

FEDERAL TAXATION: INSTRUCTION TO PAY PREMIUMS  
FOR INSURANCE ON LIFE OF DONEE FROM TRUST  
ASSETS HELD TO QUALIFY UNDER SECTION 2503 (c)

THE Fifth Circuit Court of Appeals in *Duncan v. United States*<sup>1</sup> has held that the settlor of an inter vivos trust is allowed the 3000-dollar annual exclusion under section 2503 of the gift tax provisions<sup>2</sup> although the trust instrument provides that the trustee is to use all available assets of the trust to pay the premiums on insurance policies on the lives of the minor donees. The taxpayers, husband and wife, had established separate inter vivos trusts for each of seven minor grandchildren and had transferred to each trust stock, cash, and a substantial insurance policy on the life of the grandchild. Each trust instrument provided broad discretionary powers for the professional trustee, including authority to dispose of trust property.<sup>3</sup> However, Paragraph 12 of the instrument directed the trustee to "apply any and all available funds and assets" of the trust to payment of premiums on the life insurance transferred to the trust.<sup>4</sup> The Commissioner of Internal Revenue disallowed the taxpayers' claimed exclusions on the theory that Paragraph 12 constituted a "substantial restriction"<sup>5</sup> on the trustee's discretion and thus barred the gifts from the exclusion. In the taxpayers' subsequent refund suit, the district court decided that Paragraph 12 prevented the trusts from qualifying for the annual exclusion under section 2503 (c),<sup>6</sup> particularly since the face value of each policy could be realized only after the beneficiary had died. The Fifth Circuit held, however, that the trusts did qualify because the specific language of the direction to pay premiums did not restrict the trustee's discretion and further because the gift of insurance on each donee's life was not inherently a gift of a future interest.

The Internal Revenue Code allows a 3000-dollar annual exclusion

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<sup>1</sup> 368 F.2d 98 (5th Cir. 1966).

<sup>2</sup> INT. REV. CODE OF 1954, § 2503 (b).

<sup>3</sup> 368 F.2d at 100, 101 nn.6, 9.

<sup>4</sup> *Id.* at 101.

<sup>5</sup> Treas. Reg. § 25.2503-4 (b) (1) (1958).

<sup>6</sup> *Duncan v. United States*, 65-2 U.S. Tax Cas. 97160 (M.D. Fla. June 9, 1965), *rev'd*, 368 F.2d 98 (5th Cir. 1966).

from taxable gifts except on gifts of future interests.<sup>7</sup> In 1945, the Supreme Court held that the distinction between present and future interests as it then existed<sup>8</sup> prevented the exclusion for a gift in trust to minors where there was no requirement that the property be presently expended for the minor's benefit.<sup>9</sup> The inhibiting effect of that decision<sup>10</sup> was never fully overcome until the passage of section 2503 (c) in the 1954 Code.<sup>11</sup> This section was added expressly to grant the exclusion to trust gifts for minors,<sup>12</sup> but then only if the "property and the income therefrom may be expended" by the trustee for the donee's benefit before he attains the age of twenty-one years and the trust is to be turned over to the donee at his twenty-first birthday or to his estate if he should die before reaching twenty-one.<sup>13</sup> The Internal Revenue Service has been generally unsuccessful in its attempts to impose a strict construction upon the provisions calling for termination of the trust when the donee reaches majority<sup>14</sup> and for transfer of the trust property to the donee's estate if he dies before reaching twenty-one.<sup>15</sup>

The regulations provide that a gift to a minor "may be expended" and hence qualify for the exclusion even though

there is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, provided there are no *substantial* restrictions under the terms of the trust instrument on the exercise of such discretion.<sup>16</sup>

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<sup>7</sup> INT. REV. CODE OF 1954, § 2503 (b); Treas. Reg. § 25.2503-3 (1958). See generally LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES § 33 (2d ed. 1962).

<sup>8</sup> Int. Rev. Code of 1939, § 1003 (b), 53 Stat. 146 (now INT. REV. CODE OF 1954, § 2503 (b)).

<sup>9</sup> *Fondren v. Commissioner*, 324 U.S. 18, 24-25 (1945), 44 MICH. L. REV. 321; *accord*, *Commissioner v. Disston*, 325 U.S. 442 (1945); see *Helvering v. Hutchings*, 312 U.S. 393 (1941) (trust beneficiary rather than the trustee is donee of gift).

<sup>10</sup> H.R. REP. NO. 1337, 83d Cong., 2d Sess. 93 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 127 (1954); see Lentz, *Drafting a Section 2503(c) Trust for a Minor*, 38 DICTA 11, 12-13 (1961).

<sup>11</sup> See *Duffey v. United States*, 182 F. Supp. 765 (D. Minn. 1960) (future interest under 1939 Code provisions would have qualified under § 2503 (c)).

<sup>12</sup> H.R. REP. NO. 1337, 83d Cong., 2d Sess. 93 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 127 (1954).

<sup>13</sup> INT. REV. CODE OF 1954, § 2503 (c).

<sup>14</sup> See *Arlean I. Herr*, 35 T.C. 732 (1961), *aff'd*, 303 F.2d 780 (3d Cir. 1962), *nonacq.*, 1962-2 CUM. BULL. 6, 43 B.U.L. REV. 356; *accord*, *Rollman v. United States*, 342 F.2d 62 (Ct. Cl. 1965).

<sup>15</sup> See *Jacob Konner*, 35 T.C. 727 (1961), *nonacq.*, 1963-2 CUM. BULL. 6; *accord*, *Carl E. Weller*, 38 T.C. 790, 807-10 (1962), *nonacq.*, 1963-2 CUM. BULL. 6.

<sup>16</sup> Treas. Reg. § 25.2503-4 (b) (1) (1958). (Emphasis added.)

Until *Ross v. United States*<sup>17</sup> in 1965, however, no reasoned opinion dealt directly with a trustee's discretion to expend the trust property.<sup>18</sup> The Fifth Circuit in *Ross* was confronted with a gift in trust under the terms of which the trustee was given the powers of a guardian but no explicit authority to invade corpus. Thus, the trustee was, under state law, able to invade corpus only through court action or in case of emergency.<sup>19</sup> Without considering whether the restrictions were "substantial," the court held that, despite the state law restrictions, the entire gift qualified for the exclusion.<sup>20</sup>

The trust in *Duncan* posed the further question whether a similarly unrestricted gift will be disqualified because insurance on the life of the donee, a common form of gifts of insurance,<sup>21</sup> is inherently a future interest since the donee can never realize the face value of the policy. While the gift tax provisions of the 1954 Code are silent on insurance,<sup>22</sup> the regulations<sup>23</sup> permit it to qualify for the annual exclusion so long as the donor surrenders the incidents of ownership,<sup>24</sup> but they make no distinction between insurance on the life of the donor and that on the life of the donee.<sup>25</sup> The only case which appears to have specifically discussed insurance on the life of the donee, *Arthur A. Frank*,<sup>26</sup> decided under the Revenue Act of 1932,<sup>27</sup> seems to indicate that a policy on the donee's life is fully capable of being a present interest.<sup>28</sup> Some state legislatures apparently have acted on that assumption by adding gifts of life insurance to their enactment of the Uniform Gifts to Minors Act,<sup>29</sup>

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<sup>17</sup> 348 F.2d 577 (5th Cir. 1965), 1966 DUKE L.J. 578.

<sup>18</sup> *But cf.* *De Concini v. Wood*, 60-1 U.S. Tax Cas. 76438 (D. Ariz. Jan. 28, 1960) (need for resort to equity court is not prohibitive restriction).

<sup>19</sup> *Ross v. United States*, 226 F. Supp. 333, 336 (S.D. Tex. 1963), *rev'd*, 348 F.2d 577 (5th Cir. 1965).

<sup>20</sup> 348 F.2d at 581. See *Commissioner v. Thebaut*, 361 F.2d 428 (5th Cir. 1966).

<sup>21</sup> McKay, *Life Insurance in Estate Planning*, 43 B.U.L. REV. 270, 281 (1963).

<sup>22</sup> *But cf.* INT. REV. CODE OF 1954, § 2042 (taxation of life insurance under the estate tax).

<sup>23</sup> Treas. Reg. § 25.2503-3 (a) (1958). See Harbeck Halsted, 28 T.C. 1069 (1957) (trust gift of insurance on donor's life qualifies for exclusion).

<sup>24</sup> Treas. Reg. § 25.2511-1 (g) (8) (1958). See Treas. Reg. § 25.2512-6 (1958) (criteria for valuation of life insurance); LOWNDES & KRAMER, *op. cit. supra* note 7, § 33.8; Note, 1967 DUKE L.J. 193 (incidents of ownership for estate tax purposes).

<sup>25</sup> *But see* 368 F.2d at 102 n.12.

<sup>26</sup> 13 P-H Tax Ct. Mem. 1291 (1944).

<sup>27</sup> Revenue Act of 1932, ch. 209, § 504 (b), 47 Stat. 247 (now INT. REV. CODE OF 1954, § 2503 (b)).

<sup>28</sup> 13 P-H Tax Ct. Mem. at 1293-94.

<sup>29</sup> See Aland, *Tax and Substantive Aspects of Gifts to Minors*, 18 ALA. L. REV. 82,

which, as originally drafted to cover gifts of cash and securities, has been ruled to meet the standards of section 2503 (c).<sup>30</sup>

The Government argued in *Duncan* that the direction in Paragraph 12 required a retention of the corpus and an accumulation of income by the trustee to pay the premiums.<sup>31</sup> The court of appeals, however, in determining whether there was any restriction seized on the phrase "apply any and all *available* funds and assets"<sup>32</sup> and accordingly decided that Paragraph 12 referred only to funds that were at the disposal of the trustee.<sup>33</sup> Hence, when it construed each trust as a whole, noting that the other terms permitted full expenditure, the court determined that availability of funds for the premium payments was "entirely dependent upon the trustee's discretion."<sup>34</sup> Regardless of the reasonableness of that construction, the court held that the trusts would nevertheless qualify for the exclusion if the restriction were insubstantial.<sup>35</sup> The district court had reasoned that the gifts themselves were future interests since the payments to be made were on policies for the minors' own lives and therefore were "not for the present benefit and enjoyment of the minors involved, but rather for their estates."<sup>36</sup> However, the court of appeals held that the payment of premiums was "not an expenditure for the future interest of the minor or his estate,"<sup>37</sup> because the cash surrender value and the possibility of immediate transfer, cancellation, or other means of disposal made each policy a viable asset the present value of which was enhanced by the premium payments. The order to pay premiums merely substituted one form of trust property, cash, for another, a paid-up policy, which still could be expended for the minor's present benefit. Thus, even if the direction to pay premiums was a restriction, it was not a substantial one.<sup>38</sup>

The Fifth Circuit read the trust instrument in a manner which

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100 n.113 (1965); CAL. CIV. CODE § 1155 (p) (explicitly includes policies on life of donee).

<sup>30</sup> Rev. Rul. 59-357, 1959-2 CUM. BULL. 212. See Newman, *The Uniform Gifts to Minors Act in New York and Other Jurisdictions—Tax Consequences, Possible Abuses, and Recommendations*, 49 CORNELL L.Q. 12, 35-43 (1963).

<sup>31</sup> 65-2 U.S. Tax Cas. at 97161.

<sup>32</sup> 368 F.2d at 102. (Emphasis supplied by the court.)

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> 65 U.S. Tax Cas. at 97,163.

<sup>37</sup> 368 F.2d at 102.

<sup>38</sup> *Id.* at 103.

seems consistent with the settlor's intentions. The wording of the trust instrument<sup>39</sup> indicates that it was deliberately designed to fit the tests of section 2503 (c). While Paragraph 12 may have purported to limit the other terms of the trust and to restrict the trustee, it is more likely, as the court indicated, that it was intended to be a guidance device for the trustee in his handling of the assets. However, this aspect of the decision should not alone mean that the gift qualified for the exclusion. The intent of Congress seemingly was to provide that gifts in trust to minors which had been held to be future interests solely because of the trust nature of the gift should thenceforth be granted the 3000-dollar exclusion from the gift tax. It would be a stultification of that intent to allow any trust gift to a minor, particularly one where the corpus of the trust was otherwise a future interest, to qualify for the exclusion merely by use of the term "available." Thus, if a gift of insurance on the life of the donee would be inherently a future interest, even if given outright instead of by trust,<sup>40</sup> section 2503 (c) should still not be applicable. Of more general importance, however, is the rejection of the district court's application of the future-interest/present-interest dichotomy to insurance on the life of the donee. The test of a life insurance gift is whether the donee, or trustee when the gift is in trust, has the ability to realize immediately the present value of the policy. When, if ever, the donee may receive the face value of the policy is irrelevant in the case of a gift on the donor's life. There is no rational basis for deciding otherwise when the insurance is on the life of the donee. The Fifth Circuit's clarification of the present-interest/future-interest distinction and its determination that insurance on the donee's life is not to be considered a future interest are significant aids in the drafting of trusts designed to meet the test of the "may be expended" clause. At the same time, *Duncan* generally reinforces the liberal interpretation of section 2503 (c) which had been initiated in cases construing other elements of the code provision.<sup>41</sup>

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<sup>39</sup> *Id.* at 100-01 nn.6-8.

<sup>40</sup> See *Rollman v. United States*, 342 F.2d 62 (Ct. Cl. 1965); Carl E. Weller, 38 T.C. 790, 807-10 (1962), *nonacq.* 1963-2 CUM. BULL. 6; Arlean I. Herr, 35 T.C. 732 (1961), *nonacq.* 1962-2 CUM. BULL. 6; Jacob Konner, 35 T.C. 727 (1961), *nonacq.* 1963-2 CUM. BULL. 6.

<sup>41</sup> See notes 14-15 *supra* and accompanying text.