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Federal Tax Rules Should Not Be Used to Limit Trust Duration

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The federal generation-skipping transfer exemption encourages perpetual trusts, and the federal government can legitimately end that incentive. However, the authors believe that professor Lawrence W. Waggoner's proposed solution would be an inappropriate use of federal tax law because it would impose a tax penalty on perpetual trusts, rather than merely eliminating the existing tax incentive to create them.

Professor Lawrence Waggoner's recent article titled "Effectively Curbing the GST Exemption for Perpetual Trusts" raises practical and policy problems with the existence of perpetual trusts and indicates that the enactment of the generation-skipping transfer tax (GSTT) is responsible for encouraging several states to repeal their limits on perpetual trusts.[1] We admire and respect Waggoner and acknowledge that the concerns he raises may be perfectly valid. We also agree that federal tax policy in the form of the GST exemption encouraged perpetual trusts and that the federal government can legitimately end that incentive.

However, we strongly disagree with Waggoner's solution because it is intended to, and would, impose a tax penalty on perpetual trusts rather than merely eliminate the existing tax incentive to create them. In our view, discouraging perpetual trusts is simply not an appropriate use of federal tax law, regardless of the arguments one can legitimately make about their evils. Moreover, as is discussed below, there are simple ways to eliminate the tax incentive to create perpetual trusts.

To date, a limit on the duration of trusts in the United States has been a rule of property law, governed by state statute or case law, and has varied from state to state. In our view, limits on trust duration, like other property law matters, should continue to be left to the states to address.[2] State law has long permitted the creation of perpetual trusts for the benefit of charity, and as explained below, some states allowed perpetual trusts for individuals before the current GSTT was enacted. Since the enactment of the GSTT, many other states have decided that individuals should be able to create perpetual trusts for the benefit of individuals as well as charities. Waggoner and others, as well as some of us, think that allowing perpetual trusts for individuals is bad public policy, while others of us disagree with that position. There can be many different opinions about how long trusts should last.

Regardless of how we or our elected representatives to the U.S. Congress may feel about whether the decision of various states to allow perpetual trusts is good public policy, the duration of trusts clearly is not a federal tax issue. Waggoner's proposal does far more than limit the tax benefits given to perpetual trusts, and as such, it would represent an unjustified federal intrusion into an area that is traditionally governed by state law.

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[1] *Tax Notes*, June 4, 2012, p. 1267, *Doc 2012-9442*, *2012 TNT 110-14*. The GSTT was enacted as part of the Tax Reform Act of 1986. It allowed each taxpayer to allocate his GST exemption to donative transfers during life or at death. Each taxpayer originally had a GST exemption of $1 million. Currently, that exemption per donor is $5.12 million, although it is scheduled to return to $1 million, indexed for inflation, at the end of 2012.

[2] There are several remedies for addressing the possible bad results that may occur by allowing perpetual trusts, such as state legislation or court action in particular cases. The doctrine of cy-pres, which Waggoner cites as addressing issues with perpetual charitable trusts, evolved largely through actual cases when issues arose with charitable trusts that may last indefinitely under state law.

Waggoner suggests that the Internal Revenue Code be revised to prohibit the allocation of GST exemption to a trust that does not have a required ending date that is either (1) 21 years after the death of lives 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. It is important to note that the proposal is to prohibit the allocation of GST exemption when the trust is created if there is any possibility that the trust could last longer than these limits, regardless of how long the trust actually lasts. For example, the proposed rule would prohibit the allocation of GST exemption to a trust for a grandchild if the trust could under any circumstances last beyond Waggoner's suggested limits. This would impose a GSTT on the trust for the grandchild when created, even if the trust actually terminates and distributes outright to the grandchild five years after the trust is created. That would be unfair and serve no legitimate federal tax purpose.

Waggoner says that the purpose of the GST exemption was to exempt trusts whose initial value did not exceed the exemption ceiling from the GSTT for the time allowed by state perpetuity law, but no longer. However, no support for this is cited. Elsewhere Waggoner notes that when the GSTT was enacted, three states allowed perpetual trusts. There is nothing in the legislative history of the GSTT that indicates that Congress intended to limit the duration of the benefit of the GST exemption to any particular period, or that Congress was or was not concerned that when the GSTT was enacted, trusts could be perpetual in three different states.

Waggoner's proposal is intended to try to stop individuals from creating perpetual trusts that are valid under applicable state law. Thus the proposal would force taxpayers to conform to the view that trusts should not be allowed to last indefinitely even if applicable state law allows this, because a failure to conform would result in no tax benefit from the GST exemption. In our opinion, that is not appropriate federal tax policy, regardless of one's views about perpetual trusts.

An even more intrusive part of the proposal would require existing irrevocable trusts that do not meet one of the three limits in the proposal to be reformed to comply with the new rule or forfeit any benefit from GST exemption allocated previously. This would apply even though the trust was validly created in a state that allowed perpetual trusts in 1986 when the GSTT was enacted. This would be an unprecedented retroactive federal tax penalty for irrevocable trusts that achieves no legitimate federal tax purpose on conduct that the taxpayer had no reason to believe violated any federal tax principle when the trust was created. This part of the proposal makes it clear that the purpose of the proposal is to end even existing perpetual trusts, not merely to eliminate the GST exemption incentive to create perpetual trusts.

The GST exemption as enacted applies to a trust permanently once allocated. The federal government has known about perpetual trusts for decades. Treasury attempted twice, once in the proposed and then in final GSTT regulations (both withdrawn), to address the allocation of GST exemption to perpetual trusts. The federal government has made no further efforts to address this issue since the final regulations were issued in late 1996, more than 15 years ago. To pass legislation now that requires reformation of irrevocable trusts after all these years to keep the benefit of the GST exemption validly allocated is unwarranted in our view, particularly when the settlor now may be dead or not competent to express an intention about which duration would be preferred.

If Congress now believes that the GST exemption should not be available for a period of time in excess of a traditional perpetuity period (although these rules often vary considerably from state to state), the appropriate federal action in our view would be to reset a trust's inclusion ratio to 1 at some point.[3] This is the solution that the Obama administration has previously proposed, and it is all that is needed to address any legitimate federal tax issue. The administration's current proposal adopts a term of 90 years, which was the original Uniform Statutory Rule Against Perpetuities period, after which time the trust's inclusion ratio becomes 1. While one can argue that in light of longer life expectancies today, it may be appropriate to use 100 years, 110 years, or even 120 years as the time limit, selecting the appropriate time limit should be done by those who are charged with the job of determining tax policy. By limiting the time period for the benefit of the allocation of GST exemption, Congress will have removed any federal tax incentive to create perpetual trusts simply and effectively. If the trust terminates before the federal time limit, no GSTT penalty would be paid. In contrast, Waggoner's proposal would adversely affect all trusts that could last longer than his three time limits, even when they do not.

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[3]A trust that is wholly exempt from the GSTT because of the allocation of the donor's GST exemption has a zero inclusion ratio. The GSTT rate is determined by multiplying the maximum federal transfer tax rate, currently 35 percent, by the inclusion ratio for the trust. Thus a trust with an inclusion ratio of zero is not subject to tax, and a trust with an inclusion ratio of 1 is subject to tax on its taxable transfers at the maximum transfer tax rate in effect at the time of the taxable transfer.

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We suggest that if a time limit is adopted for the benefit of the GST exemption, the inclusion ratio also should not change to 1 if the trust is required to terminate and distribute outright[4] at the end of 21 years plus lives in being at the creation of the trust that are described and identified in the trust instrument by name or by class. This change would be simple and has the advantage of eliminating any federal tax incentive to create perpetual trusts while allowing individuals to create trusts that last for the traditional 21-year common law rule against perpetuities, which the set time period alone would not. The 21-year rule was very common when the GSTT was enacted and still exists in many states.[5]

While the federal government chooses how to tax property rights, state law should determine what those property rights are.[6] The tax benefit of the GST exemption should not be used to try to force taxpayers to create trusts with a federally mandated termination date or to modify existing trusts to shorten their duration.

[4]"Outright" for this purpose should include a continuing trust after the termination date that is for a single beneficiary and that is includable in all events in the gross estate of that beneficiary to the extent the trust is not distributed to that beneficiary during his life. This protects any revenue loss without forcing taxpayers to make distributions to individuals who may be incapacitated or otherwise unable to manage money.

[5]The 21-year rule allows property to remain in trust for a grandchild until age 21 even if the grandchild was not living when the trust became irrevocable and even though the trust could last longer than a set number of years.

[6]*See Morgan v. Commissioner*, 309 U.S. 78 (1940).

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