

Dynasty Trusts...A Legitimate and Powerful Estate Planning Tool or An Economic Threat to the Realm... and to the State of California?

Christopher S. Armstrong

Law Offices of Christopher S. Armstrong,
A Professional Corporation
Email: chris@rmstrnglaw.com
Website: www.rmstrnglaw.com

1. Avoidance of the Rule Against Perpetuities (“RAP”) or some comparable provision of law which prohibits restraint upon alienation or limits a trust to a term of years is an essential element of the “dynasty trust”.
 - A. The creation of a dynasty trust, like the creation of any trust, may stem from some combination of one or more of the following settlor motives
 - To provide generously for his issue but in a measured fashion that promotes “happiness” but does not enable sloth taking into account the ages of beneficiaries, their needs, their ability to handle money and other factors.
 - To protect issue from their own foibles and misfortunes including torts, failed business deals and broken marriages (so called “asset protection”).
 - To reduce intergenerational transfer taxes.
 - To preserve centralized control over a family business.
 - To attract a better quality of investment management advice for the whole of the extended family assets than might be accessible if individual family members were left to their own devices in this regard.

Some or all of the foregoing may be the “ends” of a dynasty trust; but they are not the “means” by which it is created.

- B. The dynasty trust is distinguished from other trusts by the conceptual possibility of its having perpetual existence. To achieve potentially perpetual existence, one must avoid the RAP or some comparable provision of law which prohibits restraint upon alienation or limits a trust to a term of years. *A planner who undertakes to create for his client a dynasty trust without understanding the essence of what he is avoiding and carefully considering whether what he is doing will succeed may disappoint his client’s expectations and incur liability for malpractice.*
 - A California attorney’s failure to comprehend the RAP and his consequent preparation of a trust that was later held to be void by reason of violating such rule is cited frequently as the landmark case which signaled an end to lack of privity as a viable defense under California law to an action for

attorney malpractice in estate planning. *See Lucas v. Hamm*, 364 P.2d 685 (California 1961), *cert. denied* 368 U.S. 987 (1962).

- A fact sometimes overlooked regarding *Lucas* is that, although the defendant attorney lost his claim to immunity from suit based upon lack of privity between himself and the disappointed heirs, he avoided being held liable for negligence because the California Supreme Court concluded that the attorney had exercised sufficient skill and that his error based upon a failure to comprehend the RAP, which it characterized a “technicality-ridden legal nightmare”, could not be construed as negligence. *Lucas v. Hamm*, 364 P.2d, 685, 690. Fifteen years later, a California appellate court cast doubt on whether the holding of *Lucas* regarding absence of negligence by reason of the complexity of the perpetuities rule remained valid. *See Wright v. Williams*, 47 Cal. App. 3d 802, 809 n.2 (Cal. App. 2nd Dist, 1975).
- Commentators have also doubted the correctness of the *Lucas* court’s decision on the issue of negligence given the ready availability of a “savings clause” to those unwilling or unable to grasp the essence of the RAP. *See Begleiter, Attorney Malpractice in Estate Planning -- You’ve Got to Know When to Hold Up, Know When to Fold Up*, 38 U. Kan. L. Rev. 193, 232 (1990).
- Memorable quote for *Body Heat* (1981) a steamy flic of the “film noir genre” a central portion of whose plot included a purported attorney error premised upon his failure to comprehend the RAP—Matty (the female protagonist intending an alteration in her soon to die husband’s will) to Ned (an about to be duped Florida lawyer)]“You aren’t too smart, are you? I like that in a man.”

2. Evolution of the RAP.

The RAP has indisputably lost the practical relevance for which it was created in England the 17th Century, and it has been repealed by many jurisdictions during the last quarter century; but it is now invoked by its defenders as a necessary tool for the prevention of the avoidance of federal excise taxes on donative transfers. A comprehension of the current debate over the virtues and vices of the RAP requires at least a rudimentary understanding of its history.

A. Development of the doctrine in England

- The policy of English landowners was to tie up their land so as to make it descend inalienably in the family as far as the rules of law permit. See KEETON & SHERIDAN, *THE LAW OF TRUSTS* 124-125 (10th ed. 1974). In feudal times land was almost invariably devised to the eldest son and was not (as it is now) viewed as a commodity to be bartered and sold. See *In re Walker’s Will*, 258 Wis. 65, 45 N.W.2d 94 (1950).

- The general policy of *English* law and of the English judiciary has been to favor the free disposition of land. In response to restraints upon alienation which had become possible in the 17th Century with the evolution of the new property interests (e.g., executory interests and shifting and springing interests), the courts developed the RAP.
- The RAP was first invoked by the judiciary in *Duke of Norfolk v. Howard*, 1 Vern. 163 (1683). The father when still an earl had provided for the apportionment of various land titles among his sons and ultimately among his issue many generations removed from him.
- After the Duke's death, the siblings squabbled; a younger brother sought to enforce his rights against an uncooperative older brother. The gift was held void as to the younger brother by reason of the violation of the RAP; but it was not till 150 years later that the permissible period for restraining alienation was fully defined.
- Lord Guildford's statement in the report of the *Duke of Norfolk* case that if men should be permitted to settle their estates by way of trust in a manner which came nearer to a perpetuity than the common law would admit, it "...would be destructive to the commonwealth" is echoed in modern times by scholars and others who assert that they are distressed by the demise of the RAP.

B. The RAP targets "remoteness of vesting"

- In its origin the RAP aimed not at actual restrictions upon alienation but rather at the practicality of alienation *per se*. The theory of the RAP is that, if a property is not vested, the right of alienation would be illusory because it would be difficult if not impossible to find a purchaser for an unvested interest.
- Under the RAP as originally conceived, all property interests must vest within one generation and a short time thereafter (viz., "lives in being plus 21 years"). If they failed to do so, those transfers which fell afoul of the RAP were held void. One was not permitted to consider whether an interest would actually vest more than 21 years after the lives in being—the conceptual possibility of vesting beyond the permissible period (e.g., the "fertile octogenarian") was enough to void a gift in trust.
- Merely because a property interest has vested does not mean that the beneficiary of same necessarily receives it outright; it is only necessary under the RAP that the beneficiary has become indefeasibly vested so that if he dies before outright ownership inures to him, the property belongs to his estate.

C. Restraint on alienation as distinguished from the RAP

- Some American states, in lieu of a RAP, provide by statute that the power to alienate property may not be suspended for more than a particular period of time (the “Alienation Rule”). This rule which is aimed at restraints upon alienation, although distinguishably different in concept and effect from the rule against remoteness of vesting, is frequently lumped together with the vesting rule and misidentified as a RAP.
- Several American states have repealed the RAP and have adopted in its place an Alienation Rule (e.g., Alaska, Idaho, New Jersey, South Dakota and Wisconsin).
- The rule prohibiting a restraint upon alienation for a period in excess of lives in being plus 21 years mandated that the beneficiaries hold the power to dispose of an asset, not merely that they have a vested interest. It was generally held until 1950 that the trustee’s possession of the power of sale did not prevent the suspension of the power of alienation.
- In 1950 the Supreme Court of Wisconsin ruled that a trustee’s power of sale satisfied the Alienation Rule and noted the possibility that as a matter of Wisconsin law (which had no RAP but which did have an Alienation Rule) a trust could continue in perpetuity provided the trust agreement by its terms did not fetter the trustee’s power of sale. See *In re Walker’s Will*, supra.
- In response to the objection of Appellant that it was undesirable for trusts to endure longer than the Wisconsin statutory period of lives in being plus thirty years, the Wisconsin Supreme Court chose to express no opinion on the issue of desirability and stated “...[t]hat is a matter for the legislature.”

D. Modern legislation undertakes to mitigate the inequities of the RAP but outright repeal gains the upper hand

- The inequities worked by a strict construction of the RAP and its complexity (noted by the California Court in *Lucas v. Hamm*, supra) rendered it increasingly controversial. Both England and those American states which continued to adhere to the RAP abolished the rule that “possible” rather than “actual” events should determine the validity of a gift and substituted in its place the “wait and see” rule which would look to actual events. [Factoid: Critics of accuracy in film script have noted that the writer of the script for *Body Heat* (1981) failed to take account of the Florida “wait and see” rule in effect at the time the movie was made—but had the writer done so it would have spoiled the whole plot!]

- The Uniform Statutory Rule Against Perpetuities (“USRAP”), which was approved and recommended for enactment in all states by the national Conference of Commissioners on Uniform State Laws in 1986 and again in 1990 in an amended form, contains both a “wait and see” rule and a 90 year statutory period which is used in lieu of “lives in being plus 21 years” to determine whether an interest has actually vested within the maximum period permitted by law.
 - It remains the position of the Conference of Commissioners on Uniform State Laws that the USRAP should be adopted by all states because “[...]n]obody questions the fundamental policy [and because]...[p]erpetual nonvested interests should not be permitted...” The trend of legislation (which reflects the will of the people) is, however, running strongly against the Commissioners. As of early 2008 nineteen American states have abolished the RAP and permit perpetual trusts. Another seven states permit very long trusts, some so long (1,000 years) that there is effectively no constraint at all upon perpetuities. See Nenno, *Perpetual Dynasty Trusts: Tax Planning and Jurisdiction Selection*, SN048 ALI-ABA 623 (May 2008), Appendix D. By contrast only 16 states have adopted and continue to adhere to the USRAP.
- E. California has adopted and continues to adhere to the RAP as modified by the USRAP.
- California continues to apply the RAP (lives in being plus 21 years) as a validating rule for transfers of property in trust; but for transfers which are invalid under such rule, California has adopted the USRAP in order to validate those transfers which actually vest within the 90 year period established by such rule. See Cal. Prob. C. § 21205.
 - California’s cy pres rule (like the USRAP with some modest differences) permits the reformation of a trust to excise language offending the RAP. See Cal. Prob. C. § 21220 which allows a court upon receipt of a petition to reform a disposition which most closely approximates what the settlor intended but stays within the bounds of the 90 year rule established for “wait and see” purposes by the USRAP.
 - California statute law forbids a restraint on alienation and holds it void. See Cal. Civ. C. § 711. California has however made the judicial determination that absent a specific provision in a trust agreement which imposes a restraint upon the alienation of an asset by the trustee, a trustee holds the power by force of law to hold or otherwise dispose of an asset in consequence of which there is no violation of the rule regarding restraint on alienation. See *Reagh v. Kelley*, 10 Cal. App.3d 1082, 89 Cal.Rptr. 425 (1st App.Div. 1970) which also explains that even if a conveyance in trust proscribes alienation in some fashion, only the proscriptive element fails, not (as in the case of a violation of the RAP) the gift itself.

- California's taxation of trust income (based in part upon the residence of the fiduciary—a term which itself has nebulous meaning in the taxing context) coupled with its continued dogged devotion to the RAP has caused commentators to observe that whatever one thinks of the RAP, California today represents "...the Mordor [for non- J.R.R. Tolkien fans, the dark land where demons are many] of trust jurisdictions, to be avoided if at all possible." Shepard and Hayes, *R.I.P. for RAP—California's Turn To Reform The Rule?*, California Trusts & Estates Quarterly 13, 15 (Summer 2008).

F. Noncharitable purpose trusts are not subject to the RAP.

- As a general rule charitable purpose trusts have not been subject to the RAP or to the Alienation Rule, but save for exceptions for trusts for the benefit of surviving pets and for maintenance of burial plots, general noncharitable purpose trusts until recently have been impermissible as a matter of the law of American states.
- A statutory authorization for noncharitable purpose trusts may be accompanied by a limitation by reference to a period of years. See, e.g. the Uniform Trust Code § 409 which authorizes the creation of a noncharitable purpose trust for a period not in excess of 21 years; but cf. accompanying commentary which states that a longer period may be prescribed by the state adopting the UTC.
- At least six states currently permit perpetual noncharitable purpose trusts (including Delaware, Idaho, Maine, New Hampshire, South Dakota and Wyoming).

G. The RAP acquires significance in the context of US federal transfer tax law

- The long established RAP renders it impossible to postpone forever successive intergenerational levies of federal estate tax through the use of trusts. This would acquire particular significance following the enactments by Congress of a federal estate tax in 1916 and a federal gift tax in 1924.
- Responding to perceived opportunity for the legitimate avoidance of federal estate tax without doing violence to the RAP, Delaware in 1933 enacted legislation which authorized the successive creation of limited powers of appointment (the exercise of which does not ordinarily attract a transfer tax) with each new limited power measuring for RAP purposes from the date of the most recent exercise.
- Congress sought to preclude the use of serial limited power exercises to avoid the RAP and a levy of gift or estate tax by enacting IRC §§ 2041(a)(3) and 2514(d).

- H. Casual disregard for the distinction between the RAP and the Alienation Rule in tax legislation (and the regulations interpreting same) becomes vital to the evolution of the dynasty trust as a legitimate tax avoidance vehicle.
- Legislative history pertinent to the adoption US federal rules aimed at limiting the use of successive limited powers of appointment to avoid a gift or estate tax and the regulations interpreting such rules concentrate exclusively upon the RAP and suggest that there is no difference between the RAP and the Alienation Rule. See Treas. Reg. §§ 20.2041-3(e)(1)(ii) and 25.2514-3(d).
 - Federal legislators and regulators intended the 1951 predecessors of IRC §§ 2041(a)(3) and 2514(d) as a bar to the achievement of perpetuities under Delaware's 1933 measuring rule for successive exercises of limited powers. Their failure to make a distinction between the RAP and the Alienation Rule in the history of such statutes and the interpreting Regulations for same, when coupled with the 1950 determination of the Wisconsin Supreme Court in *In re Walker's Will*, contributed materially to the evolution of the dynasty trust as a modern tax planning mechanism. See Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Estate Planning Journal (February 2001).
 - When a beneficiary of a Wisconsin trust exercised a limited power to grant a limited power to her surviving husband which might be used to create a perpetual trust for the benefit of children and remoter issue, the IRS asserted that estate tax was due by reason of IRC § 2041(a)(3). The IRS lost because the Court held that the tax law required the satisfaction of either the RAP or the Alienation Rule, not both and that Wisconsin's Alienation Rule had been satisfied because the trustee had possessed a power of sale from the inception of the trust and hence there had never been a restraint upon alienation. See *Estate of Murphy*, 71 TC 671 (1979).
3. The "Accumulation Trust" (not to be confused with the perpetual trust): A "bark worse than its bite" but does the repeal of the RAP render such trusts a greater source of mischief?
- A. The essence of an accumulation Trust: the trustee is to refrain from paying out income.
- Legislatures and courts have at various times opposed and invalidated accumulation trusts out of fear that such trusts could cause such wealth and power to be amassed within private trusts as to destabilize a nation. See BOGERT, LAW OF TRUSTS AND TRUSTEES § 215 (2008), fn. 8
 - Critics have also argued that trusts should not benefit exclusively members of a later generation and that denial of any benefit to the present generation kills incentive to compel effective management of trust assets.

B. *Thelluson v. Woodford*, 4 Ves. 227 (1799) on appeal 11 Ves. 112 (1805) and the Thellusson Act, 39 & 40 George 3, ch. 98 (1800) (Eng.) (which the judgment affirming the validity of an accumulation trust provoked) illustrated the intensity of the fear regarding the threat of accumulation trusts to national well being. The ultimate history of the Thellusson Trust also exposed the fallacy of projecting the financial success of an accumulation trust on the basis of compound interest alone.

- Thellusson's will which directed the accumulation and addition to capital of all trust income during the lives of nine persons in being at the testator's death and the payment of all trust capital to the eldest lineal descendant of the testator's son, Peter, at the death of the survivor of the nine was upheld by the House of Lords on appeal.
- Reacting to a scandalized populace convinced that that the estate of the decedent would grow to obscene size in the course of the then permitted perpetuity period, the English parliament enacted legislation (with prospective effect) which limited accumulations to the life of the settlor, to 21 years from the death of the settlor, to the minority of any person living or in gestation at the death of the settlor or to the minority of any person who upon majority would be entitled to the income being accumulated.
- Contrary to fears and expectations, the Thellusson settlement came to naught. Rather than being worth somewhere between the projected £19 million and £38.4 million on termination, when the trust terminated in 1856 (51 years after the Privy Council decisions upholding the validity of the settlement) the original £600,000 of trust capital had not grown to even £ 1 million. See Sitkoff, *The Lurking Rule Against Accumulations of Income*, 100 Nw. U. L. Rev. 501, n.27 (2006).
- The venerated Benjamin Franklin's two charitable trusts established when he died in 1790 directing accumulations for 100 years and then 100 years again also performed poorly from an investment management standpoint. See Sitkoff, *id.*, fn. 30-32.

C. California has a rule against accumulations, but like most jurisdictions having rules against accumulation, it allows accumulations for the same period as the RAP. See Cal. Civ. C. § 724.

D. The repeal of the RAP by numerous jurisdictions begs the question whether a perpetual trust which directs accumulation of all income would be valid.

- Although trust law has become increasingly permissive with regard to the potential term of a trust, courts empowered to do equity and determine when public policy has been offended will not show blind deference to the commands of a deceased settlor.

- When a famed newspaper publisher directed in his will that his favorite newspaper should never be sold or otherwise disposed of, the ensuing economic calamity for the family caused the court to exercise its power to vary the trust. See *Matter of Pulitzer*, 139 Misc. 575, 249 N.Y.S. 87 (Surr. Ct. 1931), *aff'd mem.*, 237 App.Div. 808, 260 N.Y.S. 975 (1932). Critics have suggested that the court might as easily and with less deference to the late Joseph Pulitzer have grounded its holding on improper trust purpose. See Armstrong and Hastings, *Purpose Trusts and Private Trust Companies: Panacea or Placebo*, *The STEP Journal USA* 21 (June/July 2008).

4. Arguments for and against the abolition of the RAP

A. In favor of abolition of the RAP

- Avoids arbitrary termination at inconvenient moment (when primary beneficiary is very young, very old or very irresponsible in matters of money)...what merit in the settlor's decreeing that a trust must end on a date certain years in the future when he cannot know the effect of the termination; better to grant to successive primary beneficiaries or protectors the limited power to appoint outright to persons other than themselves, their creditors, their estates or creditors or their estates.
- Asset protection (against outsized tort claims, marital settlement claims premised upon "equitable division" of everything, conniving business "partners" etc)...what is the advantage to the settlor or his family of putting assets in harm's way; a long term trust may enable payouts at pre-designated ages subject to a finding by the independent fiduciary that when a designated age has been attained the beneficiary is not subject to a circumstance which would prevent his personal enjoyment of the asset if distributed.
- A disincentive to unrestrained lavish and conspicuous consumption (why shouldn't I spend it if it will be taxed or spent by my children if I don't)...with a combination of jocularly and homage to a commendable human instinct the leading treatise on Federal gift and estate taxation wittingly or otherwise makes the case for the dynasty trust when it commences with the injunction: "Squander it! Be not only generous but a spendthrift. That is the way to beat the federal taxes imposed on gratuitous shifting of interests in property...This book is addressed, however, to those who do not heed this advice, to those who do indeed accumulate some wealth and undertake thoughtfully to pass it on to survivors, and to those who assist others in such thoughtful transmission." STEPHENS, MAXFIELD, LIND, CALFEE AND SMITH, *FEDERAL ESTATE AND GIFT TAXATION* ¶ 1.01 (8TH Edition).

- Maintenance of control over a family business...but the perpetual trust facilitates perpetuation of the control of a family business only if members of the family remain committed to the business, the perpetuation of the business continues to make economic sense and those in control of the trust have a finely tuned appreciation of fiduciary duty. For an illustration of the challenging issues which may arise when a trustee is directed to maintain an investment in a family business see Newman, *The Intention of the Settlor Under the Uniform Trust Code: Whose Property Is It, Anyway?*, 38 AKRON L. REV. 649, 683-684 (2005).
- If the trust is generation skipping transfer (“GST”) tax exempt, intergenerational transfer tax (which many argue persuasively is confiscatory) is indefinitely avoided. See Layman, *Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner’s Arsenal*, 32 AKRON L. REV. 747, 748 (1999) cited (with evident disfavor) by the Joint Committee on Taxation Report (JCS-02-05) on Options to Improve Tax Compliance and Reform Tax Expenditures (by inter alia limiting perpetual dynasty trusts).

B. Against abolition and for reenactment of the RAP

- Absence of a RAP freezes property ownership for an excessive period of time...but cf. trustee power of sale. A noncharitable purpose trust is much more likely to enable a freeze of ownership than the lack of a RAP because the investment of the assets of a purpose trust is undertaken to honor a purpose whereas the investment of assets of a trust for the benefit of individuals (whether or not such trust is perpetual) is supposed to be guided by the best interests of such individuals. The tethering or realty in perpetuity may have adverse consequences (a sensitivity reflected in the modern law of Delaware which has preserved the RAP as to realty, though realty is seldom directly owned by a trust), but tethering of equities will be very often be frustrated by factors entirely independent of the RAP. See the *Pulitzer* case, *supra*, for evidence that holding a family business even for the period allowed by the classic RAP may be fraught with peril and consider that of the original 12 companies that comprised the Dow Jones Industrial Average in 1896 General Electric is the only one still in the index, and of the other 11 only a very small number still remain as independent operating enterprises.
- Destroys ambition and encourages entropy (viz., “trust fund babies”)... but how does paying everything out to the lucky winner of the perpetuity termination lottery enhance ambition? For a thoughtful treatment of the problems posed by inherited wealth for those who are “privileged” to enjoy it, see Hughes, *The Often Unexpected Consequences of the Creation of a Perpetual Trust*, *The Chase Journal* (2001).

- Trust companies will control a disproportionate share of the world's wealth...this is a truly silly argument when one considers that most large trusts are now "directed" as to investment by family committees and professional investment advisors. Cf. Clarke and Zeydel, *Directed Trusts: The Statutory Approaches to Authority and Liability*, 35 ESTATE PLANNING 14 (September 2008). Some who rail about the evils of dynasty trusts appear not to have gotten this message. See Dobris, *Undoing Repeal of the Rule Against Perpetuities: Federal and State Tools for Breaking Dynasty Trusts*, 27 CARDOZO L. REV. 2537, fn. 6 (2006) ["I believe that most folks don't trust banks or believe in the efficacy of fiduciary duty and yet there is a willingness to create these [perpetual] trusts. I don't understand. It does not compute. Why are folks willing to commit their stuff and their families to the eternal deep?"].
- Rich will get too rich...this may lead to revolution. Hughes, *supra*, suggests a possible link between perpetual trusts and revolutions which occurred in France and in Russia, but people don't become rich simply because they have perpetual trusts, and the potential for perpetual existence is not what enables the maintenance of family wealth and the avoidance of "shirt sleeves to shirt sleeves in three generations." Perpetual trusts, to achieve the ends sought for them by most settlors, must have continuing access to savvy investment advice, they must be guided as to distribution by mature, dedicated family members and the beneficiaries must be imbued by parents or others with sound personal values. The financial failures of the Thelluson settlement, of the Franklin charitable trusts and of the Joseph Pulitzer Trust all serve to illustrate the fallacy of projecting the future worth of a trust solely on the basis of a compound interest table.
- Allows a leveraging of the GST Tax Exemption unintended by Congress...this is what the JCT would have us believe in its 2005 and 2008 Reports, but the Report fails to acknowledge that as of 1986 when the current version of the GST Tax was adopted judicial construction opening the way to perpetual trusts in Wisconsin was already 36 years old and South Dakota had abolished its RAP in 1983 with the specific goal of attracting trust business. See King, McDowell and Worthington, *Dynasty Trusts: What The Future Holds For Today's Technique*, TRUSTS & ESTATES 28, 32 fns. 7 and 8 (April 1996) ["In 1983, by creating an exception to its statute that limited the duration a trust could be in existence and formally disposing of the common law rule against perpetuities by statute, South Dakota provided one of just a few jurisdictions in the world to theoretically allow a trust to last forever!"]

5. Tax traps for the unwary

A. The “Delaware Tax Trap”

- Exercise of LPOA to create further LPOAs triggers a gift or estate tax and renders the power exerciser the new transferor for GST tax purposes if the exercise suspends vesting for a period which measures from a date other than the date of the creation of the original power.
- Is there merit to a “super-sized” years in gross (e.g., Wyoming: 1000 years; Alaska which has abolished its RAP but continues to provide that if a trust contains a power of appointment, the perpetuities period runs for 1,000 years)? Some have argued that if a state has abolished its RAP and does not have an Alienation Rule whose permissible suspension period is measured from the creation of the original power, the “tax trap” is sprung. See Greer, *supra*, 28 Estate Planning Journal (February 2001) [“In a jurisdiction that abolished the rule against perpetuities and has no rule against the suspension of the power of alienation, there is no stated period of time within which a property interest must vest. When a power of appointment is exercised to create a successive nongeneral power of appointment, the property subject to this power will have its vesting postponed for a period of time that cannot be ascertained by referring back to the date of the instrument creating the first power of appointment... Thus, if trust property is subject to the exercise of a nongeneral power of appointment, the exercise of that power to create a trust giving the beneficiaries nongeneral powers of appointment renders that property subject to estate tax or gift tax.”]
- Delaware tax experts respond to the 1000 year rules adopted by states such as Wyoming and Alaska to deal with the tax trap problem perceived by Greer with the observation that Federal regulators perceive no difference between a period which may run forever and one which may run for 1000 years, that it is a misreading of IRC § 2041(a)(3) to construe the necessity of a “period” to avoid the tax trap rule, and that even if a period were required, Delaware has such a period...an indefinite one. See Nenno, *supra*, SN048 ALI-ABA 623, 684-685 (May 2008)

B. Don’t mess with “grandfathered” GST trusts.

- An attempt to lengthen the duration of an irrevocable trust exempt from GST tax by reason of the grandfathering provisions of the 1986 Tax Act re pre-effective date trusts will destroy the exemption. See Treas. Reg. §§ 26.2601-1(b)(4)(i)(E), Ex.4 and 26.2601-1(b)(1)(v)(B)(2).

C. Future federal legislation limiting the use of dynasty trusts to escape GST tax.

- If future federal legislation were to mandate GST tax every other generation for zero inclusion rate trusts, it is highly likely that such legislation would be prospective only, but even if it were not, better a multi generational trust that effectively avoid federal transfer tax every other generation than one which is subject to such tax every generation.
- Professor Dobris of the UC Davis School of Law argues among other things in a bizarre polemic that "...[t]here is no vested interest in a pattern of taxation..." from which one may infer that he considers the retroactive application of legislation which would destroy a perpetual trust's GST tax exemption feasible and reasonable. Dobris, *supra*, 27 CARDOZO L. REV. 2537, 2541-2542 (2006).

6. Use of a "foreign" trust to avoid the "local" RAP—does it implicate public policy

A. Does a California resident's settlement of a trust in a foreign jurisdiction for the purpose of avoiding the California RAP violate California public policy?

- Restatement (Second) Conflict of Laws § 269, Comment g. takes the position that jurisdictional differences in the RAP do not raise issues of public policy that would warrant the judicial voiding or variation of a trust. If a testator by will creates a trust to be administered in a state other than that of his domicile, the trust will not be invalid as in violation of the rule against perpetuities if it would be valid either under the local law of the state of his domicile or under the local laws of the state of the place of administration. Accord, Restatement (Second) Conflict of Laws § 270, Comment d re an inter vivos trust where the settlor has opted for a local law other than that of his domicile to avoid the perpetuity rule in his own domicile.
- Commentary advocating California's repeal of the RAP acknowledges that the use by California residents of out of state trusts to avoid California's RAP is common place. See Shepard and Hayes, *supra*, California Trusts & Estates Quarterly 13, 15 (Summer 2008) ["If the Rule has not been abolished in their home state, wealthy trustors will create perpetual trusts in those fiduciary income tax friendly states that have repealed the Rule."]

B. Can assets of a trust subject to a RAP be decanted into a trust subject to the laws of a different jurisdiction which has abolished the RAP (or never had it) and thereafter decanted a second time into a perpetual trust subject to such jurisdiction's laws?

- It is persuasively argued by a leading commentator that Delaware will permit the transformation of a perpetuity period constrained trust to a

potentially perpetual trust through the medium of decanting provided the trust agreement by its terms does not prohibit same. See Nenno, *supra*, SN048 ALI-ABA 623, 737-739 (May 2008) ["Consequently, a beneficiary who possesses a limited power of appointment over an irrevocable trust that is governed by the common-law rule against perpetuities or the USRAP should, in certain circumstances, be able to move the trust to a state that has abolished the rule against perpetuities so that he or she can exercise the power to make it possible for the trust to last forever."]

7. California tax: Some constraints but several incentives for creating an out of state potentially perpetual trust

- Many states do not tax fiduciary accumulations (e.g., SD has no state income tax; DE does not tax a trust having no DE beneficiary residents); CA cannot tax a foreign fiduciary and does not tax a contingent CA beneficiary till income is distributed or distributable to him. See Cal. Rev. and Tax Code § 17745(b).
- CA does not recognize an accumulation of income in an out of state trust as a transmutation of such income to trust capital, provisions of local trust law to the contrary notwithstanding. See Cal. Rev. and Tax Code § 17745(c). This preserves California's right to levy a throwback tax upon actual distribution to a CA beneficiary.
- Because CA has incorporated the provisions of Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, any distribution from an out of state trust should be treated as being first derived from "distributable net income" to the extent available and only after DNI has been exhausted would accumulation rules apply.
- CA has not incorporated IRC §665-668 (accumulation/throwback) provisions; hence there is no interest like surcharge imposed upon beneficiary receipt by reason of the deferred tax collection. See Cal. Rev. and Tax Code § 17779.
- CA calculates income tax on an accumulation which has taken place during the time that a beneficiary was resident in CA by prorating it over the lesser of (a) the current year plus the immediate preceding five year period and (b) the period during which the accumulation occurred. See Cal. Rev. and Tax Code § 17745(d).
- CA does not tax a "grantor" on income of an out of state trust for the benefit of CA persons because IRC §679 re "foreign trusts" is expressly excluded from Rev & Tax Code. See Cal. Rev. and Tax Code § 17024.5. This is consistent with the reluctance of states which have incorporated the federal "grantor trust" principles into their local codes to adapt IRC § 679 so as to impose a tax on a local resident who creates an irrevocable trust (over which he retains no controls) for the benefit of persons who include residents of his own state. One commentator has encouraged states to consider such action, but he has not explored the ramifications inherent in adapting at the state level a section of the IRC which is not properly part of the "grantor trust rules" (as it is not predicated upon retained or

acquired control) and which is dependent upon (a) barriers to the grantor's escape from federal taxing jurisdiction which are not available to a state and (b) reasonably precise definitions of tax residence governing beneficiaries which do not have a counterpart at the state level. See, Blackburn, *Grantor Trusts, Trust Throwback Rules, and Their Application—Or Not—By the States*, 16 JOURNAL OF MULTISTATE TAXATION AND INCENTIVES 28, 36 (August 2006).

- A CA resident beneficiary who anticipates the possibility of receiving in the future a material distribution of accumulated income from a discretionary foreign trust may terminate CA residence without any of the adverse tax consequences attributable to a termination of "long term residence" (viz., green card status) at the federal level. California's only inhibition to such conduct is the rule which provides that if a person who has been a resident during a period of out of state accumulation of income leaves CA within 12 months prior to the date of a distribution and thereafter reacquires residence within 12 months after the distribution, he shall be presumed to have been resident during the time of the distribution. See Cal. Rev. and Tax Code § 17745(d).

San Francisco, California
September 8, 2008

This article should not be construed as legal advice which is given only to clients in response to inquiries involving specific facts.