Louisiana Law Review

Volume 34 | Number 1
Fall 1973

Valuation of Interests in Trust: A Louisiana Perspective

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COMMENTS

VALUATION OF INTERESTS IN TRUST: A LOUISIANA PERSPECTIVE

The use of trusts is expanding dramatically in Louisiana as the practicing bar realizes the estate planning opportunities which they afford. An inherent flexibility, the availability of professional management, and innumerable tax advantages have led to the incorporation of this common law device into the Louisiana civilian system of successions, donations and property law at a pace which often leaves confusion, or at least uncertainty, in its wake. One such murky area is valuation of beneficial interests in trusts for taxation purposes. Although some basic principles are indicated in the Trust Code[1] and a handful of cases dealing with the difficulties have been decided, most valuation questions remain open and require a careful analysis of the Trust Code in conjunction with the Internal Revenue Code and the Louisiana Inheritance Tax Act.[2]

The Louisiana Trust Code permits the designation of one or more beneficiaries as to income, principal or both.[3] If there is only one beneficiary, the valuation problem is minimal. The entire trust is valued as his interest using the total value of all of the property in the trust as the measure.[4] However, difficulty arises when there are several principal or income beneficiaries, especially where there is a shifting of income interests, a possibility of an invasion of principal or an allocation of accumulated income to the principal beneficiaries. The least complicated of the above situations is that in which there are separate income and principal beneficiaries for the duration of the trust with no shifting interests whatsoever.[5] Such an arrangement is similar to the civilian concept of usufruct with income beneficiaries approximating usufructuaries, and principal beneficaries, naked owners.[6] That is, where *S* creates a trust with *A* as income beneficiary for life and *B* as principal beneficiary, the effects are quite similar to those flowing from *S*'s having made *A* usufructuary and *B* naked owner, the essential difference being that *A*, as income beneficiary, is not burdened with the management of the property. Frequently this occurs where the settlor wishes to leave his widow an income interest analogous to the usufruct of the surviving spouse provided in

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1. LA. R.S. 9:1721-2252 (Supp. 1964).
2. LA. R.S. 47:2401-23 (1950).
3. LA. R.S. 9:1805, 1806 (Supp. 1964).
4. LA. R.S. 9:1731, 1801, 1805 (Supp. 1964).
5. LA. R.S. 9:1805 (Supp. 1964).
6. LA. CIV. CODE art. 533.

Civil Code article 916. So long as the children's legitime does not comprise part of the trust res, the term of the trust may either be fixed or can terminate upon the death of the last surviving income beneficiary.[7] When the legitime is placed in trust,[8] the trust must terminate as to each heir's forced portion upon his death.[9] Furthermore, since the burden placed on the legitime cannot exceed that which could be imposed through usufruct,[10] the trust over the legitime must terminate, as would the legal usufruct, upon the death or remarriage of the surviving spouse.[11]

Next in complexity are trusts with multiple income beneficiaries. These interests may be either concurrent or successive;[12] the term may be definite, until the happening of a stated event or for the duration of the beneficiary's life.[13] Thus *A* and *B* may be income beneficiaries for the entire term of the trust, either in equal shares or some other fixed proportion, with or without the power of either to succeed to the share of the other upon his death. Alternatively, *A* may be income beneficiary for life or for a fixed term with *B* to succeed him for the remainder of the life of the trust. The possible variations are practically unlimited.

Any of the above situations can be further complicated by the inclusion of an invasion of principal[14] or an accumulation of income clause[15] in the trust instrument. Although reminiscent of the prohibited substitution[16] in that they divest a beneficiary of a vested right to property by transferring some of that property to another beneficiary, both clauses are specifically permitted by the Trust Code[17] and should be used in the proper circumstances. The propriety of the circumstances may often be dictated by the taxation value placed on each of the interests. This in turn depends in each of the above situations on the contingencies involved and the probability of their occurrence. Even though the probability of such contigencies can be evaluated statistically, in many instances the certainty of the calculations is not sufficient for tax purposes and the shift is treated either

7. LA. R.S. 9:1831 (Supp. 1964), *as amended by* La. Acts 1968, No. 132 § 1; LA. R.S. 9:1832-33 (Supp. 1964).

8. LA. R.S. 9:1841 (Supp. 1964).

9. LA. R.S. 9:1841, 1844 (Supp. 1964).

10. LA. R.S. 9:1844 (Supp. 1964).

11. LA. R.S. 9:1961 (Supp. 1964); 9:2068 (Supp. 1964), *as amended by* La. Acts 1972, No. 661 § 1.

12. LA. R.S. 9:1806, 1807 (Supp. 1964).

13. LA. R.S. 9:1961 (Supp. 1964).

14. LA. R.S. 9:2068 (Supp. 1960), *as amended by* La. Acts 1972, No. 661 § 1.

15. LA. R.S. 9:1961 (Supp. 1964).

16. LA. CIV. CODE art. 1520.

17. LA. R.S. 9:1961 (Supp. 1964).

as having already occurred or as having no chance of occurring. Tax law, both federal and state, dictates what treatment is given in each instance.

Federal Estate Taxation

The very nature of the federal estate tax prevents the problem of valuation of the interest of each beneficiary from arising in most cases. Since this transfer tax is computed on the basis of the entire estate, rather than the component legacies,[18] reference need not usually be made to the individual beneficiary's inheritance.[19] The gross estate of the decedent provides the appropriate measure. It is only when the beneficiary's share in the trust is classified as a deduction in computing the taxable (or net) estate[20] or when an interest in trust passes as a gift or part of the estate that the particular interest must be valued. This has frequently arisen in mixed trusts[21] where a qualified public, charitable or religious institution is either the income or the principal beneficiary, with a private beneficiary holding the other interest.[22]

A well settled body of law had been developed under the Internal Revenue Code of 1954 and its predecessors in regard to valuation of the charitable portion of the mixed trust. For the deduction to be available, the charity's interest had to be both ascertainable and susceptible of valuation at the time of the creation of the trust[23] and

18. INT. REV. CODE OF 1954, §§ 2001, 2051; Reinecke v. Northern Trust Co., 278 U.S. 339 (1929); Edwards v. Slocum, 264 U.S. 61 (1924); Aldrich v. United States, 346 F.2d 37 (5th Cir. 1965); Walter v. United States, 341 F.2d 182 (6th Cir. 1965); Succession of Henderson, 211 La. 707, 30 So. 2d 809 (1947).

19. INT. REV. CODE OF 1954, § 2031.

20. INT. REV. CODE OF 1954, § 2051.

21. LA. R.S. 9:1951 (Supp. 1964), *as amended by* La. Acts 1972, No. 659 § 1.

22. INT. REV. CODE OF 1954, § 2055. Such trusts are called charitable income trusts and charitable remainder trusts, respectively. *See generally* Comment, 45 TUL. L. REV. 115 (1970).

23. INT. REV. CODE OF 1954, § 2055; Treas. Reg. §§ 20.2055-2(a), 25.2522(a)-2(a) (1958); Humes v. United States, 276 U.S. 487 (1928). In *Humes* at 494, Mr. Justice Brandeis stated the requirements in the following manner: "One may guess, or gamble on, or even insure against, any future event. The Solicitor General tells us that Lloyds of London will insure against having twins. But the fundamental question in the case at bar, is not whether this contingent interest can be insured against or its value guessed at, but what construction shall be given to a statute. Did Congress in providing for the determination of the net estate taxable, intend that a deduction should be made for a contingency, the actual value of which cannot be determined from any known data? Neither taxpayer, nor revenue officer,—even if equipped with all the aid which the actuarial art can supply,—could do more than guess at the value of this contin-

there could be at most a negligible probability that the charity would not get the bequest.[24] Thus a charitable remainder trust could qualify for deduction of the charity's interest even though the trust instrument contained an invasion of principal clause if the trust contained sufficiently definite standards for invasion and if those standards met the requirements set forth above.[25]

The Tax Reform Act of 1969 replaced these jurisprudentially developed guidelines with the requirement that the bequest must be in the form of an annuity trust or a unitrust in order for the charitable donation to qualify for the deduction.[26] These trusts are ones which annually pay the income beneficiary (annuitant) an annuity of at least five percent of the trust corpus.[27] In the annuity trust the valuation of the corpus is at the commencement of the trust and the annuity is fixed for the duration of the trust.[28] The unitrust share is based on an annual valuation of corpus and, therefore, may vary from year to year.[29] Thus if *S* creates a trust with property valued at $100,000, with *A* as income beneficiary to be paid five percent of the trust corpus annually, *i.e.*, $5,000 a year, the trust is an annuity trust. If the valuation of the corpus is to be made annually and *A* is to receive five percent of that annual valuation, it is a unitrust. In the first type *A*'s annual income from the trust is permanently fixed at its creation, whereas in the second it may vary.[30]

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gency. It is clear that Congress did not intend that a deduction should be made for a contingent gift of that character."

24. Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595 (1949); Merchants Nat'l Bank v. Commissioner, 320 U.S. 256 (1943); Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). In *Ithaca Trust Co.* at 154, Mr. Justice Holmes lookd for: (1) A "standard was fixed in fact and capable of being stated in definite terms of money." (2) Lack of discretion in the private beneficiary. (3) "No uncertainty appreciably greater than the general uncertainty that attends human affairs." For an excellent survey of the jurisprudence on this point see *Kline v. United States*, 202 F. Supp. 849 (N.D. W.Va. 1962).

25. *Id.*

26. *See* INT. REV. CODE OF 1954, §§ 170(f)(2), 2055(e)(2), 2522(i)(2); Comment, 45 TUL. L. REV. 115 (1970).

27. INT. REV. CODE OF 1954, § 664(d)(1), (2).

28. *Id.* § 664(d)(1).

29. *Id.* § 664(d)(2).

30. Until the Trust Code was amended in 1972 the practitioner was faced with the possibility that annuity trusts and unitrusts could not validly be created in Louisiana. Because of this danger, the legislature, on the recommendation of the Louisiana Law Institute, amended Trust Code Articles 1951, 1952 and 2068 to specifically authorize the use of such trusts. (La. Acts 1972, Nos. 659-61). The standards provided in the Internal Revenue Code are by reference adopted as controlling. LA. R.S. 9:1951 (Supp. 1964), *as amended by* La. Acts 1972, No. 659 § 1; LA. R.S. 9:1952 (Supp. 1964), *as*

Valuation of annuity and unitrusts is relatively straightforward. The value of the annual income under the annuity trust is computed using the fair market value of the trust corpus and the percentage return (at least five percent) specified in the trust instrument.[31] The term must be ascertained, whether it is fixed or for the annuitant's life. In this latter case mortality tables must be used to compute the annuitant's life expectancy, which is used as the term of the trust. Value is then calculated as for any annuity. In the case of the unitrust similar computations are made, taking into account probable fluctuations in the value of the property.[32]

Louisiana Inheritance Taxation

In contrast to the federal estate tax which is levied upon the transfer of the entire estate, the Louisiana inheritance tax is on the privilege of receipt of each legacy or inheritance by the legatees.[33] As a result, the measure of the tax is the size of the individual legacy; the portion of the legacy exempt from taxation and the applicable tax rates are dependent upon the relation of the legatee to the testator.[34] Therefore the valuation problem will arise every time a testamentary trust is created and whenever a beneficial interest in trust passes in the estate of a decedent. In cases where there is only one beneficiary, valuation is simple: the value of the beneficiary's share equals the value of the trust corpus. Similarly, where the income and principal beneficiaries are the same persons, holding both income and principal interests in the same proportion, the value of each one's share equals the fractional value of his interest in the trust.[35] Complications arise only when there are separate income and principal beneficiaries.

In the conventional trust without an invasion of principal clause

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amended by La. Acts 1972, No. 660 § 1; LA. R.S. 9:2068 (Supp. 1964), *as amended by* La. Acts 1972, No. 661 § 1. Because of this the annuity trusts and unitrusts permitted under Louisiana law will always coincide with those required for federal tax purposes. *See generally* Oppenheim, *The 1972 Amendments to the Trust Code of 1964*, 47 TUL. L. REV. 315 (1973).

31. INT. REV. CODE OF 1954, § 664(d)(1)(2); Treas. Reg. §§ 1.664-2 to -3 (1972).

32. The above outline of the procedures is, of necessity, greatly simplified. Treasury Regulations 1.664-1 through 1.664-4 (1972) provide detailed guidance in this complex process.

33. Succession of Henderson, 211 La. 707, 30 So. 2d 809 (1947); LA. R.S. 47:2401 (1950).

34. LA. R.S. 47:2402 (1950), *as amended by* La. Acts 1972, No. 543 § 1; 47:2403 (Supp. 1958), *as amended by* La. Acts 1958, No. 543 § 1.

35. In this instance valuation is identical for both the federal estate tax and the Louisiana inheritance tax.

or any provision for accumulation of income, the financial position of the parties is very similar to that involved in usufruct.[36] Since the legislature has provided a method for valuation of a usufruct or an annuity,[37] it would seem that the proper method of valuation of the analogous trust interest is to consider the interest of the income beneficiary to be similar to a usufruct over the trust res and to use the tables provided in R.S. 47:2405 to calculate its worth.[38] This actuarial value is then subtracted from the value of the trust property to determine the value of the principal beneficiary's interest.[39] This approach has the further benefit that it can be readily adapted for use in more complicated situations, as was done in *Succession of Kaufman.*[40] In that case the testatrix had left her property in trust with her husband and daughter as concurrent income beneficiaries and her grandchildren as principal beneficiaries. The trust instrument further provided that the daughter was to succeed to the husband's income interest upon his death and that the grandchildren were to succeed her as income beneficiaries. The trustee was authorized to invade principal for the care of the husband during his life and thereafter for the care of the daughter. In approaching the valuation problems, the court began by holding that the income interest should be treated as if it were a usufruct over the trust corpus. The income interest relating to the property which would have been subject to the usufruct of the surviving spouse was considered to be analogous to a testamentarily confirmed usufruct and thus was held to be exempt from inheritance taxation.[41] The first time the court of appeal heard the case it held that the invasion of principal clause would cause the entire trust corpus (except for the legitime which could not be invaded under the provisions of the Trust Code) to be taxable to the income beneficiary, the settlor's husband.[42] The court first calculated the husband's tax liability and the value of the property (both taxable and exempt) which was considered for tax purposes as passing to him. The court

36. Succession of Bellinger, 229 So. 2d 749 (La. App. 1st Cir. 1969).

37. LA. R.S. 47:2405 (1950).

38. Succession of Bellinger, 229 So. 2d 749, 751 (La. App. 1st Cir. 1969): "We therefore feel, that even though the inheritance tax sections of our law do not speak in terms of an income interest or income benefit, but rather in terms of a usufruct, we feel that the same tax rules should be applicable here."

39. LA. R.S. 47:2405 (1950).

40. 274 So. 2d 471 (La. App. 1st Cir. 1973). The case had previously been heard by the court, 229 So. 2d 752 (La. App. 1st Cir. 1969), *writs refused*, 255 La. 279, 230 So. 2d 587 (1970), at the same time as *Succession of Bellinger*, 229 So. 2d 749 (La. App. 1st Cir. 1969).

41. 274 So. 2d 471, 473.

42. 229 So. 2d 752.

next determined the tax due by the daughter of the settlor. In so doing the court held that the possibility of an invasion of principal for her benefit was so remote as to have no tax consequences for her.[43] The reasoning was that the imposition of the tax is based upon the situation as it existed at the time of the death of the testatrix, and therefore contingent occurrences which might or might not occur in the future could not be considered. The same approach caused the court to hold that successive contingent income interests could not be taxed to those potential future beneficiaries since the interests did not come into being at the time of the testatrix's death.[44] Future interests which do not vest "seizin in fact" in the recipient are not subject to the Louisiana inheritance tax.[45]

After having valued the interests of the husband and daughter, the court proceeded to value the rights of the principal beneficiaries, the grandchildren. Although it first carefully pointed out that these interests should be valued at their actual cash value, the court concluded that the only equitable way it could compute this was by deducting the value previously attributed to the husband and the daughter from the total value of the trust corpus to reach the value of the remainder.[46] In this manner the court assured that the entire estate would be valued for taxation, but that none of the property would be counted more than once. There certainly is a logical appeal to any approach which concludes that the sum of the parts equals the whole.

Should other courts refuse to follow the First Circuit "seizin in fact" analysis, then where successive income interests have been created, whether for fixed terms or the life of each beneficiary, the value of each may be calculated using the tables in R.S. 47:2405. If *A* is the first income beneficiary for life, *B* to succeed him for the duration of his life, *A*'s life expectancy is obtained from the mortality table and from this the value of his interest is computed. Using *B*'s age as of the projected date of death of *A*, the same calculations are performed for the second income interest. The value is totaled and subtracted from the fair market value of the trust res to determine the value of the principal interest. If the term of either or both income interest were fixed rather than for life, the stipulated term is used in the computation, rather than the actuarially determined life expectancy.

43. 274 So. 2d 471, 476.

44. *Id.*

45. 274 So. 2d 471, 476, *citing* Succession of Martin, 234 La. 566, 100 So. 2d 509 (1958).

46. 274 So. 2d 471, 477.

In each case, a reasonable, though arbitrary, rate of return on the trust principal is assumed in order to figure the value of the income interest.[47]

If the term of the interest is dependent upon the happening of an event, the occurrence or timing of which is insusceptible of mathematical computation or forecast, complex valuation problems occur. With an incalculable term, the income interest cannot be fixed with any precision. Frequently this problem arises in Louisiana when the legitime is placed in a trust which serves the function of the legal usufruct of the surviving spouse.[48] The Trust Code provides that the term of the trust cannot exceed the life of the forced heir nor can the burden on the legitime be for a greater time than would be possible using usufruct.[49] Since the legal usufruct of the surviving spouse must terminate upon the death or remarriage of the spouse,[50] it would seem that the trust over the legitimate would of necessity terminate upon the happening of the first of these events to occur. Although the actuarially expected dates of death of both the surviving spouse and the forced heir can be computed, there is not sufficient certainty as to the occurrence of the last contingency, remarriage, to allow for computation of its anticipated date. Yet without this, the term cannot be forecast and the value cannot be fixed. It is instructive to note that the Louisiana courts have extracted themselves from this quandry in valuing the usufruct of the surviving spouse by merely ignoring the unmeasurable contingency and calculating the value with regard only to the expected date of death of the usufructuary.[51] If this approach is followed in the case of the legitime in trust, value can be calculated by using the shorter of the life expectancies (1) of the surviving spouse (or other income beneficiary in similar incalculable situations) or (2) of the forced heir (or principal beneficiary) as the term of the trust.

A much different result is reached, however, in cases of private trusts containing invasion of principal clauses.[52] Although it has been

47. LA. R.S. 47:2405 (1950) fixes the rate currently at six percent.

48. LA. CIV. CODE art. 916.

49. LA. R.S. 9:1841, 1844 (Supp. 1964).

50. LA. CIV. CODE art. 916. In *Succession of Chauvin*, 260 La. 828, 257 So. 2d 422 (1972) the supreme court held that a testamentarily confirmed usufruct of the surviving spouse would terminate upon the death or remarriage of the surviving spouse as is provided in Civil Code article 916.

51. Succession of Baker, 129 La. 74, 55 So. 714 (1911); *In re* Stelly's Estate, 185 So. 637 (La. App. 1st Cir. 1939); LA. R.S. 47:2405 (1950); OP. LA. ATT'Y GEN. 1183 (1934-36).

52. Succession of Kaufman, 274 So. 2d 471 (La. App. 1st Cir. 1973); Succession

strenuously argued that criteria similar to that developed by the federal courts in charitable remainder cases should be adopted in Louisiana, such a result has not been reached.[53] Rather the courts have treated the entire trust as being inherited by the income beneficiary, and thus taxable to him. There is strong indication in *Succession of Kaufman*,[54] however, that the courts may be reevaluating this position.

One final problem that should be dealt with is the valuation of annuity trusts and unitrusts for the Louisiana inheritance tax. The most logical approach would be to adopt the federal tax value, reasoning that these devices are creatures of the federal tax law which have been incorporated into the Louisiana Trust Code to allow the Louisiana resident the benefit of the available federal tax advantages. Since the Trust Code looks to the Internal Revenue Code for definitions and rules regarding the use of unitrusts and annuity trusts,[55] shouldn't Louisiana inheritance tax law likewise look to federal procedures of valuation? If so, problems are minimal; the procedure previously outlined in conjunction with federal taxation would be used.

If, on the other hand, the courts look to traditional state valuation concepts, we might reach different results with regard to unitrusts. The annuity trust would be valued as is provided in the explicit statutory provisions dealing with valuation of annuities and property subject thereto.[56] This is the same procedure as is used for federal taxation. Using the tables provided we calculate the life expectancy of the beneficiary[57] and find the present value of the right

of Kaufman, 229 So. 2d 752 (La. App. 1st Cir. 1969); Succession of Bellinger, 229 So. 2d 749 (La. App. 1st Cir. 1969); Succession of Lindsey, 179 So. 2d 669 (La. App. 2d Cir. 1965).

53. *Id.*

54. 274 So. 2d 471 (La. App. 1st Cir. 1973).

55. LA. R.S. 9:1951 (Supp. 1964), *as amended by* La. Acts 1972, No. 659 § 1; 9:1952 (Supp. 1972); LA. R.S. 2068 (Supp. 1964), *as amended by* La. Acts 1968, No. 133 § 1; 1972, No. 661 § 1.

56. LA. R.S. 47:2405 (1950). That an annuity such as the one from an annuity trust is contemplated in the above statute see *Succession of Cotton*, 172 La. 819, 135 So. 368 (1931). It must be admitted that Louisiana courts could extend the reasoning of the *Kaufman*, *Bellinger* and *Lindsey* cases and hold that, since principal could be depleted in the annuity trust, the entire trust must be treated as a legacy to the annuitant for inheritance taxation purposes. But in order to so hold, the courts would have to ignore the clearly applicable statutory provision for annuity valuation. LA. R.S. 47:2405 (1950).

57. If the duration of the trust is a fixed, determinable length of time, we merely use that period.

to receive the principal at the end of that time, giving us the value of the principal beneficiary's interest. The value of the income beneficiary's interest is calculated by discounting the annuity to be received over his life expectancy to its present value[58] and adding those present values together to reach a total figure.[59] Valuation of the unitrust is not provided for in the inheritance tax statutes. However, an answer to our dilemma may be found by looking to the principles embodied in the Louisiana jurisprudence dealing with trust taxation. Since principal can possibly be exhausted and the value of the unitrust share varies each year with fluctuations in principal, it can be expected that the rationale of earlier cases might be followed to hold that the entire corpus of the trust must be taxed as a legacy to the income beneficiary.[60] The sounder approach would certainly value the unitrust, and likewise the annuity trust, in the same manner as is done for federal tax purposes, thereby approximating, as closely as possible, the actual value of the interest involved.

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58. The "Present Value" table of LA. R.S. 47:2405 (1950) is used, computing the present value of the annuity for each year in the annuitant's life expectancy.

59. LA. R.S. 47:2405 (1950).

60. However, this approach might not be followed, since the court in *Succession of Kaufman*, 274 So. 2d 471 (La. App. 1st Cir. 1973) indicated a questioning of the reasoning behind it. If that were the case, the Louisiana courts certainly should look to the method of Treas. Reg. § 1.664-4 (1972).

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