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Effectively Curbing the GST Exemption for Perpetual Trusts

By Lawrence W. Waggoner

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Current law allows a married couple to transfer up to $10.24 million into a trust that is exempt from the federal generation-skipping transfer tax. The proposal would deny the GST exemption prospectively, unless the trust must terminate within one of three perpetuity periods: (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) after the death of the last living beneficiary who is no more than two generations younger than the settlor. A trust now in existence would be allowed a grace period during which it could be modified to terminate within the allowed period, but absent modification, the trust would lose its GST exemption at the end of the grace period.

The proposal is offered as a part of the Shelf Project, a collaboration of tax professionals to develop proposals raising revenue while making the tax system more efficient and reducing deadweight loss. The inventory of the prior 64 shelf projects is found at http://www.utexas.edu/law/faculty/calvinjohnson/shelf_project_inventory_subject_matter.pdf. Shelf projects follow the format of a congressional taxwriting committee report in explaining current law, what is wrong with it, and how to fix it.

In 1986 Congress passed the federal generation-skipping transfer tax as a supplement to the federal estate and gift taxes. The purpose was to ensure that accumulations of great wealth are taxed at least once a generation. The GST tax, however, allows an exemption. For a married couple, the ceiling on the exemption, originally set at $2 million, is now $10.24 million; for one individual, the ceiling is half that amount. Congress did not impose a federal durational limit on trusts that qualify for the GST exemption, but most states had viable perpetuity laws that limited the life of the trust. The absence of a time limit on the GST exemption provided an incentive for banks and the estate-planning bar to lobby their state legislatures to pass laws allowing trusts to last forever or for several centuries. The lobbying efforts proved successful in many states. The result is that trusts can now be exempt from GST tax for much longer than Congress originally intended. Moreover, those trusts can have as many as 450 living beneficiaries 150 years after creation, and more than 7,000 living beneficiaries after 250 years, and more than 114,000 living beneficiaries after 350 years. After 175 years, the settlor’s genetic relationship to all his then-living beneficiaries will drop below 1 percent, and as the trust presses on into the more distant future, the settlor’s genetic relationship to the beneficiaries will decline further as the trust benefits ever more remote relatives.

Congress should close the loophole in the GST exemption by imposing a federal durational limit on trusts that qualify for the exemption. Treasury agrees but proposes a remedy that would leave many trusts and much wealth perpetually exempt. The proposal advanced here would not do that and therefore is more consistent with the original purpose of the GST tax and its exemption.

The proposal would give the GST exemption only to a trust that limits its term to one of three alternative periods, each of which has a foundation in perpetuity law: (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) after the death of the last living beneficiary who is no more than two generations younger than the settlor, with special rules for cases in which a beneficiary’s share is distributable on reaching the specified age of 30 or younger and for trusts whose sole current beneficiary is a named great-grandchild. Congress


2 See supra note 1.
should allow the trust settlor to select which period is most reasonable to the needs of the trust. The settlor, however, would have to select one of the alternatives beforehand and could not, for instance, choose termination at the last (or second-to-last) period to expire.

For perpetual trusts that were established before the effective date and therefore have already qualified for the GST exemption, the proposal would give the trust a post-enactment grace period, say of six months or perhaps of a year, during which the terms of the trust could be modified to terminate within one of the three permitted periods. Modification could be achieved judicially under existing case law or under statutory law that is already enacted or could be promptly enacted. Or, modification could be achieved privately by the exercise of trustee or trust-protector powers that many perpetual trusts already contain. Any trust not so modified during the grace period would lose its GST exemption and pay appropriate GST tax on any generation-skipping transfer occurring after the grace period expires. It is anticipated that trusts would avoid future GST tax by complying with the new requirement.

A. Current Law

The GST tax, enacted in 1986, imposes a flat tax at the highest federal estate tax rate on generation-skipping transfers. The purpose of the GST tax is to ensure that property is taxed every time it shifts from generation to generation or skips a generation.

The GST tax applies to three types of generation-skipping transfers (unless exempted): taxable terminations, taxable distributions, and direct skips. In general, a taxable termination occurs when an interest in trust property terminates, unless immediately after the termination a non-skip person has an interest in the property or unless at no time after the termination a distribution be made from the trust to a skip person. A taxable distribution occurs when income or principal is transferred to a skip person in a manner that is subject to the federal gift tax or federal estate tax. A skip person is defined as (1) a natural person assigned to a generation that is two or more generations below the generation assignment of the transferor or (2) a trust if all interests in the trust are held by skip persons or if there is no other person holding an interest in the trust and at no time after the transfer may a distribution be made from the trust to a non-skip person.

The GST exemption allows settlors to create trusts that are exempt from the GST tax. As of 2012, the ceiling on the exemption is $5.12 million (twice that for a married couple). The ceiling was set at $5 million in 2010 to be the same as the estate and gift tax exemption. The increase to $5.12 million resulted from an inflation adjustment that took effect at the beginning of 2012. The current GST exemption and estate tax exemption sunset at the end of 2012. In the absence of additional action by Congress, the GST exemption ceiling drops in 2013 to $1 million. A GST-exempt trust retains its exemption no matter how much the trust’s post-creation value appreciates above the maximum exemption amount. It is now well documented that various estate-planning techniques can be used to leverage the amount exempted beyond the exemption’s ceiling.

B. Reasons for Change

1. Explosive growth of perpetual trusts. Before the passage of the GST tax and GST exemption in 1986, the wealthy had little incentive and probably little desire to establish perpetual trusts, even though they were permitted to do so under the laws of Idaho, South Dakota, and Wisconsin. Passage of the GST tax with an exemption for trusts of any duration gave settlors an incentive to create trusts of perpetual or very long duration. When Congress granted the exemption, it did not impose a duration limit on exempt trusts, relying on state perpetuity laws to supply that limit. The reliance on state perpetuity laws was badly misplaced. At the instigation of state banking groups and estate-planning attorneys, states began to pass legislation allowing transferors to create perpetual trusts—trusts that can last for several centuries or even forever.

5See section 2613.
9One thousand years in Colorado, Utah, and Wyoming; 500 years in Arizona; 365 years in Nevada; 360 years in Alabama, Florida, and Tennessee.

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Congress and state legislative bodies have therefore combined to set the perpetual-trust movement in motion. Although Congress did not intend to do so, whereas the state legislative bodies acted deliberately, the primary responsibility still rests with Congress. Because it created, albeit inadvertently, a tax advantage for trusts that can remain tax exempt for centuries, Congress is the legislative body that facilitated the movement.

Because Congress has not yet acted to rectify its mistake, the perpetual-trust movement is in full flower. With state perpetuity laws out of the way, the wealthy are creating perpetual trusts in significant numbers. An empirical study found that roughly $100 billion in trust assets had flowed into states allowing perpetual trusts. The study was based on data through 2003 from the annual reports that institutional trustees file with federal banking authorities. Considerably more wealth has undoubtedly moved into those states since 2003. Moreover, the $100 billion figure undercounts the actual value of trust assets flowing into those states, because the sources on which the study was based were reports from federal regulatory agencies.

Those reports contain no data on trusts in which the trustee is a family trust company, organized under state law for the limited purpose of administering trusts of one family. Family trust companies, which are becoming popular vehicles for administering perpetual trusts of the very wealthy, are regulated under state law for the limited purpose of administering trusts of one family. Family trust companies, which are regulated under state law for the limited purpose of administering trusts of one family.

2. Treasury’s partially ineffective proposal. As part of the Obama administration’s fiscal 2013 revenue proposals, Treasury stated its position that the absence of a durational limit on the GST exemption is inconsistent with the purpose of the exemption and undermines the policy of the GST tax, but its proposed solution would not end the perpetual-trust movement or its associated perpetual GST exemption. For perpetual trusts created before enactment, the Treasury proposal would allow them to continue to be unburdened by a durational limit. For perpetual trusts created after the effective date of enactment, the Treasury proposal would still allow them to qualify for the GST exemption but would have the exemption expire 90 years after the trust was created.

If Congress were to enact the Treasury proposal, the reaction would be predictable:

a. Pre-effective-date trusts. For previously established pre-effective-date GST-exempt perpetual trusts, no action would be required. They would be safe.

For perpetual trusts not yet established, the rush would be on to beat the deadline once the effective date became known to the estate planning bar. The rush would actually start earlier, once the estate planning bar discovered that the Treasury proposal
was likely to become law. Super-rich clients who were on the fence would be encouraged to establish GST-exempt perpetual trusts before the door closed on the opportunity.

b. Post-effective-date trusts. For post-effective-date GST-exempt perpetual trusts, generation-skipping transfers would not be taxable for 90 years. Settlers therefore would have several options. To be certain that the GST tax would never apply, some post-effective-date trusts might be crafted to terminate on or shortly before expiration of the 90-year period.

Some and maybe most post-effective-date GST-exempt trusts likely would take a different form. Ninety years is a very long time. The whole tax system might change during the next few years, let alone the next 90. Some and maybe most post-effective-date trusts might therefore be crafted with no termination date but with trustee or trust protector powers that would enable the trustee or the trust protector to adjust the terms of the trust to take account of tax law as it changes over time. The trustee's or trust protector's powers could take different forms, but the idea would be that if the GST tax and the 90-year limit were still in effect as the trust neared its nine-decade mark, the trustee or trust protector would then have the option of avoiding GST tax by terminating the trust and distributing the assets on or shortly before expiration of the 90-year period.

The Treasury proposal, if adopted, would dampen the perpetual-trust movement and its associated perpetual GST exemption, but it would leave many trusts and much wealth exempt from GST tax for much longer than Congress originally intended.

C. Proposed: An Effective Solution

A solution that would truly end the perpetual-trust movement and its associated perpetual GST exemption (let us call it the Effective Solution) would impose a reasonable duration for trusts eligible for a GST exemption for both new and existing trusts.

1. New trusts. For trusts created after the effective date, the Effective Solution would deny the exemption for any perpetual trust. For that purpose, a perpetual trust would be defined as a trust controlled by the law of a state or other jurisdiction that allows perpetual trusts, except that such a trust would not be a perpetual trust if its terms require the trust to terminate within the perpetuity period defined by the GST exemption. The perpetuity period for the exemption would be defined as (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) the death of the last living beneficiary who is no more than two generations younger than the settlor, with special rules for cases in which the share of a beneficiary is distributable on reaching the specified age of 30 or younger and for trusts whose sole current beneficiary is a named great-grandchild. The settlor

22For a list of jurisdictions allowing perpetual trusts, see supra notes 10 and 11.


24See Property Restatement, supra note 1, at section 27.1(a), which provides that “if, upon the expiration of the [two-generation] perpetuity period, the share of a beneficiary is distributable upon reaching a specified age and the beneficiary is then younger than the earlier of the specified age or the age of 30, the beneficiary’s share may, without judicial modification, be retained in trust until the beneficiary reaches or dies before reaching the earlier of the specified age or the age of 30.”

25See Property Restatement, supra note 1, at section 27.1(b)(2), which provides: “In the case of a trust or other property (Footnote continued on next page.)
would be allowed to choose any one of the three alternatives, but could not choose the last (or second to last) of the three periods. (The settlor could, however, choose the earliest to expire of two or three of the alternative periods or some period that expires even earlier.)

Each of the three periods has a basis in perpetuity law. Allowing trust settlers the option of choosing which of the three periods (but not the last of the three or the later of two of the three) best suits the terms of the trust would be consistent with the original purpose of the GST exemption. Because all three perpetuity periods represent reasonable ways to limit deadhand control and are backed by the Uniform Law Commission or the American Law Institute. Congress should allow the settlor to select the period that best fits the needs of the trust.

2. Existing trusts. For perpetual trusts that were established before the effective date and therefore have already qualified for the GST exemption, it might be unconstitutional to deny the exemption retroactively or to terminate the exemption on arrangement for the sole current benefit of a named individual who is more than two generations younger than the transferor or more than the equivalent of two generations younger than the transferor, the measuring life is the named individual.” As explained in commentary, that provision “establishes the establishment of a trust or other property arrangement for the sole current benefit of a beneficiary such as a living great-grandchild.” Id. at h. It may be desirable for Congress to allow a trust for the current benefit of more than one great-grandchild.

The life-in-being-plus-21-years period tracks the common law rule against perpetuities and the Uniform Law Commission’s Uniform Statutory Rule Against Perpetuities, section 1(a)(1) (1986) (incorporated in the Uniform Probate Code as section 2-901(a)(1)). The 90-year period tracks the wait-and-see element of the Uniform Statutory Rule Against Perpetuities, section 1(a)(2) (1986) (incorporated in the Uniform Probate Code as section 2-901(a)(2)). The two-generation limit tracks the perpetuity rule adopted by the American Law Institute. See Property Restatement, supra note 1, at section 27.1. The Property Restatement perpetuity rule does not produce a period that is materially longer or shorter than the traditional common law period. Id. Introductory Note to Chapter 27, at 570.

A somewhat similar two-generation approach was proposed in 2005 by the JCT. See JCT, “Options to Improve Tax Compliance and Reform Tax Expenditures,” JCS-02-05, at 393 (Jan. 27, 2005), Doc 2005-1714, 2005 TNT 18-18.

The Uniform Law Commission (nccusl.org) and the American Law Institute (ali.org) are the two premier deliberative bodies devoted to impartial law reform based on the public interest.

The constitutional question is whether retroactive tax legislation violates the due process clause of the U.S. Constitution. See U.S. Constitution amendment V (“Nor [shall any person] be deprived of . . . property, without due process of law”). The constitutional prohibition of ex post facto laws is irrelevant, because it applies only to criminal matters.

The controlling due process decision on retroactive tax legislation is United States v. Carlton, 512 U.S. 26 (1994), Doc 94-5582, 94 TNT 114-1. In Carlton, the Supreme Court upheld the constitutionality of retroactive estate tax legislation to correct a congressional mistake. In the key passage, the Court said: “The due process standard is met simply by showing that the retroactive application of the legislation is itself justified by a rational legislative purpose.” Id. at 30-31. The Court also noted that “Congress acted promptly after discovering the mistake and therefore established only a modest period of retroactivity and that much immediate tax revenue was going to be lost if the mistake was not corrected retroactively. Neither of those features — prompt action or immediate loss of substantial tax revenue — is present in the case at hand, but it is unclear whether either one is a requirement. Justice Sandra Day O’Connor, concurring in the result, did say, however, that in her view, “a period of retroactivity longer than the year preceding the legislative session in which the law was enacted would raise . . . serious constitutional questions.” Id. at 38.

It might be constitutional to terminate the GST exemption upon enactment (id.), but that approach seems to be harsh when a less intrusive approach — the grace period approach advocated by the Effective Solution — is more consistent with the original purpose of the GST exemption, which was to allow trusts whose initial value does not exceed the exemption ceiling to be exempt from GST tax for the time allowed by state perpetuity law.

See supra notes 28 and 29. Requiring existing trusts to be modified to satisfy new tax requirements is not unprecedented. See sections 2055(e) and 2522(c).

To facilitate modification under state law, Congress should add a provision similar to section 2055(e) or section 2522(c) for modification of split-interest charitable trusts. For state law authority to modify trusts in the light of changes in tax law, see supra note 20. See also Diana S. C. Zeydel and Jonathan G. Blattmachr, “Tax Effects of Decanting — Obtaining and Preserving the Benefits,” 111 J. Tax’n 288 (Nov. 2009). The Property Restatement’s perpetuity rule also calls for modification, providing: “Upon the petition of an interested person, the court shall modify a disposition that [might extend beyond the perpetuity limit] . . . . The form of the modification must be in a manner that most closely approximates the transferor’s manifested plan of distribution and is within the perpetuity limit.” See Property Restatement, supra note 1, at section 27.2 (2011).

A trustee or trust-protector power might take the form of a decanting power, which is a power of appointment, typically a non-general power, that enables the donee of the power to create a new trust. Technically, any trust created after the effective date by the exercise of a decanting power might be regarded as a post-effective-date trust, but the GST exemption would be preserved only if the perpetuity period runs from the date when the original trust was created.
expiration of the grace period. The GST tax would then apply to any post-grace-period generation-skipping transfer, whether it is a taxable termination, a taxable distribution, or a direct skip.

3. Adaptations to the Effective Solution proposal. If Congress were to enact the Effective Solution, what would be the reaction?

a. Pre-effective-date trusts. Perpetual trusts established before the effective date likely would be modified during the grace period to require them to terminate within whichever of the three perpetuity periods best suits the settlor’s purposes.

b. Post-effective-date trusts. Perpetual trusts would no longer be created after the effective date. Trusts whose purpose is to remain exempt from GST tax for as long as possible would be crafted to terminate within whichever of the three perpetuity periods best suits the settlor’s purposes.

D. Tax Revenue

Neither the Effective Solution nor the Treasury alternative would raise much present or future GST tax revenue. But that was not the purpose of the GST exemption. The purpose was to exempt trusts whose initial value does not exceed the exemption ceiling from the GST tax for the time allowed by state perpetuity law, but no longer. On this score, the Effective Solution is more aligned with the original purpose of the GST exemption than the Treasury alternative.

Congress should enact the Effective Solution rather than the Treasury alternative. If it does, existing and future trusts will terminate within the time allowed by state perpetuity law. When the trusts terminate, the beneficiaries will own their shares outright and free of trust. Any transfer tax revenue will arise from their future taxable transfers. That’s exactly what Congress contemplated when it adopted the GST exemption.

33If a perpetual trust were not modified during the grace period, the GST exemption could be restored by modifying the trust later, but the restoration would be effective only upon modification.

34Termination on the expiration of the earliest to occur of the three periods would be permissible under the Effective Solution.