 30, 1955).
ducing or not—or even whether the gift property were by its very nature a future interest in property, such as a vested remainder subject to an outstanding life estate. Life insurance policies as well as other types of nonincome-producing properties would thus appear to be valid subjects for gifts to a Section 2503(c) trust, although there might be other tax reasons militating against this type of transfer.

(g) Trustee: Anyone may presumably act as trustee under Section 2503(c). He might be a friend or even a "related or subordinate party." However, from an estate tax standpoint, it would be inadvisable for the donor to act as trustee or co-trustee for this would cause the corpus to be included in his estate should he die before the trust terminated.

The reward to be gained in using the statutory boiler-plate trust is a dollar of gift tax exclusion for each dollar of value transferred to the trustee up to the maximum statutory limit. The price to be paid for this is compliance with the rigid trust pattern imposed by Section 2503(c)—particularly the requirement for mandatory distribution of the entire property, including accumulated income, at a time when the beneficiary may not have attained sufficient maturity to accept full financial responsibility.

**Gilmore-Stifel Trust**

If the donor is desirous of securing the full exclusion but is not willing to meet the demands of Section 2503(c), he has one more string

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6Gifts in trust of life insurance policies or of premium payments thereon have previously been held to involve gifts of future interests. E.g., Comm'r v. Boeing, 123 F. (2d) 86 (C. C. A. 9th, 1941); Jesse S. Phillips, 12 TC 216 (1949); Dora Roberts, 2 TC 679 (1943), aff'd 143 F. (2d) 657 (C. C. A. 5th, 1944), cert. den. 324 U. S. 841 (1949); cf. Frances P. Bolton, 1 TC 717 (1943). But cf. Rev. Rul. 55-408, 1955-26 IRB 32, considered in notes 3-5.


6As to the income tax consequences of funded insurance trusts, see notes 34 and 35.

6A definition of this term for the purposes of Subpart E of the income tax provisions, see IRC § 672(c).

6For a donor-trustee's reservation of a discretionary power of invasion will result in the trust corpus being includable in his estate under IRC § 2038(a)(1). See Lober v. United States, 346 U. S. 355 (1953); cf. Comm'r v. Holmes, 326 U. S. 480 (1946). As to a discretionary power of accumulation, see note 24, supra. As to a discretionary power to substitute trustees, see notes 43 and 48, supra. As to the use of trust income or corpus to discharge the donor's legal obligations, see note 32, supra. For a consideration of these and related problems under the 1939 Code, see Schneider, The Inter-Vivos Trust for a Minor: Its Estate Tax Aspect (1950) 28 Taxes 825.
to his bow: he may be willing to do battle for the full exclusion by establishing a trust similar to the ones found in the Gilmore and Stifel cases.

This type of trust usually provides for the continuation of the trust during the lifetime of the minor beneficiary, with income to be distributed or accumulated in the discretion of the trustee, but with the beneficiary or any legally appointed guardian being granted an absolute and unlimited right to demand the accumulations and corpus at any time. A legal guardian is usually not appointed under this arrangement.

By providing for a continuation of the trust beyond the beneficiary's 21st birthday, the donor has violated what appears to be one of the primary requirements of Section 2503(c). His only basis for claiming the full exclusion would be on the theory (a) that Section 2503(c) does not preempt the area dealing with the full exclusion for gifts in trust, and (b) that existing case law on the subject continues to possess its full vitality. From this he would argue that the beneficiary's unlimited right to terminate the trust was tantamount to a gift of a present interest as described in the Fondren and Disston cases; and that the technical legal disability of minority did not convert what would be a present interest for an adult into a future interest for a minor.

He probably would prevail on his first premise that Section 2503(c) was not intended as the exclusive method for determining whether a gift in trust constituted in its entirety a gift of a present interest. But as to his second proposition, he would encounter a conflict in the cases.

Absent the prior appointment of an independent legal guardian, he would undoubtedly be defeated in the Internal Revenue Service, the Tax Court and the Second Circuit. Before these tribunals, the infant's legal inability to make an effective demand for the corpus and accumulations would be regarded as defeating his "right presently to use, possess or enjoy the property."

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160 WASHINGTON AND LEE LAW REVIEW [Vol. XIII

[ Footnotes]

74Fondren v. Comm'r, 324 U. S. 18 (1945).
76Rev. Rul. 54-91, 1954-1 CB 207.
TRUSTS FOR MINORS

However, before the Sixth and Seventh Circuits he would prevail.80 There, "the right given to the donee, in the trust instrument, to use, possess, or enjoy ... determines whether the gift is one of present or future interest."81 The restrictions and contingencies imposed by the legal disability of minority are not regarded by these two courts as being decisive.

In all events, if the trust instrument should provide for the mandatory application or distribution of income on at least an annual basis, he would be entitled to a partial exclusion under the Sensenbrenner-Fisher rule as implemented by Section 2503(b).82 And under what may turn out to be a strained interpretation of Section 2503(b), he may be entitled to this partial exclusion even though there has been reserved to the trustee a discretionary power to accumulate the trust income.83

Sensenbrenner-Fisher Trust

The donor might not be willing to create a Section 2503(c) trust, nor might he be willing to include the right of termination found in a Gilmore-Stifel type trust. All that he may be interested in accomplishing is to provide for the mandatory application or distribution of income during the life of the minor or during a specified period of time.

If this is his sole wish, he will be gratified to learn that he will be making a gift of a present interest in income, although the gift of corpus will plainly constitute a future interest.84 Under the Sensenbrenner and Fisher line of cases,85 this present right to income is generally valued under the tables set forth in the gift tax regulations for the valuation of annuities, life estates, remainders and reversions.86 On occasion, particularly where nonincome-producing properties are involved, these tables may not be regarded as the sole determinative of value.87

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82 See notes 97-102, infra.
83 See notes 108-111, infra.
86 Some courts have found that gifts of nonincome-producing properties in-
Here, though, he will encounter an “anomalous” result bearing on valuation. For, in the computation of the annual exclusion available to him, a higher value will be placed upon (a) a gift in trust granting to the beneficiary a present right to income for life, with remainder to another, than upon (b) a gift in trust granting to the beneficiary a present right to income for a shorter period of time, with remainder to this same beneficiary. This follows from the fact that the courts regard transfers in trust as having effected two separate gifts—a present interest in income and a future interest in corpus—with the valuation of the income interest being dependent upon the duration of the trust term.

"Spray" or "Sprinkling" Trust

The donor should be cautioned, however, that if he desires to add a "spray" or "sprinkling" provision to his Sensenbrenner-Fisher type trust he will lose the exclusion in its entirety. Thus, if he requires the trustee to apply or distribute all of the trust income to a class of designated beneficiaries, but grants the trustee the discretion to determine each year the portion of the income to be applied or paid to each particular beneficiary, there is no accepted actuarial method for placing a value on the present right to receive income. Each of such beneficiary's right to receive income may technically be a present interest; yet as the Internal Revenue Service recently pointed out, the value of this right to income as to any particular beneficiary is not susceptible of determination. And this result follows whether there is a "horizontal" spray as between brothers or sisters, or a "vertical" spray as between parent and child.
Judge Learned Hand, in *Helvering v. Blair*, aptly described the valuation problem in a "spray" trust in the following fashion: "In order to calculate the value of an interest subject to such a condition, we should have to have some actuarial basis for the probability that trustees who had once made such a division would not disturb it. Obviously nothing of the kind is available or would in all likelihood be a sound basis for inference if it was compiled."

Even when the beneficiaries' respective shares have been fixed initially by the donor, the exclusion will be denied if the trust instrument specifically provides for a discretionary power to open up the class of beneficiaries. Such unrestricted discretion to cause the income to be divided among a larger group destroys any reasonable basis for valuing the present interests of the individual donees.

However, if the number in a class may be altered only by the contingency of death or birth, the Internal Revenue Service has recently indicated that part of the exclusion would be available. In Revenue Ruling 55-679, it held that "where it can be demonstrated that the value of the present interest of each beneficiary in the income from a trust...will equal $3,000, the gift tax exclusions authorized by Section 2503(b) of the Internal Revenue Code of 1954 are allowable although the number of eventual donees is not ascertainable or the present interest of each beneficiary is not susceptible of valuation." An explanation of this approach is found in Revenue Ruling 55-678, which states: "In other words, if after taking into consideration all possible future contingencies, it can be shown that the present interest given has some ascertainable value, based upon sound actuarial principles, then the exclusion is allowable to the extent of the minimum value of such interest, or $3,000, whichever is the lesser. In such cases it is not necessary that the exact value of the gift of the present interest in property be determinable on the basis of recognized actuarial principles."

This practical solution of a difficult problem offers a sharp contrast to the highly conceptualistic approach taken by the Internal Revenue Service in the *Evans-Brody* type of trust. 

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1.21 *F. (2d)* 945, 947 (C. C. A. 2nd, 1941).
4. Id. at 11.
5. See notes 97 and 98, infra.
Evans-Brody Trusts: Section 2503(b)

Prior to the adoption of the Revenue Act of 1954, a donor lost the exclusion in its entirety where, in a mandatory distribution trust, he inserted a discretionary invasion provision in favor of the income beneficiary. While the beneficiary of such a trust obviously possessed a more valuable present economic interest than an income beneficiary who had no possibility of receiving corpus, the rule gradually—and, it seems, erroneously—evolved that the income interest of such a beneficiary was incapable of valuation. Sylvia H. Evans and Jennie Brody were the leading carriers of this disturbing news.

Be that as it may, Section 2503(b) was inserted in the Code with the stated aim of correcting this judicial deviation. It accomplishes this by providing that where “there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded... if no part of such interest will at any time pass to any other person.”

Today, therefore, Section 2503(b) entitles the creator of this type trust to an exclusion under the Sensenbrenner-Fisher rule, so long as the income must be paid to or applied for the benefit of the beneficiary, and so long as the invasion power is exercisable only in favor of the income beneficiary. The partial exclusion is here not dependent upon the disposition of the remainder interest. For, whether the remainder is payable to the income beneficiary, his estate, or to another, the same portion of the exclusion will be available to the donor. Presumably his present right to receive income will be valued at the same amount that it would be in the absence of this power of invasion.

Section 2503(b) is a relief provision which is operative only if “no part” of the beneficiary’s present right to income may be diminished by the exercise of a power in favor of another. Nevertheless, the section does not purport to supersede prior case law and, under these decisions, a partial exclusion should still be allowed to the extent that the income beneficiary’s interest is not subject to diminution. For example, when the power to invade in favor of another is unlimited, no part of the exclusion is allowable under either Section 2503(b) or

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17 TC 206 (1951), aff’d 198 F. (2d) 495 (C. A. 3rd, 1952).
19 TC 126 (1952). Also, see Rev. Rul. 54-92, 1954-1 CB 207; Estate of Brigid A. Casey, 25 TC No. 86 (1956); Robert C. Ross, TC Memo 1955-273, 14 TCM—(1955); Regina L. Herrmann, TC Memo 1955-212, 14 TCM—(1955); Cadwell Tyler, II, 12 TCM 407 (1953).
89 See notes 84-88, supra.
90 See notes 85-87, supra.
Previous judicial decisions. On the other hand, where such power is limited by some ascertainable standard or by a dollar amount, Section 2503(b) would still not be available, but, under the cases, a partial exclusion should be allowed for that part of the beneficiary's present right to income which cannot be diverted to someone else.

It should be kept in mind that Section 2503(b) corrects a valuation problem, not one of "future interests." If the section is to be relied upon, therefore, the donor must be sure that both the property conveyed and the terms of the trust meet the present interest test.

**Discretionary Accumulation Trust**

Under the *Disston* and *Fondren* cases, the exclusion is forfeited when the trustee is granted a discretionary power to accumulate income, at least in the absence of "some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required." This type trust has been held to involve transfers of future interests, both as to income and corpus.

Yet, Section 2503(b) of the 1954 Code provides that where there...

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103 Andrew Geller, 9 TC 848 (1947); Margaret A. C. Riter, 9 TC 301 (1944).
104 See William Harry Kniep, 9 T.C. 943 (1947), aff'd 172 F. (2d) 755 (C. A. 8th, 1949) (invasion limited to $1,000 per year for each beneficiary). Also, cf. Andrew Geller, 9 TC 484, 495 (1947), (recognizing "ascertainable standard" approach but making distinction on the facts); Saul Reinfeld, HC Memo 1955-25, 14 TCM—(1955).
106 See notes 66-68, supra.
107 Where the trust provides for a delay period before distributing income, a "future interest" is created. Hessenbruch v. Comm'r, 178 F. (2d) 785 (C. A. 3rd, 1950) (three months); Matthew P. Whittall, 24 TC No. 91 (1955) (until time of school enrollment). Similarly, a provision making income payments contingent or uncertain will create a "future interest." E.g., Comm'r v. Brandegee, 123 F. (2d) 58 (C. C. A. 1st, 1941) (contingent upon discharge of mortgage); Shefner v. Knox, 131 F. Supp. 936 (D. C. Minn. 1955) (uncertainty as to time and amount); Matthew P. Whittall, supra (various contingencies).
109 E.g., Frances McGuire Rassas, 17 TC 160 (1951), aff'd 196 F. (2d) 611 (C. A. 7th, 1952); Andrew Geller, 9 TC 484, 494 (1947); William H. Pope, 12 TCM 646 (1953). This same result was reached before the Fondren and Disston cases even where the income beneficiary had a vested right to the accumulations. Comm'r v. Gardner, 127 F. (2d) 929 (C. C. A. 7th, 1943).
has been a transfer of a "present interest" in property, the possibility that this interest may be diminished by the exercise of a "power" shall be disregarded if no part of such interest is to pass to any other person. The statute does not attempt to define the term "power"; and it might be argued that a power of accumulation, as well as a power of invasion, falls literally within the ambit of the section. While the Committee Reports discuss a difficulty sought to be cured—that is, the invasion problem raised in the Evans type case—10—the position could reasonably be taken that the comments in the Committee Reports were not meant to be exclusive, and that the plain meaning of the statute applies equally to both accumulation and invasion powers.

This analysis presupposes that, except for the existence of such a power, a "present interest" had otherwise been created. Why would not this be so if the trust were drafted along the following lines: "Income to be paid to or applied for the benefit of Able during his life, with corpus over to Baker. Provided, however, that during Able's minority, the trustee may accumulate income; but, in all events, these accumulations shall be paid to Able at age 21 or, if he should die before then, to his estate"?111 Does the initial income provision constitute a "present interest" under the Sensenbrenner-Fisher rule?112 Can it be said that "no part of such interest will at any time pass to any other person"? Is Able's estate to be regarded as another "person"?

The donor of such a trust may make a persuasive argument supporting the allowance of the exclusion under the Sensenbrenner-Fisher approach. However, unless the forthcoming regulations give recognition to this type trust, the donor will undoubtedly have to litigate if he is to prevail.

Mandatory Accumulation Trust

Where the donor inserts in the trust instrument a direction that the income must be accumulated over a given period of time, there is little chance that part of the exclusion would be allowable under Section 2505(b). Such a right to income would clearly constitute a

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111This argument for discretionary accumulation trusts leans heavily on the "niceties of the art of conveyancing." Cf. Helvering v. Hallock, 309 U. S. 106, 117 (1940). For example, the suggested draft is substantially the same as a trust which provides for mandatory accumulation but which allows discretionary invasion. Gifts to this latter type trust have been held to be transfers of "future interests" under prior law, even where the beneficiary possessed a vested right in the accumulations. E.g., Comm'r v. Taylor, 122 F. (2d) 714 (C. C. A. 3rd, 1941); Welch v. Paine, 120 F. (2d) 141 (C. C. A. 1st, 1941); cf. Wyss v. United States, 55-1 USTC paragraph 11,543 (S. D. Ill. 1955).
112See notes 84-88, supra.
future interest under the *Pelzer* and *Ryerson* cases; accordingly, it is dubious whether the new statute would be of any avail.

The solution may not appear as simple as it first sounds after testing it against a specific example:

Let us suppose that the trust initially provides for a mandatory distribution of income during the lifetime of the beneficiary, and then includes a clause to the effect that, during the beneficiary's minority, the income is to be accumulated, with provisions for the ultimate distribution of the accumulations either to the beneficiary or to his estate. The arguments asserted in favor of the exclusion for a discretionary accumulation trust might again be marshalled here. Nevertheless, it is difficult to envisage a court being persuaded that this trust created a "present interest" in income through what is essentially a mere drafting technique. For, unlike a discretionary accumulation trust, the proposed trust makes it impossible for any income to be distributed during the beneficiary's minority.

Where a mandatory accumulation trust also provides for a discretionary power of invasion, the problem of limiting the availability of the exclusion becomes more acute. Here, the trust would be substantially the same as a discretionary accumulation trust; and if the latter is to qualify under Section 2503(b) so should the former.

**CONCLUSION**

Section 2503(c) was proudly presented to the tax world with the beguiling announcement that it describes "a certain type of gift to a minor which will not be treated as a gift of a future interest." While this statement is entirely accurate as far as it goes, it must not be forgotten that one of the conditions to the availability of this section is a trust provision requiring the outright distribution to the income beneficiary of both corpus and accumulations at his 21st birthday. This can prove to be an extremely unwise dispositive program, particularly when the beneficiary is not personally equipped to handle a large distribution.

Both the American Law Institute and the Tax Section of the

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113 United States v. Pelzer, 312 U. S. 399 (1941); Ryerson v. United States, 312 U. S. 405 (1941). The Supreme Court had laid the groundwork for this result when it previously held that the beneficiary—and not the trustee—was the donee to whom the exclusion applied. Helvering v. Hutchings, 312 U. S. 393 (1941).

114 Under prior law, this trust clearly would create "future interests." Cf. Comm'r v. Glos, 123 F. (2d) 548 (C. C. A. 7th, 1941) (vested right and power of appointment over accumulations).

115 See note 111, supra.

American Bar Association have recognized this underlying weakness in Section 2503(c). The ALI has recently made a number of far-reaching suggestions, one of which would permit the full exclusion though the trust continued during the lifetime of the income beneficiary.117 While the ALI approach seems consistent with the original Congressional Committee Reports dealing with the future interest problem,118 the ABA is not presently asking for that much leeway. Instead, it would be satisfied if the trust could be continued up to 10 years beyond the beneficiary's 21st birthday.119

It is obvious that Section 2503 (c) as it exists today does not provide a complete solution. On balance, a greater variety of more satisfactory arrangements is available through Section 2503 (b). This provision permits the creation of a trust with income to be paid to the minor for his entire life, or for any shorter period. The corpus, in turn, may be payable to the minor personally, to his estate, or to any other person or organization designated by the donor.120 In addition, the trustee may be granted the discretion to invade corpus at any time for the minor's benefit. With all of this, only a comparatively small part of the gift will not qualify for the annual exclusion.

Under the Sensenbrenner-Fisher formula,121 where a Section 2503(b)
TRUSTS FOR MINORS

trust provides for income to be paid or applied for a minor during his life, the "present interest" value of gifts made during minority—computed under the current actuarial tables—will average more than 80 per cent of the actual value of the gift properties. In other words, annual gifts to such a trust of $3,750 will produce an average annual exclusion of $3,000, or, with gift-splitting, $7,500 of gifts will produce taxable gifts of only $1,500.

A gift tax return will have to be filed for that portion of the gift constituting a future interest; and practical difficulties may arise in the handling of the funds required to be distributed. However, the problems are not insurmountable, and are well worth undertaking when balanced against the flexibility made possible by such a trust in the ultimate disposition of gift properties.

1956]
Washington and Lee Law Review

Member of the Southern Law Review Conference

Volume XIII 1956 Number 2

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