Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner's Arsenal

I. INTRODUCTION

During the next eight to ten years, the "millionaire" population will grow "five to seven times faster than the household population in general."[1] The number of decedents' estates which will be valued at more than $1 million will increase by 246% during that same period.[2] Stanley and Danko note that "as our population ages, more and more affluent parents and grandparents are reaching the age of estate tax realization."[3] In 1996, "[m]illionaire households accounted for nearly half of all private wealth in America," but only accounted for 3.5% of the total households in America.[4] By 2005, the millionaire household population is expected to reach approximately 5.6 million.[5]

Eighty percent of millionaires are first-generation affluent and worked very hard to accumulate their wealth.[6] These individuals do not want their children and grandchildren to have to work as hard.[7] They want to provide their children and grandchildren the best education possible so that they can have an easier life.[8] To keep their wealth within the family for as long as possible, these millionaires will use every option that the law provides to preserve their wealth.[9]

Although these statistics may not be earth-shattering, they should provide the enlightened estate planner with some comfort that business in this field will increase for approximately the next twenty years.[10] Because these

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[1] THOMAS J. STANLEY & WILLIAM D. DANKO, THE MILLIONAIRE NEXT DOOR 143-44 (1996). The conclusions which Drs. Stanley and Danko have reached are a result of the most comprehensive study ever conducted on America's affluent. *Id.* at 4. More than one thousand people responded to their most recent survey. *Id.* The authors then interviewed the respondents' financial advisors who provided insight into how and why some people accumulate wealth, but others do not. *Id.* at 5.

[2] *Id.* at 144. These estates will possess a value in excess of $2 trillion. *Id.* In addition, these same individuals will be giving approximately the same amount to family members during life. *Id.* at 144. These estimates were made as of 1990 and were not reduced to present value. *Id.*

[3] *Id.*

[4] *See Id.* at 212. There were approximately 3.5 million millionaire households out of 100 million households in America. *Id.*

[5] *Id.* These households will hold approximately 59% of the private wealth in America ($16.3 trillion of $27.7 trillion). *Id.* at 212.

[6] STANLEY & DANKO, *supra* note 1at 9.

[7] *Id.* at 10.

[8] *Id.*

[9] *Id.* at 216.

[10] *Id.* at 212, 214. Between 1996 and 2005, an estimated 692,493 decedents will leave

individuals spend nearly twice as much time planning their financial futures as those who have not attained the millionaire status,[11] these individuals recognize and are willing to pay for high-quality financial advice.[12] These same individuals realize that their accumulated wealth could be subject to federal transfer taxes and will seek the advice of respected estate planners.[13]

One of the most effective tools to accomplish the goal of preserving family wealth is a perpetual dynasty trust. Such a trust permits discretionary distributions of income and principal for as many generations (in terms of years) as the state's law allows. Alaska, Arizona, Delaware, Idaho, Illinois, Maryland, Ohio, South Dakota and Wisconsin have abolished, or provided trust settlors with the ability to opt out of their respective Rules Against Perpetuities.[14] This means that a trust established in one of these jurisdictions could last forever. The essence of such a trust is that, if properly drafted and funded, to be exempt from the federal generation skipping transfer tax, it will avoid transfer taxes after creation of the trust until the last beneficiary dies. Because of the transfer tax-free compounding, the trust should recognize significant wealth accumulation, doubling every ten years.

This Comment is intended to introduce the practitioner to many issues to consider when determining whether a perpetual dynasty trust is a viable option for a client.[15] Section II discusses the history and implications of creating a trust in a jurisdiction that has adopted the common law Rule Against Perpetuities, or the Uniform Statutory Rule Against Perpetuities, or a state

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estates worth at least $1 million. *Id.* at 212.

[11] *Id.* at 97.

[12] STANLEY & DANKO, *supra* note 1at 108.

[13] *Id.* at 213. "[E]state attorneys will likely generate more than $25 billion in revenue from servicing estates in the $1 million or more range during the 1996-2005 period. This figure is greater than the net income generated by all law partnerships for all services in 1994." *Id.* at 215.

[14] *See infra* note 73 and accompanying text.

[15] It is beyond the scope of this article to discuss thoroughly every issue involved with perpetual dynasty trusts. Therefore, the author has provided some references to background material to analyze issues relevant to perpetual dynasty trusts which were not discussed in this article. For a discussion of taxable terminations and taxable distributions for generation skipping transfer tax purposes, *see infra* note 46. For background material discussing grantor trusts, *see infra* note 116. For background material discussing the use of family limited partnerships in perpetual dynasty trust planning, *see infra* note 128. For an analysis of spendthrift trusts, *see infra* note 130. For background material analyzing the use of Crummey withdrawal powers, *see infra* note 134. For a discussion of the generation skipping tax inclusion ratio, *see infra* note 159. Finally, for background material discussing split-dollar life insurance, *see infra* note 184.

which has abolished its Rule Against Perpetuities.[16] Section III discusses some of the most important drafting choices involved when creating a perpetual dynasty trust.[17] Section IV discusses the generation skipping transfer tax considerations implicated by a perpetual dynasty trust.[18] Section V discusses the use of life insurance to leverage the generation skipping transfer tax exemption that effectively limits the amount of assets that can be placed in perpetual dynasty trusts that avoid transfer taxes.[19]

II. BACKGROUND OF DYNASTY TRUSTS

A. Rule Against Perpetuities (RAP)

The common law Rule Against Perpetuities (RAP)[20] is designed to prevent the perpetuation of wealth disparities, promote alienability of property, and make property productive.[21] However, the Rule's stated purposes have been criticized as no longer applying in today's capital market system.[22] The Rule's application has baffled practitioners who have failed to master the Rule.[23]

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[16] *See infra* notes 20-77 and accompanying text.
[17] *See infra* notes 78-133 and accompanying text.
[18] *See infra* notes 134-167 and accompanying text.
[19] *See infra* notes 168-184 and accompanying text.
[20] "No interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest." W. Barton Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638, 639 (1938).
[21] David M. Becker, *If You Think You No Longer Need to Know Anything About the Rule Against Perpetuities, Then Read This!*, 74 WASH. U. L. Q. 713, n.4 (1996).
[22] Lewis M. Stimes, *The Policy Against Perpetuities*, 103 U. PA. L. REV. 707, 712 (1955). Most contingent future interests exist within a trust which consists of stocks and bonds. *Id.* at 713-15. The trustee is generally authorized to sell the assets and, therefore, the property is alienable. *Id.* In addition, the court may apply the doctrine of unproductive property to force the trustee to sell land that does not produce income in order to benefit the beneficiaries. *Id.* at 715-17.
[23] Ronald C. Link & Kimberly A. Licata, *Perpetuities Reform in North Carolina: The Uniform Statutory Rule Against Perpetuities, Nondonative Transfers, and Honorary Trusts*, 74 N. C. L. REV. 1783, 1784-85 (1996). One of the most difficult concepts for a lawyer or student to grasp is that of the life in being and the "requirement of absolute certainty as to the time limits of vesting." *See* Becker, *supra* note 21, at n.2. The measuring life could be anyone and does not have to be the recipient of an interest. *Id.* Further, the practitioner must assume facts which are known to have an insignificant probability of actually occurring, such as "that a person can conceive a child at any time during his or her life." *See Id.* at n.3 These traps have become known as the "fertile octogenarian" and the "precocious toddler." Link & Licata, at 1783. For a discussion of the presumption of fertility as it pertains to the RAP, see

The common law RAP has inhibited the use of dynasty trusts (trusts which last forever) because such a trust would violate the Rule. No perpetual dynasty trusts would vest within the perpetuities period because a person three generations below the trust's settlor is not alive at the creation of the trust. The United States adopted much of its probate law from England.[24] Hauser notes that "[a]merican lawyers take for granted that a person has. . . the freedom to dispose of his or her property as he or she sees fit."[25] However, the ability to sell land or dispose of land at death was a change created by the American Revolution.[26] Before that, ownership rights were a political issue regulated strictly by the government.[27] As views in the United States regarding the right to dispose of property to reward wealth accumulation have increased, legislation regarding transmission of property has increased as well.[28]

RONALD H. MAUDSLEY, THE MODERN LAW of PERPETUITIES, 49, 52-53 (1979); ROBERT J. LYNN, THE MODERN LAW of PERPETUITIES 58, 60-61 (1966).

For a discussion of the issues involved when a lawyer drafts an instrument which violates the Rule, *see e.g.,* George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 FORDHAM L. REV. 273 (1998)(analyzing Lucas v. Hamm, 364 P.2d 685, 690 (Cal. 1961), the landmark case which recognized that a drafting error which violated the Rule did not give rise to malpractice liability); John W. Weaver, *Fear and Loathing in Perpetuities*, 48 WASH. & LEE L. REV. 1393 (1991)(noting that notwithstanding *Lucas*, a drafter may be liable for malpractice and also be subject to discipline for professional responsibility violations); S. Alan Medlin & F. Ladson Boyle, *What Every South Carolina Lawyer Should Know About the (Ugh!) Rule Against Perpetuities*, 2 S.C. LAW 27 (1991)(discussing the use of savings clause to avoid malpractice); Gerald P. Johnston, *Legal Malpractice in Estate Planning and General Practice*, 17 MEM. ST. U. L. REV. 521 (1987)(noting that malpractice liability may attach when beneficiaries become aware that a generalist drafted an instrument which violated the rule); Evelyn Betts Thomason, *How Estate Planners Can Cope with the Increasing Risk of Malpractice Claims*, 12 EST. PLAN. 130 (1985)(analyzing the increasing trend of cases that recognize liability for estate planning malpractice, which began with *Lucas*).

[24] Barbara R. Hauser, *The Tale of the Testament*, 12 PROB. & PROP. 58, 59-60 (1998). An understanding of the history of the law of wills will allow a practitioner to provide better service to his or her multi-national clients. *Id.* at 64. For an excellent discussion of the history of testamentary disposition beginning with Hammurabi's Sealed Deeds (1792 B.C.), see *id* at 58-64.

[25] *See id.* at 60.

[26] *Id.*

[27] *Id.*

[28] For a discussion of the policy arguments for and against inheritance *see generally*, EDWARD C. HALBACH, JR., DEATH, TAXES AND FAMILY PROPERTY 3-7 (1977)(arguing that allowing inheritance promotes hard work, initiative and productivity); JEREMY BENTHAM, THE HISTORY OF LEGISLATION 184 (C.K. Ogden ed. 1950)(stating that as one's life

B. Uniform Statutory Rule Against Perpetuities

To alleviate some of the perpetuities problems, "[i]n 1986 the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Statutory Rule Against Perpetuities (USRAP)."[29] USRAP gives the drafter the opportunity to comply with the common law RAP.[30] If the drafter fails to comply with the common law rules, an alternative ninety-year wait-and-see period applies.[31] According to the alternative rule, an interest will be valid if the interest vests within the ninety years.[32] After the ninety years expires if the instrument fails, a court may reform the trust to comply with the RAP and still carry out the settlor's intention.[33] Dukeminier observes that "under USRAP, trust settlors may elect to create either a trust measured by lives in being at the creation of the trust plus twenty-one years or a trust measured by ninety-years."[34]

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nears its end, the ability to transmit property is a mental comfort); JOHN A. BRITTAIN, INHERITANCE AND THE INEQUALITY OF MATERIAL WEALTH (1978)(arguing that inheritance denies opportunities to the poor and concentrates economic power in the already wealthy); RONALD CHESTER, INHERITANCE, WEALTH AND SOCIETY (1982)(arguing that inheritance rewards the chance of fortunate birth instead of merit or productivity); LESTER C. THUROW, GENERATING INEQUALITY: MECHANISMS OF DISTRIBUTION IN THE U.S. ECONOMY (1975)(arguing that inheritance perpetuates wide disparities within society); Mark L Ascher, *Curtailed Inherited Wealth*, 86 MICH. L. REV. 69, 72-76 (1990)(proposing a scheme which would transfer all property of a decedent to the federal government with limited exceptions); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case of Progressive Taxation*, 19 U. CHI. L. REV. 417, 701-504 (1952) (arguing that economic inequality stems from social inequality, not wealth transmission); John H. Langbein, *The Twentieth-Century Revolution in Family Wealth Transmission*, 86 MICH. L. REV. 722, 723-45 (1988) (arguing that wealth transmission occurs through education during life and not intergenerational transfers upon death); STEPHEN R. MUNZER, A THEORY OF PROPERTY 380-418 (1990); Adam J. Hirsh & William K.S. Chang, *A Qualitative Theory of the Dead Hand*, 68 IND. L.J. 1, 6-14 (1992)(recognizing that control by the dead hand can have little social utility if a trust could last more than a century, especially if the person transmitting the property does not really have a thorough understanding of the consequences of the transmission).

[29] *See,* Jesse Dukeminier, *The Uniforms Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities*, 30 REAL PROP. PROB & TR. J. 185, 186 (1995) (citing UNIF STATUTORY RULE AGAINST PERPETUITIES [hereinafter USRAP], 8B U.L.A. 321 (1990)). The problem with the common law rule is that it invalidates ab initio interests that likely would never actually violate the Rule because of the strict "if-any-possibility-of-remote-vesting" way the common law Rule operates. Link and Licata note that:

> [t]his has led to the creation of such notable doctrines as the 'fertile octogenarian' doctrine, which presumes a couple is fertile until death

> despite any medical evidence to the contrary; the 'unborn widow' doctrine, which presumes that a 45-year-old life beneficiary's spouse might die and the life beneficiary might remarry a person who was unborn at the testator's death and then produce offspring; the 'precocious toddler' doctrine, which presumes that a child of less than five years is capable of producing children; and the 'administration contingency' doctrine, which presumes that administration of an estate or probate of a will or other event will not occur in due course but may take more than 21 years.

Link and Licata, *supra* note 23, at n.21.

[30] Dukeminier, *supra* note 29, at 186-87.

[31] *Id.* at 187. Because of the difficulties created by the common law RAP, many practitioners and commentators urged reform. David S. King & Alexander M. Meiklejohn, *The Uniform Statutory Rule Against Perpetuities: Wait-and-See for 90 Years*, 17 EST. PLAN. 24, 25(1990). Wait-and-see will prevent "inept lawyers or unsophisticated laypersons" from violating the Rule at the time the instrument was drafted. *See id.* at 26. However, King and Meiklejohn argue that such persons probably drafted the dispositive provisions poorly as well and that such an instrument will not allow the beneficiaries to obtain relief until the end of the waiting period. *Id.* Wait-and-see is the most widely accepted reformation of the common law Rule and has been adopted by a majority of jurisdictions and the Restatement (Second) of Property. *Id* at 26. Wait-and-see has been adopted by about half of the jurisdictions following the common law Rule and twenty-two states have adopted USRAP, which includes a wait-and-see clause. Jesse Dukeminier, *Dynasty Trusts: Sheltering Descendants from Transfer Taxes*, 23 EST. PLAN. 417, 419 (1996). *See also*, *infra* note 39.

[32] Dukeminier, *supra* note 29, at 187. The purpose of the wait-and-see doctrine is to allow interests to vest, which would have been invalid under the common law Rule. Lawrence W. Waggoner, *Perpetuities: A Perspective on Wait-and-See*, 85 COLUM. L. REV. 1714, 1717 (1985)(analyzing the method of ascertaining the proper measuring lives under wait-and-see). The wait-and-see doctrine determines whether a non-vested interest is valid by focusing on the actual events that occur by the end of the perpetuities period. Sheldon F. Kurtz, *The Iowa Rule Against Perpetuities—Reform at Last, Restatement Style: Wait-and-See and Cy Pres*, 69 IOWA L. REV. 705, 711 (1984). This doctrine "represents a fundamental departure from the analytical methodology under the common-law Rule, which tested the validity of a nonvested interest by events that 'might have been.'" *See id.*

[33] Dukeminier, *supra* note 29, at 187. Such a reformation is analogous to the cy pres doctrine. Kurtz, *supra* note 32, at 735-36. The court will reform the non-vested interest to most closely approximate the settlor's intention. *Id.* at 736.

[34] Dukeminier, *supra* note 29, at 187. Dukeminier is concerned that because the wait-and-see doctrine now exists students and practitioners will fail to master the common law Rule. King & Meiklejohn, *supra* note 31, at 28. Such a phenomenon may lead to poor drafting skills which could have significant effects on a client's future. *Id.*

USRAP has given estate planners a valuable tool: the ability to create a dynasty trust to last for ninety years or for the common law perpetuities period.[35] A ninety-year dynasty trust may be more appropriate for a settlor who wants control of the trust as long as possible because the trust is guaranteed to last for the ninety years.[36] Conversely, if the settlor chose a dynasty trust to last for lives in being at the creation of the interest plus twenty-one years, the trust may not last ninety years.[37] After such a trust ends, there is no guarantee, nor any requirement, that the beneficiary extend the trust into the future.[38] Therefore, in a jurisdiction which has adopted USRAP, a ninety-year dynasty trust may provide the settlor with the maximum length of control.[39]

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[35] Dukeminier, *supra* note 29, at 207. A dynasty trust is generally structured to provide the settlor's child or children with a life estate with a special power to appoint trust principal. *Id.* at 206. "This power permits [the child] to terminate the trust at any time during her life or at death, if it seems wise, by distributing the trust principal among her family." *See id.* Similar life estates and special powers of appointment are created in successive generations below that of the child until the perpetuities period expires. *Id.* At that time, the trust principal will be distributed to the child's living issue. *Id.*

[36] *Id.* at 208.

[37] *Id.* at 207. The measuring life may "yield a perpetuities period of less than ninety years." *Id.*

[38] *Id.* The settlor has a drafting choice: whether to include a perpetuities savings clause to terminate the trust after the life in being plus twenty-one years expires. *Id.* "[U]nless very carefully crafted, [a perpetuities savings clause] may prevent the donee of a special power from extending the duration of the trust by using extraneous lives." *See id.* Therefore, the settlor may choose not to include a savings clause because USRAP does not invalidate an interest "for violating the common-law rule against perpetuities for ninety years." *See id.*

In addition, a dynasty trust to last for a measuring life plus twenty-one years "requires affirmative action by the donee of a special power to extend the trust if the initial measuring lives produce a period shorter than ninety years." *See id.* The beneficiary may not exercise the power of appointment for several reasons: failure to execute a will, incompetence, or execution of a will extending a trust which is invalidated by the controlling jurisdiction. *Id.* at 207-08.

[39] Twenty-two states have adopted USRAP: CAL. PROB. CODE _21200 (West 1995); COLO. REV. STAT. ANN. S _15- 11-1101 (West 1994); CONN. GEN. STAT. ANN. _45a-490 (West 1993); FLA. STAT. ANN. _689.225 (West Supp. 1995); GA. CODE ANN. _44-6-200 (1991); HAW. REV. STAT. _525-1 (1993); IND. CODE ANN. _32-1-4.5-1 (Burns Supp. 1994); KAN. STAT. ANN. _59-3401 (1994); MASS. GEN. LAWS ANN. ch. 184A, _1 (West 1991 & Supp. 1994); MICH. COMP. LAWS ANN. _554.71 (West Supp. 1994); MINN. STAT. ANN. _501A.01 (West 1990 & Supp. 1995); MONT. CODE ANN. _72-2-1001 (1993); NEB. REV. STAT. _76-2001 (1990); NEV. REV. STAT. ANN. _111.103 (Michie 1993); N.J. STAT. ANN. _46:2F-1 (West Supp. 1994); N.M. STAT. ANN. _45-2-901

C. Generation Skipping Transfer Tax (GSTT)

The United States wealth transfer tax system is "designed to erode the concentration of multigenerational wealth" to reduce economic disparities within society.[40] The government's goal is to tax the transmission of assets at each generation.[41] Before 1986, dynasty trusts were free from any transfer tax after the time of creation, when they would have been subject to an estate or gift tax, until either the last beneficiary died with the assets in her estate or gave the assets away.[42] Dynasty trusts were also limited by the RAP.[43] However in 1986, Congress felt that it was necessary to close a loophole in the transfer tax system and enacted the generation skipping transfer tax (GSTT).[44]

(Michie 1993); 1995 N.C. ADV. LEGIS. SERV. 190; N.D. CENT. CODE _47-02-27.1 (Supp. 1993); OR. REV. STAT. _105.950 (1990); S.C. CODE ANN. _27-6-10 (Law. Co-op. 1991); TENN. CODE ANN. _66-1-201 (Supp. 1994); W. VA. CODE _36-1A-1 (Supp. 1994).

[40] *See,* Richard A. Oshins & Jonathan G. Blattmachr, *The MegatrustSM: An Ideal Family Wealth Preservation Tool*, 267 PRAC. L. INST. 715, 737 (1998)(recognizing that "[f]rom a policy standpoint, leveling and reducing the economic differences of members of society is generally deemed socially attractive."). However, our transfer tax system raises an insignificant portion of the revenue for the country. Christopher E. Erblich, *Recent Development Recent Development: To Bury Federal Transfer Taxes Without Further Adieu*, 24 SETON HALL L. REV. 1931, 1933 (1994). In fact, transfer taxes have not exceeded 2.33% of the government's tax revenue in the past thirty years. *Id*. Therefore, the government's goal of raising revenue through transfer taxes has failed miserably. *Id.*

[41] *See generally,* Brian A. Chard, *A Practical Look at Estate Planning With Family Limited Partnerships*, 1 T.M. COOLEY J. PRAC. & CLINICAL L. 83, 83 (1997). The estate tax system is designed to prevent excess accumulation of wealth, while the gift tax system prevents individuals from avoiding estate tax liability. *Id.* at 84.

[42] David L. Delicath, *Comment, Estate Planning Ramifications of the Taxpayer Relief Act of 1997: Nobody Said Anything About Simplification,* 33 LAND & WATER L. REV. 697, 708 (1998)(noting that "[t]he GSTT defeated dynasty trusts by imposing an additional tax on generation skipping transfers, which is greater than the tax such trusts sought to avoid"); Dukeminier, *supra* note 31, at 417 (stating that Congress chose to close the loophole that permitted successive life estates from being subject to transfer tax by imposing a tax when property passes to a person two or more generations below that of the transferor). The GSTT met substantial resistance. JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 1077, n. 24 (5th ed. 1995).

Another version of the GSTT was originally enacted in 1976 but annually postponed and retroactively repealed until the 1986 version was finally enacted. *Id*.

[43] J. Ronald Skipper, *Should You Be Recommending Generation Skipping Trusts to Your Clients?*, 70 FLA. B.J. 61, 61 (1996)(noting that before the GSTT, individuals had tax and non-tax reasons for creating dynasty trusts, e.g., asset protection).

[44] I.R.C. _ 2601-63 (1986).

The GSTT applies when a person passes property to another person two or more generations below the transferor.[45] The GSTT is calculated by applying the highest rate of estate tax (currently fifty-five percent) to the fair market value of the transferred asset at the time of transfer.[46] Congress only targeted large family fortunes by exempting the first $1 million of generation-skipping transfers any individual makes so it did not completely eliminate the use of dynasty trusts.[47]

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[45] JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING _2.23.1 (1992)(stating that the GSTT imposes a tax on transfers of wealth to "skip persons:" an individual two or more generations below the transferor or a trust in which all interests are held by "skip persons").

[46] I.R.C. _2641(b). The GSTT is considered to be cost prohibitive because it applies in addition to the gift or estate tax. There are three types of generation skipping transfers: direct skips, taxable terminations, and taxable distributions. The amount subject to the GSTT is the amount received by the donee in a direct skip. I.R.C. _2623. The GSTT erodes wealth by applying a tax that could be greater than the gift: 55% GSTT plus a 55% gift/estate tax (depending on the size of the gift and whether the taxpayer has exhausted the unified credit) applied to the value of the asset plus the GSTT liability. REGIS W. CAMPFIELD ET AL, TAXATION OF ESTATES, GIFTS AND TRUSTS 666 (20th ed. 1997)(citing I.R.C. _2515 for the proposition that a secondary gift tax exists for the amount of GSTT paid by the transferor). The following example illustrates the problem.

Assume that A has exhausted her unified credit and GSTT exemption. A then makes a $1 million GST. The GSTT will amount to $550,000. In addition, A will have to pay a 55% gift tax on $1,550,000 (the value of the asset plus the GSTT liability) equal to $852,500. Consequently, for this $1 million GST, A will have to pay $1,402,500 in transfer taxes. To most people, this seems ludicrous. This is the way in which the government prevents the wealthy from perpetuating their wealth. For this reason, most millionaires will use their $1 million GSTT exemption and NOT make any further GST.

However, the formula is slightly different for taxable terminations. CAMPFIELD ET AL, *supra*, at 665. A taxable termination occurs when an interest in a trust terminates in favor of a skip person. *Id.* at 664 (citing I.R.C. _2612(a)). The amount subject to the GSTT for a taxable termination is the "fair market value, at the time of termination, of the property with respect to which the termination occurs, decreased by expenses, debts, and taxes attributable to the property." *Id.* at 665. A taxable termination is tax inclusive in that the amount subject to the GSTT will include the amount used to pay the GSTT. *Id.* This Comment focuses on dynasty trusts that are exempt from the GSTT altogether, including both direct and non-direct skips. For a discussion of taxable terminations, *see e.g.,* Arthur D. Sederbaum & David J. Wray, *Planning for the Generation Skipping Transfer Tax*, 267 PRAC. L. INST. 685 (1998)(analyzing thoroughly when a taxable termination or a taxable distribution occurs under the Treasury Regulations); Jay D. Waxenberg, *Preparation of the Federal Estate Tax Return*, 265

The reason that individuals seek to create dynasty trusts is to recognize the significant benefit of transfer tax-free compounding.

> Assume you put $1 million into a Dynasty Trust that will benefit your child, grandchild, and great grandchild (sic) during their lives and then whatever remains, the trustee will distribute outright to your great-great grandchild. Assume the trust's net growth is 7% after making some distributions to the trust beneficiaries annually. When the trust terminates it will have $159.8 million dollars to distribute to your great-great grandchild! If instead you gave this $1 million outright to your child and your child and her descendants continued to pass what remained to the next generation, your great- great grandchild would receive only about $14.5 million. The Dynasty Trust accumulates $144 million more in assets for your great-great grandchild because of the 'magic' of transfer tax-free compounding.[48]

The advantage of the dynasty trust is that a direct exponential correlation exists between the length of the trust and the compounding (leverage effect).[49] Therefore, most estate planners agree that proper timing (early creation of the trust) and early allocation of the $1 million GSTT exemption is very important to reduce transfer taxes and increase accumulated wealth.[50]

PRAC. L. INST. 233, 304-306 (1998)(explaining that a taxable termination will occur unless a non-skip person has an interest after termination and that a taxable distribution will occur when the trust makes a distribution of income or principal to a skip person); Pam H. Schneider & Lloyd Leva Plaine, *TRA '97 and the Generation-Skipping Transfer Tax*, 87 J. TAX'N 341 (1997)(discussing the exceptions to and exemptions from the taxable termination and the taxable distribution); David R. Hodgman & Paul J. Collins, *The 'Double-Skip' Trust: A Valuable GST Tax Planning Tool*, 22 EST. PLAN. 273 (1995)(describing the best methods of handling a taxable termination once it has occurred).

[47] Delicath, *supra* note 42, at 708, n. 113-14.

[48] *See id.* To see the chart illustrating the example and describing its assumptions.

[49] A pair of estate planners created a dynasty trust which they trademarked as the MegatrustSM. Oshins & Blattmachr, *supra* note 40, at 738. To see the chart illustrating the example and describing its assumptions, *id.* 123-24. *See also*, Ruud *supra* note 48, at 12.

[50] F. Ladson Boyle, *The Use of Life Insurance in Estate and Generation-Skipping Transfer Tax Planning*, C660 A.L.I. - A.B.A. 419, 451 (1991)(emphasizing that the earlier one exhausts one's GSTT exemption, the greater the leveraging effect through transfer tax-free compounding).

D. Current Status of Dynasty Trusts

1. Common Law RAP Jurisdiction

To gain the benefit of the GSTT exemption and the compounding for a lengthy period of time, a settlor in a common law RAP jurisdiction has a decision to make: who should be selected as the measuring life? Most estate planners choose the settlor's then-living descendants or the then-living beneficiaries.[51] However, to extend the trust beyond twenty-one years after these persons' lives, the settlor may choose to select an "extraneous" validating life, a person not connected to the trust or the settlor.[52] Dukeminier notes that "[t]hese lives can be any persons who were alive when the trust was created:" "12 healthy babies," the beneficiaries' in-laws, members of the law firm, or members of a prominent family.[53]

However, when selecting the extraneous validating lives, the settlor should choose persons whose death will be widely publicized.[54] Therefore, practitioners rarely choose "12 healthy babies" because keeping track of their deaths over the next 100 years is difficult and burdensome.[55] Practitioners are more likely to choose prominent families, such as England's Royal Family or the Kennedy Family, because their deaths will be widely publicized and noticed.[56] In the alternative, the settlor may choose not to use extraneous validating lives, but "give the life beneficiar[y] a power to appoint in further trust."[57] The life beneficiary

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[51] Dukeminier, *supra* note 42, at 419.

[52] *Id.*

[53] *See id.* Statistically at least one of the twelve healthy babies should live to at least eighty years old so these validating lives should produce a period of more than 100 years. *Id.* "[B]y selecting a period which terminates 21 years after the death of the last survivor of (1) the descendants of the grantors' parents, and (2) the descendants of Josheph P. Kennedy (father of John F. Kennedy), the trust vesting should exceed. . . 120 year[s]." *See* Alfred J. Olsen & Susan K. Smith, *Family Business and Professional Corporate Tax Strategies*, C472 A.L.I. - A.B.A. 207, 242 (1990). If the trust is revocable the lives in being are determined when the trust becomes irrevocable, which usually occurs upon the settlor's death.

[54] Dukeminier, *supra* note 42, at 419.

[55] *Id.* In addition, all twelve babies my die "short of their life expectancy." *Id.*

[56] *Id.*

[57] *See id.* (citing RESTATEMENT (SECOND) OF PROPERTY, DONATIVE TRANSFERS, SECTION 19.3 (1984), for the proposition that a beneficiary with a special power of appointment has the implied authority to extend the trust by changing the validating lives). The Restatement states that

> [u]nless the donor has manifested a contrary intent, a donee of a non-general power is permitted to make any appointment that

could exercise the power "when the original measuring lives are about to expire."[58] The beneficiary may exercise the power by using extraneous measuring lives to extend the trust.[59]

2. USRAP Jurisdictions

In 1986, as the USRAP drafters were working on the new statute, they failed to take into consideration that Congress was drafting the GSTT.[60] Because the Treasury would not accept a clause stating that the trust would endure for the longer of the common law perpetuities period or the ninety-year period, USRAP was amended to invalidate such clauses.[61] Under USRAP jurisdictions adopting the amendment,[62] the common law termination date is given effect.[63] The Treasury Regulations do not prohibit the creation of a trust with such a clause because the Treasury relied on USRAP being amended.[64] However, not all USRAP jurisdictions adopted the amendment and in these jurisdictions, settlors still have the ability to include "longer of' clauses.

Another method exists for extending the duration of the trust beyond the original perpetuities period. The settlor can give a beneficiary a special power of appointment to extend the duration of the trust. If permitted by the trust instrument or local law, a beneficiary with a special power of appointment can "switch a 90 year trust to the common law perpetuities period."[65]

> benefits only objects of the power that the donee could make of owned property in favor of those objects.
>
> a. Rationale. It is to be inferred, unless the donor indicates otherwise, that the donor of a non-general power intends the donee to have the same breadth of discretion in appointment to objects that he has in the disposition of his owned property to objects of the power. The extent to which the rule of this section curtails the donee from creating a power in another in exercising the donee's non-general power is considered in §19.4.

Id.

[58] *See,* Dukeminier, *supra* note 42, at 419.

[59] *Id.*

[60] Dukeminier, *supra* note 29, at 189.

[61] Dukeminier, *supra* note 42, at 420. Treasury felt that such an option would give USRAP jurisdictions an unfair advantage because it could result in a substantial extension of the GST exemption. *Id.* at 422.

[62] All of the USRAP jurisdictions except Florida, Georgia, Massachusetts, Michigan, Minnesota, Nebraska, South Carolina and West Virginia enacted the USRAP amendment, section 1(e). *Id.* at 420. *See supra* note 39 for USRAP jurisdictions.

[63] Dukeminier, *supra* note 42, at 420.

[64] *Id.* at 422.

[65] Dukeminier, *supra* note 42, at 421-22.

Additionally, the beneficiary with a special power of appointment should be able to switch from a common law perpetuities period to a ninety-year trust to lock in the GSTT exemption if the beneficiary fears that the next generation will fail to act.[66]

In the past, the exercise of such a special power would constitute a new transfer for transfer tax purposes. Currently however, if a beneficiary exercises a special power of appointment to extend the trust for the longer of ninety years or the common law period, the exercise will no longer be treated as a new transfer by the donee and will not be subject to federal estate or gift tax, [67]

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[66] *Id.* at 422. Even though the common law period is statistically longer, the powerholder may choose to switch for the reasons stated in *supra* notes 37-38 and accompanying text. "The official comment to USRAP states that a switch in this direction might be nullified by section 1(e) if it were predictable that the 90-year period would prove to be longer than the common law period," but this will never occur statistically. *Id.* (citing USRAP section 1(e), comment G, 8B U.L.A. 352 (1990)). The Regulations specifically permit a beneficiary to switch from the common law period to a 90 year period without losing the GSTT exemption. *See supra* note 66. Under the Regulations, a beneficiary should also be permitted to switch to the common law period. Dukeminier, *supra* note 42, at 422. (speculating that such a switch would be valid since USRAP accepts such a switch, the Treasury accepted the two perpetuities periods as equivalents, and Treasury accepts a switch in the opposite direction).

[67] Regs. _26.2652-1(a)(4) and _26.2652-1(a)(6) Example 10 had previously treated such an exercise as a new transfer. However, the explanation of these provisions states that

> [s]ection 2652(a)(1) provides generally, that the term transferor means--(A) In the case of any property subject to the tax imposed by chapter 11, the decedent, and (B) in the case of any property subject to the tax imposed by chapter 12, the donor. An individual is treated as transferring any property with respect to which the individual is the transferor. Under _26.2652- 1(a)(2), a transfer is subject to Federal gift tax if a gift tax is imposed under section 2501(a) and is subject to Federal estate tax if the value of the property is includible in the decedent's gross estate determined under section 2031 or section 2103. Under _26.2652-1(a)(4), the exercise of a power of appointment that is not a general power of appointment is also treated as a transfer subject to Federal estate or gift tax by the holder of the power if the power is exercised in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date of the creation of the trust, extending beyond any specified life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation.

and the settlor's GSTT exemption will not be lost.[68]

Therefore, the benefit of USRAP dynasty trusts is the ability to choose which perpetuities period shall apply and the ability to lock in the GSTT exemption if the ninety year period applies. However, USRAP dynasty trusts have lost much of their appeal in jurisdictions which have adopted the amendment, which eliminated "longer of" options at the creation of the trust, and the jurisdictions which have abolished the RAP.[69] Because of the growing number of jurisdictions which allow a trust not to be governed by the RAP, many estate planners and settlors are choosing to comply with the statutory requirements of these jurisdictions and avoid the Rule altogether, common law and USRAP alike.

3. Jurisdictions Which Have Repealed the RAP

> The purpose of the rule in _26.2652-1(a)(4) was to impose the GST tax when it may not otherwise have applied. It was never intended to (nor could it) prevent the application of the tax pursuant to the statutory provisions that apply based on the original taxable transfer. To eliminate any uncertainty concerning the proper application of the GST tax, the regulations under section 2652(a) are clarified by eliminating _26.2652-1(a)(4) and Example 9 and Example 10 in _26.2652-1(a)(6) from the regulations.

Generation-Skipping Transfer Tax, 62 Fed. Reg. 27498 (1997)(to be codified at 26 C.F.R. pt. 26). Therefore, such a transfer will no longer cause the powerholder to be treated as the transferor for GSTT purposes when she exercises the power to extend the trust.

[68] Regs. _26.2652-1(a)(6) Example 9 had previously stated that such an exercise would disqualify the settlor's allocation of her GSTT exemption. *See supra* note 66. However, the elimination of this Example expressly states that such an exercise will no longer constitute a new transfer with respect to the powerholder. Generation-Skipping Transfer Tax, 62 Fed. Reg. 27498 (1997)(to be codified at 26 C.F.R. pt. 26).

[69] Professor Jesse Dukeminier of the University of California at Los Angeles predicted that 90 year dynasty trusts would become popular with millionaires because of the ease of drafting and the predictability of the trust's termination date. Dukeminier, *supra* note 29, at 211.

However, with the repeal of the RAP in several jurisdictions, discussed *infra*, millionaires and estate planners are flocking to these jurisdictions to create perpetual dynasty trusts. Assuming that an estate planner drafts a trust which is governed by USRAP, the trust can only last ninety years or the common law perpetuities period. However, if the trust is governed by a jurisdiction which has repealed its RAP, the trust is not limited by any perpetuities period. This provides greater flexibility for future beneficiaries, greater transfer tax advantages, and greater compounding potential. For these reasons, estate planners and state legislatures alike are becoming much more attracted to the advantages of perpetual dynasty trusts.

Because the Internal Revenue Code permits trusts to last as long as permitted by state law for GSTT purposes,[70] states are now repealing their rules against perpetuities to compete for trust business.[71] Currently, nine jurisdictions have entered the race and in some manner have abolished the Rule or permit the settlor to choose not to have it apply.[72] These states argue that the Rule's functions are outdated.

The Rule was designed to ensure that property is alienable, but trust property is "almost always alienable because the trustee has the power of sale."[73] The Rule's other function is to curtail a dead hand from controlling the

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[70] Becker, *supra* note 21, at 731.

[71] Dukeminier, *supra* note 23, at 422-23, recognizing that

> [t]he preamble to the Delaware statute states that its purpose is to keep Delaware competitive in the formation of trust capital 'against several innovative jurisdictions that have abolished the rule against perpetuities. Several financial institutions have now organized or acquired trust companies, particularly in South Dakota, at least in part to take advantage of their favorable trust law.' The Delaware repeal had the express purpose of attracting perpetual $1 million dynasty trusts into the state.

Id.

[72] ALASKA STAT. _34.27.050(a)(3)(eliminating the RAP if the trustee has discretion to distribute income or principal); ARIZ. REV. STAT. _14-2901(A) (1998)(validating a non-vested interest if it complies with the common law RAP or USRAP or if a trust, the trustee has the power to sell trust assets and a person living when the trust was created has the power to terminate the interest); DEL. CODE _503(a)(stating that a trust and any interest created in trust will not be void by reason of the common law RAP); IDAHO CODE _55-111(abolishing the RAP and stating that no RAP applies to trusts); 765 LL. COMP. STAT. _305/1-5 (West 1998)(defining a "qualified perpetual trust" as a trust to which the RAP does not apply by reason of the settlor specifically opting not to have the RAP govern the trust); MD. CODE ANN., EST & TRUSTS _11-102(2) (1998)(retaining the common law RAP, but not subjecting a trust to the Rule if the governing instrument specifically states that the Rule does not apply and the trustee has the power to sell, lease or mortgage the property beyond the perpetuities period); OHIO REV. CODE ANN. _2131.09(B)(1)(Banks-Baldwin 1999)(retaining the common law Rule, but allowing a settlor to have no perpetuities period apply if specifically stating intention not to have Rule apply and granting the trustee the power to sell assets or terminate trust); S.D. CODIFIED LAWS ANN. _43-5-1, 43-5-8(stating that the common law RAP does not apply in South Dakota); WISC. STAT. ANN. _700.16(stating that the common law RAP does not apply in Wisconsin).

[73] *See,* Dukeminier, *supra* note 42, at 423.

property.[74] However, a properly drafted dynasty trust gives income beneficiaries special powers of appointment to terminate or extend the trust, thereby vesting the control in the beneficiaries, not the settlor.[75] Because the Rule is no longer essential to fulfill these functions, and the Rule's complexities can easily lead to malpractice, a strong argument exists for abolishing the Rule.[76]

III. DRAFTING CHOICES

In general, practitioners must have a thorough understanding of the client's situation and goals to create an effective estate plan.[77] Although in most circumstances a lawyer's imagination is the only limit to the substantive terms of a trust, there are many choices the drafter and settlor must make when creating a perpetual dynasty trust because of its extended duration.[78]

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[74] *Id.* However, at least one commentator feels that the "current tax law has provided enormous incentive for extending dead hand control." *See,* Becker, *supra* note 21, at 731. This belief is based on the fact that the "Internal Revenue Code permits a married couple to insulate" $2 million from the GSTT for as many generations as the local law permits, which could be forever in a jurisdiction which has abolished the RAP. *See id.* at 731-33. The significance is staggering because the trust corpus should double in value every ten years if income is accumulated and the fund is compounded after the settlor's death. Edward C. Halbach, Jr., *Living with the Generation Skipping Transfer Tax,* 22 U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. 10-1, 10-54 (1988). In addition, most married couples will never be subject to the GSTT because they do not have $2 million of assets.

[75] Dukeminier, *supra* note 42, at 423.

[76] *Id.* To avoid possible malpractice liability, most estate planners include a savings clause in every trust instrument which may be subject to the RAP. DUKEMINIER & JOHANSON, *supra* note 42, at 874. A savings clause ensures that the trust will not violate the perpetuities period by automatically terminating the trust at the end of the perpetuities period. *Id.* at 874-75. When the perpetuities period expires, the assets will be distributed to the beneficiaries living at that time. *Id.*

[77] Barry A. Nelson & Rosario Ferrero Carr, *Drafting to Achieve Maximum Flexibility in the Estate Plan*, 25 EST. PLAN. 252, 252 (1998). Practitioners must remember that estate planning evolves over time. Therefore, changes to an estate plan are necessary depending on changes in the client's circumstances and changes in federal and local law. *Id.* Flexibility is the key to a successful estate plan. *Id.* at 258. The estate planner has may tools to accomplish flexibility, including the power to remove/replace a trustee, asset protection, spendthrifts and delay of distribution clauses, change of situs of trust assets, administration and governing law, allocation of income and principal for partnership and other problem assets, creating and eliminating general powers of appointment, and division into separate GST trusts. *Id.* at 252-58.

[78] *See e.g.,* AUSTIN W. SCOTT, TRUSTS 3, 4 (William F. Fratcher 4th ed. 1987); Thomas H. Foye, *Using South Dakota Law for Perpetual Trusts*, 12 PROB. & PROP. 17, 17

The jurisdiction with the most favorable law today may not have the most favorable law tomorrow. The reasons for this is that this is a dynamic area of the law and also because competition between states is becoming more profound.[79] Additionally, the practitioner must consider the client's situation carefully because certain jurisdictions may be best to accomplish one purpose, but not all purposes.[80] The following is not exhaustive, but it lists some of the most important choices a drafter and client must make.

A. Trust Situs and Conflict of Laws

Choosing the jurisdiction whose laws best protect and promote the client's objectives may be the most important choice in drafting the trust because of the significant impact of this decision. Because only a few jurisdictions have repealed their RAP, the "selected" state will probably be a foreign state. The practitioner must be familiar with the laws of the "selected" state because each state has its own rules as to what is necessary to have its laws govern the trust.[81] The practitioner must do more than simply include a

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(1998). For a discussion of other considerations with respect to trust options, see Jonathan G. Blattmachr, *Factors in Considering the Use, Structure and Situs of Trusts,* 267 PRAC. L. INST. 715, 719-21 (1998) (including choice of type of trust, escape hatches for early termination, federal and local rules limiting accumulation of income, and choosing an appropriate situs of a trust with respect to convenience, taxation and reporting).

[79] Foye, *supra* note 79, at 18.

[80] *Id.* For example, Alaska, South Dakota and Delaware (if the trustee is a non-Delaware resident) do not impose any state income tax on trusts. *Id.* Alaska provides a statutory rule clearly defining the requirements of becoming and remaining an Alaska trust. Jonathan G. Blattmachr et al, *New Alaska Trust Act Provides Many Estate Planning Opportunities*, 24 EST. PLAN. 347, 357 (1997). These and other differences are discussed in *infra* notes 82, 83, 99, 104, and 106 and accompanying text.

[81] In Delaware, common law will probably determine whether Delaware law governs the trust. The Delaware Supreme Court noted that

> [c]ontracting parties, within definite limits, have some right of choice in the selection of the jurisdiction under whose law their contract is to be governed. . . . [T]here seems to be no good reason why [a settlor's] intent should not be respected by the courts, if the selected jurisdiction has a material connection with the transaction.

Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d 309, 313 (Del. 1942). *See also*, Restatement (Second) of Conflicts of Laws 268-70 (1971) (stating that if "selected" state would recognize trust as valid, "selected" state's law will govern even though settlor's domicile would not recognize trust as valid). However, other jurisdictions have statutory provisions which clearly establish what is necessary to have the "selected" states' law govern. South Dakota permits the law of the "selected" clause selecting a state to govern the trust.[82]

When creating a perpetual dynasty trust in a foreign state, the drafter should include more than just the governing law clause.[83] The trust instrument should name at least one trustee who is a resident of the "selected" state.[84] The trust assets should be physically present in the "selected" state.[85] As much administrative activity as possible should occur in the "selected" state.[86] Foye recommends that "[t]he trust instrument should contain a forum selection provision requiring that any disputes arising under the instrument be submitted" to a court in the "selected" state.[87] In addition, the trust instrument should specify that the "selected" state's arbitration statute applies, and that arbitration will take place in the "selected" state if arbitration is the method by

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state named in the trust instrument to govern unless contrary to South Dakota public policy. S.D. CODIFIED LAWS _29A-2-703. Alaska sets forth the requirements that a trust must satisfy before Alaska law will govern. Blattmachr, *supra* note 81, at 357 (stating that at a minimum, one Alaska trustee must maintain records and prepare or arrange for preparation of the trust's tax returns, maintain the trust assets in Alaska, and some trust "administration must occur in Alaska, such as holding some trustee meetings there or effecting some 'trades' there").

[82] *E.g.* Rudow v. Fogel, 426 N.E.2d 155 (Mass. Ct. App. 1931)(holding that trust's choice of governing law clause was only one criterion for determining what law governs the trust); Allstate Ins. v. Hague, 449 U.S. 302 (1981) (indicating that constitutional due process and full faith and credit would not be a basis for enforcing a choice of governing law clause if the clause was the only contact with the "selected" state). This in not a simple step in drafting the trust instrument. However, at least one commentator states that it is "fairly easy." Ruud, *supra* note 48, at 13 (stating that a trust must establish "significant contacts:" including a choice of governing law clause, naming a trustee doing business in the "selected" state, and having the trustee administer the trust assets in the "selected" state).

[83] Foye, *supra* note 79, at 19. The provisions are designed to conform with South Dakota law, but also should comply with the law of most other jurisdictions.

[84] *Id.* The settlor could satisfy this requirement by naming an administrative trustee that is a resident of the "selected" state to act in conjunction with trustees who reside in other jurisdictions. *Id.* The "administrative trustee's duties would typically be limited to holding physical evidence of trust assets, filing federal income tax returns, preparing accountings, holding legal title to trust assets and conducting trustee meetings. The other trustees… would possess powers over discretionary distributions and trust investments." *Id.*

[85] *Id.* This may include stock certificates, and bank or brokerage accounts. *See, e.g.,* Blattmachr et al, *supra* note 81, at 357.

[86] Foye, *supra* note 79, at 19. This includes "preparation of trust accountings, trustee meetings and the preparation and filing [of] federal income tax returns." *Id.*

[87] *Id.*

which the settlor chooses to resolve disputes.[88] The more contacts between the trust and the "selected" state, the greater the likelihood that the "selected" state's law will govern.[89]

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[88] *Id.*

[89] Ruud, *supra* note 48, at 13.

Because this area of law is evolving so quickly, a prudent planner should include a provision allowing the trust to be shifted to another jurisdiction which may be more beneficial in the future.[90] Such a provision should include a clause that allows for a change of the situs of the trust assets, administration and governing law.[91] Each change must be included because any one of the three included individually would not cause the others to be effectuated.[92] Therefore, the "trust instrument should unequivocally address whether, in the event of a change of situs of trust assets or administration, the applicable governing law is to remain the same or whether the trust is to be governed by the law of the new situs jurisdiction."[93] To assure that the settlor's objectives are upheld, the drafter should include factors and standards which the trustees should consider when deciding whether to change the situs.[94] As a precaution, the trust instrument should include a savings clause in the event that the change in situs is invalid and the trust is still governed by a jurisdiction retaining the RAP.[95] This should ensure flexibility for the maximum length of time permitted by all jurisdictions.[96]

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[90] Nelson & Carr, *supra* note 78, at 255. Depending on the law of the controlling jurisdiction, a new trustee may have to be appointed. Therefore, the instrument should address this issue and state whether the previous trustee or the beneficiaries have the power to make such a decision.

[91] *Id.*

[92] SCOTT & FRATCHER, THE LAW of TRUSTS _614 (4th ed., 1989). Generally, a change of situs of trust administration is permitted if in accordance with the donor's intentions. *Id.* A change of trustee, if the new trustee is a resident of another state, may permit a change in the situs of trust administration. *Id.* However, change in trust assets does not necessarily cause change in trust administration. *Id.* Additionally, change in trust assets or administration does not necessarily change the governing law to the new jurisdiction. *Id.* To change the governing law, the language in the trust instrument must clearly indicate the settlor's authorization. *Id.*

[93] *See,* Nelson & Carr, *supra* note 78, at 255.

[94] *Id.* This is significant primarily for tax reasons: allowing the trustee to move the administration of the trust to another jurisdiction to extend the duration of the trust to take advantage of the GSTT exemption. *Id.* When deciding whether to change the jurisdiction and governing law, the settlor should require in the instrument "that the trustees take into account tax and asset protection considerations that allow the preservation of the trust." *See id.* If the trustee has the power to change the governing law, the drafter should permit the trustee to amend or alter the trust instrument "to ensure that the trust would be valid and effective under the laws of the new jurisdiction." *See id.*

[95] Nancy G. Fax, *Using and Drafting Trusts in Estate Planning*, EPTR MD. C.L.E. 33 (1998)(selecting a skilled drafting attorney to act as the technician for the client becomes more important and complex when drafting a trust instrument which is intended to allow different jurisdictions' laws to apply during the trust's existence).

[96] Nelson and Carr, *supra* note 78, at 255.

A settlor who has already established an irrevocable trust in a state which has not repealed its RAP may wish to change the governing law to one of the jurisdictions which has repealed its RAP.[97] If the trust instrument does not forbid extending the duration of the trust beyond the perpetuities period, changing the situs to one of these jurisdictions will allow for an unlimited term if "an effective change of the law governing the validity of the trust occurs."[98] An agreement between the settlor (if living), the present trustees, and all beneficiaries to transfer the situs to the "selected" jurisdiction could accomplish the transfer.[99] In the alternative, if the trust instrument permits, one of the trustees could resign, and the beneficiaries could appoint a trustee who resides in the "selected" state.[100] Then, the trustee would transfer the assets to the "selected" state. Finally, the trustees or beneficiaries could petition a court in the state in which the trust was established to order the change of situs to the "selected" state.[101] Foye suggests that "[t]he method the parties use will depend on the terms of the trust instrument and local law" and an analysis of the GSTT.[102]

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[97] Foye, *supra* note 79, at 19.

[98] *See id.* If the trust instrument limits the length of the trust to a perpetuities period, changing the situs of the trust will not overcome this limitation. *Id.* The only advantage of moving such a trust is avoiding state income tax. *Id.* This depends on how each jurisdiction defines a "resident trust" for income tax purposes. *Id.* If, after changing the situs to the "selected" state, "the trust remains a resident of another state for income tax purposes, the trust will continue to be subject to that state's fiduciary income tax." *See id.* MINN. STAT. _290.01, subd. 7b; N.J. REV. STAT. _54A: 1-2(m)(3) (defining a trust as a resident trust if settlor was domiciled in state when trust became irrevocable). *But see, e.g.*, OR. REV. STAT. _128.135; HAW. REV. STAT. _235-1 (basing trust residency on the administration of the trust in the state or trustee's residency in the state); ARIZ. REV. STAT. _43-313; CAL. REV. & TAX CODE _17742(a) (basing trust residency on beneficiaries' residency in state).

[99] Foye, *supra* note 79, at 19.

[100] *Id.*

[101] *Id.*

[102] *See id.* at 19-20. If the trust is exempt from the GSTT because the settlor allocated a portion of her GSTT exemption, changing the perpetuities period should not invalidate the exempt status of the trust. *Id.* at 20. *See also, supra* notes 66-70 and accompanying text. However, if the trust was grandfathered, and exempt from the GSTT, extending the trust term will probably cause the trust to lose its exempt status. *Id.* For a discussion of trusts grandfathered from the GSTT, see Boyle, *supra* note 51, 457-59 (1991).

The potential planning opportunities for perpetual dynasty trusts are significant, but the particular advantages of the states which have repealed their RAP have not been tested. Alaska, Delaware (if the beneficiaries are non-Delaware residents), and South Dakota do not impose an income tax on trusts.[103] Alaska and Ohio provide clear guidelines to follow in order to have Alaska or Ohio law govern the trust.[104] Delaware and Alaska "provide asset protection for certain donors."[105] Because these benefits are not definite yet, the conservative approach may be to include a clause providing for a shift to one of these jurisdictions "once case law has provided more certainty."[106]

B. Trustee Considerations

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[103] Blattmachr et al, *supra* note 81, at 357. This is significant because

> an 85 year trust could accumulate up to $1.9 billion from a $1 million initial contribution. If a New York resident created an identical trust at the same time under New York law and based on the same assumptions, the New York trust would accumulate only to $488 million.

See Foye, *supra* note 79, at 255. Obviously, a client would not want to have more than half of her potential wealth eroded by income tax if it is unnecessary.

[104] Blattmachr et al, *supra* note 81, at 357. *See also, supra* notes 73, 81-82 and OHIO REV. CODE ANN.§2131.09(B)(1)(stating that a settlor may opt to not have the Rule apply if the trust instrument was executed in Ohio, a trustee is domiciled in Ohio, the trust is administered in Ohio, a substantial portion of the assets are located in Ohio, or the trust instrument states that Ohio law applies to the trust).

[105] *See* Nelson & Carr, *supra* note 78, at 255. For a summary of the specific provisions of and exceptions to the asset protection laws of Alaska and Delaware, see Jeffrey N. Pennell, *Recent Wealth Transfer Tax Developments*, SC75 A.L.I. - A.B.A. 193, 221-23 (1998). The unresolved question involving these statutes is "whether the inability of the settlor's creditors to reach a retained discretionary trust instrument means that the settlor did not retain a sufficient string or enjoyment to avoid a completed gift inter-vivos or to cause estate tax _2036(a)(1) inclusion at death." *Id.* at 222. Pennell believes such a retention of enjoyment will result in estate taxation even though the settlor incurred gift tax on creation of the trust because the ability to receive discretionary distributions is a transfer that is not sufficiently complete to avoid inclusion in the settlor's estate. *Id.* This may result in a significant increase in estate tax because the tax is imposed on the value of the assets at the settlor's death, which may have greatly appreciated since the creation of the trust. Even though litigation is certain in this area, Pennell feels that this may be an aggressive position which a client may wish to take because the position is not frivolous and the consequences are not too severe (gift tax liability and loss of new basis at death). *Id.* at 222-23. For a thorough analysis of Pennell's arguments and support for his conclusion, see *id.* at 222-23, 243-47.

[106] Nelson & Carr, *supra* note 78, at 255.

The settlor should have a clear understanding of the important role of the trustee, including duties, responsibilities and potential liability, to make an informed decision as to who should act as the trustee.[107] Because of the extended duration of perpetual dynasty trusts, the settlor should thoroughly analyze abilities and qualities of the candidates for trustee.[108] If the settlor and drafter come to the conclusion that the trustee will not have "the desire or ability to serve for the duration of the trust," the drafter must include a provision concerning trustee succession.[109]

Most settlors would choose to retain control of the power to remove and replace the trustee of a perpetual dynasty trust and then transfer this power to the beneficiaries upon the settlor's death because of the unforeseen circumstances which may arise more than a century after the settlor created the trust.[110] Because the Internal Revenue Service recently changed its position with respect to such a power, the retention of this power no longer causes inclusion in the settlor's estate.[111] Therefore, most estate planners should include a trustee removal power for "virtually all testamentary and inter-vivos trusts."[112]

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[107] Kathryn A. Johnson & Adam J. Wiensch, *Trustee Selection for Successful Trust Administration*, 8 PROB. & PROP. 38, 38-40 (1994) (discussing common law duties, trustee liability, environmental liability , and general considerations for trustee selection).

[108] *Id.* at 38, 40.

[109] *See id.* at 40. An individual will never have the ability to serve as trustee for the duration of a perpetual dynasty trust because an individual cannot live forever. However, a corporate trustee may not desire to serve as trustee for a perpetual trust because of the risks and uncertainties involved with a trust which may possibly last for centuries.

[110] Nelson & Carr, *supra* note 78, at 252. The changes may include changes to tax law, federal or local laws, family composition or investment objectives.

[111] *Id*. In 1995, the IRS issued Rev. Rul. 95-58, 1995-2 C.B. 191, reversing the IRS's previous position stated in Rev. Rul. 79-353, 1979-2 C.B. 325 (causing inclusion in the settlor's estate if the settlor could remove and replace the trustee because the settlor was "deemed to possess the discretionary powers of the trustee."). *Id*. The IRS's current position is that a retention of the power to remove and replace will only cause inclusion if the settlor can appoint himself, or a related or subordinate party as trustee and "the trustee has the right to 'designate the person who shall possess or enjoy the property or the income therefrom."' *See* Johnson & Wiensch, *supra* note 108, at 41 (quoting I.R.C. _2036(a)(2)).

I.R.C. _2038(a)(1) will cause inclusion if the settlor retains the right to appoint himself as trustee and the trustee has the right "to alter, amend, revoke, or terminate" the trust or if the trustee's distribution powers are not limited by an ascertainable standard or the trustee has the authority to terminate the trust. *Id*. at 41. If the trust instrument does not comply with the Code provisions, the inclusion rules apply even if the settlor never exercised the power to remove and replace. *Id*.

Therefore, the trust instrument should clearly indicate that the settlor cannot appoint himself as trustee and distributions should be limited by an ascertainable standard as defined in I.R.C. _2041(b)(1)(A) if beneficiaries can serve as trustees. A provision stating that the trustee may distribute income and/or corpus for the beneficiary's "health, education, maintenance or support" will qualify as an ascertainable standard. Because HEMS provisions have been accepted by the IRS and courts, drafters should not stray from the specific terms set forth in I.R.C. _2041(b)(1)(A). *See, e.g.*, Merchants Nat'l Bank v. Comm'r of Internal Revenue, 320 U.S. 256 (1943)(holding that "happiness" does not constitute an ascertainable standard); Independence Bank Waukesha (N.A.) v. United States, 761 F.2d 442 (7th Cir. 1985)(allowing wife to use her own discretion as to how much of trust corpus would be used for her own maintenance, created a general power of appointment; thus, the assets were taxable as part of wife's estate); First Virginia Bank v. United States, 490 F.2d 532 (4th Cir. 1974) (explaining that under applicable Virginia law, widow's "right to dispose, sell, trade, or use (the stock) during her lifetime for her comfort and care as she may see fit" was not limited to ascertainable standard); Lehman v. United States, 448 F.2d 1318 (5th Cir. 1971)(holding that under Texas law, power to invade corpus for "support, maintenance, comfort and welfare" not limited by ascertainable standard); Peoples Trust Co. of Bergen County v. United States, 412 F.2d 1156 (3d Cir. 1969)(noting that even if utilization by decedent, who was life beneficiary under trust and had power to invade the principal, of principal had been limited and even if she was accountable as a fiduciary to remaindermen for any invasion not made in "good faith," statutory requirement that power be limited by an ascertainable standard would not be met if grant of power to invade principal was too broad); Miller v. United States, 387 F.2d 886 (3d Cir. 1968)(holding that testamentary trust which authorized trustees to make disbursements to widow out of principal for her proper maintenance, support, medical care, hospitalization, or other expenses "incidental to her comfort and well-being" conferred upon widow a general power, which though never exercised, required that the value of the trust be included in widow's gross estate); Strite v. McGinnes, 330 F.2d 234 (3d Cir. 1964)(recognizing that holders of power of appointment were limited by standard of "good faith" in Pennsylvania was not sufficient to constitute an ascertainable standard); State Street Bank Co. v. United States, 313 F.2d 29 (1st Cir. 1963) (recognizing that 'reasonable requirements" is not an ascertainable standard within meaning of 'health, education, maintenance and support"); Hyde v. United States, 950 F.Supp. 418 (D.N.H.1996)(noting that discretion of beneficiary to invade principal as "necessary and desirable" was a general power of appointment, resulting in trust assets being included in beneficiary's gross estate for federal estate tax purposes; necessary and desirable was not an ascertainable standard in that neither state law nor testator's will limited purposes for which beneficiary could use trust principal and testator intended for beneficiary to use trust assets as she wished); Schlotterer's Estate v. United States, 421 F.Supp. 85 (W.D.Pa. 1976)(holding that where wife could consume corpus "to the extent deemed by her to be desirable not only for her support and maintenance but also for her comfort and pleasure without recourse to any property of her own," such unlimited power to apply the property for her comfort and pleasure constituted a "general power of appointment" which rendered the amount in her estate upon her subsequent death derived from her husband's estate taxable in her estate); Stafford v. United States, 236 F.Supp. 132 (E.D.Wis.1964) (explaining that life tenant's power under will to invade principal if necessary for his care, comfort or enjoyment was not limited by an ascertainable standard and hence life tenant possessed a general power of appointment for estate tax purposes and value of the property was properly included in his gross estate).

[112] *See* Nelson & Carr, *supra* note 78, at 252. Because of the implication and importance of such powers,

> [e]very instrument granting trustee removal and appointment powers should indicate: (1) who has the power to remove and replace a designated trustee and, if more than one person has such power, the priority in which they may act; (2) whether the persons having the removal and replacement power can appoint an individual successor trustee or only an institutional trustee; and (3) if an individual successor trustee can be designated, what limitations, if any, apply as to who may serve as individual trustee. Furthermore, the document could limit the number of times that a person may exercise a trustee removal and replacement power during his lifetime.

Id. at 253.

If the settlor chooses to name an "independent trustee,"[113] this trustee can have complete discretion to distribute income and principal without causing inclusion of the trust assets in the settlor's or beneficiary's estate.[114] However, if the settlor names a beneficiary as trustee, the drafter must be careful not to cause the trust to be included in the "estate of the settlor or a beneficiary, or [unintentionally] make the trust a grantor trust for income tax purposes."[115] The settlor may choose this option to reduce administrative costs[116] or permit the

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[113] Johnson & Wiensh, *supra* note 108, at 41. An "independent trustee" can be anyone "who is not the [settlor], a beneficiary, or a 'related or subordinate party', as that term is defined in Code _672(c)." *See id.* However, if the settlor names an independent and non-independent trustee as co-trustees, the trust instrument should clearly indicate that "only the independent trustee can exercise tax-sensitive powers and should require that there always be at least one independent trustee." *See id.* Because perpetual dynasty trusts generally accumulate income, an independent co-trustee should have the discretion to distribute income. Bruce A. Schilken & Michael C. Schilken, *How to Bullet-proof a Child's Inheritance*, 22 COLO. LAW. 37, 39 (1993). This will avoid having all of the income taxed to the beneficiary, while still allowing the beneficiary to mange investment decisions. *Id.*

[114] *Id.* This point is moot if the settlor intends that the trust be included in the beneficiary's estate. However, this would not be the intention of a dynasty trust settlor because the dynasty trust is intended to avoid transfer tax for as many generations as possible.

[115] *See,* Johnson & Wiensh, *supra* note 108, at 41. The settlor may want to create a perpetual dynasty trust which accumulate the income for the beneficiaries while the settlor pays the tax for the beneficiaries "benefit," thereby intentionally creating a defective grantor trust. For a discussion of grantor trusts, see *e.g.*, Michael Denham, *Comment*, *Taxpayers Get a Sigh of "Relief": Congress Corrects Mistaken Interpretation of the Grantor Trust Rules by the IRS in the Taxpayer Relief Act of 1997*, 29 TEX. TECH. L. REV. 181 (1998)(analyzing when ownership by seller and purchaser as grantor causes taxability); JACOB MERTENS, JR., THE LAW of FEDERAL INCOME TAXATION _37.29 (1998); Frank P. Riggs, *Revocable Inter-vivos Grantor Trusts*, 71 FLA. B. J. 70 (1997)(cautioning settlors from choosing to create a grantor trust because the risks outweigh the benefits); Joyce Q. Lower, *Form Over Substance in Estate Tax Audits - Twenty Years of Evolution in Gifts from Grantor Trusts*, 75 MICH. B.J. 1284 (1996)(analyzing the history of grantor trusts within the confines of the ever-changing tax laws); Jay D. Waxenberg & Henry J. Leibowitz, *New Grantor Trust Reporting Regs. Offer Greater Flexibility*, 23 EST. PLAN. 291 (1996)(concluding that the new reporting Regs. are more burdensome and will likely only create limited flexibility because of the confusion the Treasury has created); Thomas W. Abenworth, *Grantor Trusts Are Now Useful Planning Tools*, 47 TAX'N FOR ACCT. 240 (1991)(determining that grantor trusts allow for tax benefits even though all of the income is taxed directly to the owner).

[116] Johnson & Wiensh, *supra* note 108, at 40.

beneficiary to control the management of investment decisions.[117] To prevent inclusion in the beneficiary- trustee's estate, the drafter should include a HEMS provision, limiting distribution of income and principal to an ascertainable standard.[118]

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[117] Schilken & Schilken, *supra* note 114, at 38. Even though the beneficiary-trustee has the power to control investment decisions to benefit herself, the beneficiary-trustee still has a fiduciary obligation to future beneficiaries. *Id.*

[118] Johnson & Wiensh, *supra* note 114, at 41-42. *See also, supra* notes 106 and 112.

> For federal tax purposes, a general power of appointment is, with certain exceptions, a power exercisable by the holder to transfer or appoint property to or in favor of himself, his estate, his creditors, or the creditors of his estate. Generally, property subject to a decedent's general power of appointment must be included in his gross estate under section 2041, and the lifetime exercise or release of a general power of appointment (in favor of another person) is treated as taxable gift transfer under section 2514(b). However, where such power is subject to an ascertainable standard relating to the health, education, support, or maintenance of the powerholder, it is specifically excluded from treatment as a general power of appointment.

See, Richard W. Harris, *Ascertainable Standard Restrictions of Trust Powers Under the Estate, Gift, and Income Tax*, 50 TAX LAW. 489, 515-16 (1997).

A power restricted to such an ascertainable standard is generally referred to as a HEMS provision. HEMS provisions can provide great flexibility within a trust by providing the powerholder the opportunity to benefit the herself without causing any adverse tax consequences to arise.

If the trust instrument includes a spendthrift provision, the HEMS provision will have the added benefit of protecting the trust assets from creditors. Schilken & Schilken, *supra* note 114, at 38. The spendthrift provision should preclude the payment of debts incurred except for the beneficiary's health, education, maintenance and support. *Id.* If the trust was discretionary, then no creditors could reach any assets of the trust until the beneficiary became entitled to the assets, which occurs when the trustee exercises her discretion. This will ensure that if the creditor attempts to collect from the trust, that the issue is clearly addressed and the creditor cannot assert that the instrument is ambiguous with respect to asset protection. *See* discussion *infra* Part III.D. "If an independent trustee is a co-trustee, there is no need to limit the trustee's discretionary powers to distribute income and principal if the trust prohibits the beneficiary-trustee from participating in these decisions." *See,* Johnson & Wiensh, *supra* note 114, at 41.

Because the main purpose of perpetual dynasty trusts is to avoid transfer taxes and preserve wealth through accumulation of assets, few distributions will be made from the trust.[119] Therefore, the drafter should provide the trustee the flexibility to retain income even if the trust's marginal tax rate exceeds the beneficiary's marginal tax rate.[120] Thus, the trust instrument should permit the trustee the power to consider current and future income and transfer tax consequences.[121] This will permit the trustee to make distributions to beneficiaries if necessary.[122] In this way, the trustee can balance income

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[119] Oshins & Blattmachr, *supra* note 40, at 739. This is especially effective when the asset is intended for the beneficiaries' use. *See supra* Section III.C.

[120] Oshins & Blattmachr, *supra* note 40, at 739.

This occurs because the amount of income necessary to reach the highest income tax rate for trusts would be in the lowest tax bracket for an individual. It is easy to see that if a modest trust retains its income annually, that the trust would be subject to a 39.6% income tax on all of the income in excess of $8,350. I.R.C. _1(e). A single individual would not begin paying a 39.6% income tax until her income exceeded $250,000. I.R.C. _1(c). For example, assume that a trust earns $100,000 of income during the year. If the trust retains the income, the trust will pay $38,653 in income tax. I.R.C. _1(e). However, if the trust distributes the income to the beneficiary of the trust, the individual will only pay $26,522 in income tax related to the distributed trust income. I.R.C. _1(c). These figures are based on 1998 tax rates for a single individual. This further assumes that the individual had no other income. Therefore, the individual beneficiary would have a marginal tax rate of 31%. The beneficiary's other income and the beneficiary's classification (e.g., married filing joint or head of household) will have an impact on the differences between retention and distribution.

Even though retention of income is counterproductive from an income tax standpoint, it still makes sense from a transfer tax standpoint. Oshins & Blattmachr, *supra* note 40, at 739. The trustee should weigh the options of distributing or retaining income with these considerations in mind. If the settlor established the trust with the intention that the trust grow as large as possible, the trustee should retain the income to take advantage of the transfer tax-free compounding available within a perpetual dynasty trust.

[121] *Id.*

[122] Even though the settlor of a perpetual dynasty trust generally expects the beneficiaries to absorb most expenses (food, education, vacations), the trustee may deem it necessary to provide the beneficiary with basic living expenses. *Id.* Such a distribution may be beneficial where the beneficiary has not taken full advantage of her GSTT exemption. *Id.* If the asset distributed to the beneficiary had a low basis (such as Microsoft stock which had been held for seventy-five years), and the beneficiary dies with the asset, then the recipient of the asset from the beneficiary's estate would receive a stepped-up basis under I.R.C. _1014(a). *Id.* The asset would probably be completely free from transfer taxes because if the beneficiary has not exhausted her GSTT exemption, she probably has not exhausted her unified credit. This could

taxes, which are imposed immediately, with transfer taxes, which are deferred.[123]

C. Choice of Assets

The settlor should only place assets into a perpetual dynasty trust which will extend the benefit of the GSTT exemption. Therefore, the trustee should acquire assets for the "use" of the beneficiaries instead of making distributions to the beneficiaries.[124] The trustee should have the discretion to acquire non-traditional investments which may have appreciation potential and "use" value, but which are not assets that a "prudent" trustee would normally hold.[125] This would allow the trust to purchase a home, art, or jewelry for the benefit of the beneficiaries without the beneficiaries owning the asset.

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leverage the asset for several more generations if transferred to another perpetual dynasty trust.

123 *Id.*

124 Oshins & Blattmachr, *supra* note 40, at 739. In this manner, the beneficiary will have the use and enjoyment of the asset, but avoid the transfer tax problem: if the trust distributed cash and then the beneficiary purchased the asset, the GSTT exemption would be lost. *Id.* To protect the distributed asset from transfer taxes, the beneficiary would have to use her GSTT exemption and/or unified credit. "Further, the property would be insulated from divorce and creditor claims against the beneficiary." *Id.* *See* discussion *infra* Part III.D.

125 Oshins & Blattmachr, *supra* note 40, at 740. The trustee should have broad discretion to allow use of trust property because there is no income tax imposed on rent-free (or rent-reduced) use of property under I.R.C. _7872 as there is for "rent-free" (interest free) use of money. *Id.* at 739. In addition, the settlor and drafter should consider the possibility of holding assets which produce no or low amounts of income (e.g., growth stocks). From a transfer tax perspective, the trustee should charge the beneficiary rent on the property to maximize accumulation of trust property. *Id.* Obviously, a "prudent" investor would not purchase an asset that had no potential rate of return. Because beneficiaries have a present income interest, the trustee has an obligation to obtain current income. If the settlor foresees or intends that the beneficiaries use property at a price below which a trustee would normally be obligated to charge, the drafter must include a provision negating the rule that a trustee invest as a "prudent" person. *Id.* at 740.

Some of these concepts are in a state of flux due to the concept of "total return." RESTATEMENT (THIRD) OF TRUSTS §5 (1992). Under the modern portfolio theory, the principles of prudence include diversification, a duty to analyze and make decisions according to the specific circumstances surrounding the trust, and balancing total return between the income beneficiary and the remainderman. *Id.* If the situs of the trust was in a jurisdiction which follows the Restatement, then the trustee could probably hold "use" assets for the beneficiaries even if the trust instrument did not specifically authorize the trustee to do so.

The assets would then appreciate within the trust, thereby maximizing the settlor's GSTT exemption. In addition, the drafter should not include a duty of diversification if the settlor wishes to pass a family business or residence through multiple generations.[126] Finally, the settlor may consider transferring assets which can be discounted, including family limited partnership and closely-held business interests.[127] A discounted asset could maximize the GSTT exemption because the underlying value of the property may be significantly greater than $1 million.

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[126] *Id.* However, because this duty exists in the majority of jurisdictions, the settlor should waive the duty of diversification. *Id.*

[127] Ruud, *supra* note 48, at 12. Oshins defines a discounted asset as follows:

> The Code bases the value of assets for estate and gift tax purposes on what a willing buyer would pay a willing seller, neither having any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. __ 20.2031-1(b) & 25.2512-1. A client can often arrange his or her assets so as to transfer them at a discount from their underlying value. This in an important step in maximizing the leveraging possible with a sale to a defective trust. The most popular device used to create discounts is a family limited partnership (FLP). An FLP is a limited partnership among family members or trusts for their benefit. Consistent with state limited partnership laws, the general partners control the affairs of the partnership, and the limited partners do not participate in the operation of the partnership. Appraisers generally value limited partnership interests at a discount from the pro rata value of the partnership's underlying assets because limited partners cannot participate in the management of the partnership and because there is no ready market for interests in a closely held family controlled entity.

See, Steven J. Oshins, *Sales to Grantor Trusts: Exponential Leverage Using Multiple Installment Sales*, 13 PROB. & PROP. 46, 47-48 (1999). Family Limited Partnership (FLPs) take advantage of significant leveraging through valuation discounts. Susan Smith, *Wealth Preservation Planning*, CA43 A.L.I. - A.B.A. 255, 268 (1996)(including discount for minority interests or lack of control, discount for lack of marketability, discount for restriction on disposition).

An analysis of the use of FLPs in perpetual dynasty trust planning is beyond the scope of this article. For a detailed discussion of FLPs, *see e.g.*, Laurence Keiser, *"Hot Issues" in Estate Planning Part II: Asset Protection Vehicles, Valuation Discounts, Family Limited Partnerships and Limited Liability Companies*, 267 PRAC. L. INST. 875 (1998)(discussing choice of entity, reporting rules, how fair market value may be determined, and court decisions affecting family limited partnerships); Myron Kove & James M. Kosakow, *Gifts of Family Limited Partnership Interests Did Not Qualify for Annual Exclusion, Rules IRS*, 25 EST. PLAN. 185, 186 (1998)(recommending that

D. Asset Protection (Spendthrift Provisions)

The more discretion the trustee has to distribute income and principal to the beneficiaries, the more "creditor-proof" the trust will be.[128] Where an independent trustee has absolute discretion to make distributions, the beneficiaries have no enforceable rights against the trust.[129] If the beneficiary has no right to the assets, the creditors cannot reach the trust assets. If the settlor does not want the trustee to have absolute discretion, the drafter should include circumstances under which the trustee may suspend the beneficiary's distribution (including the beneficiary using drugs or marital dissolution).[130]

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estate planners comply with "Ltr. Rul. 9415007 rather than providing for an absolute prohibition on sale or assignment" as described under TAM 9751003); Claire E. Toth, *The Family Limited Partnership Under Seige*, 59 TAX'N FOR ACCT. 346, 350 (1997)(arguing that although the IRS has been attacking the valuation discounts claimed for family limited partnerships, planning opportunities exist if the FLP is "well-planned, well-documented, well-run"); Stanley Rosenberg & Sanford J. Schlesinger, *The Benefits of Family Limited Partnerships in Estate Planning and the Impact of "Anti-abuse" and "Check-the-box" Rules*, 69 N.Y. ST. B.J. 30 (1997)(stating that FLP's enable the donor to preserve significant management control, generate substantial valuation discounts, avoid the estate tax rates which impose the highest tax on a small amount of income, and avoid the double taxation applicable to corporations); Travis L. Bowen & Rick D. Bailey, *Limited Partnerships: Use in Tax, Estate and Business Planning*, 32 IDAHO L. REV. 305 (1996)(discussing the appropriate methods for organizing and forming a FLP, and the tax, estate and business planning involved with FLP's); Kenneth P. Brier & Joseph B. Darby III, *Family Limited Partnerships: Decanting Family Investment Assets Into New Bottles*, 49 TAX LAW. 127, 164 (1995)(concluding that the estate planner need not restrict a FLP to an active business, but could be extended to hold family investment assets for profit); Samuel Weiner & Steven D. Leipzig, *Family Limited Partnerships Can Leverage the Annual Exclusion and Unified Credit*, 82 J. TAX'N 164 (1995)(discussing the need and importance of choosing the type of entity, whether it be a FLP, and LLC or S corporation); Kathryn G. Henkel & Elizabeth R. Turner, *Family Limited Partnerships Can Play a Major Role in Asset Protection Planning*, 11 J. PARTNERSHIP TAX'N 216, 216 (1994)(describing how a well-drafted FLP can provide asset protection while maintaining estate planning flexibility); John R. Jones, Jr., *Family Limited Partnerships Achieve Tax and Nontax Goals*, 53 TAX'N FOR ACCT. 33, 41 (1994) (recognizing that the estate planner must ascertain unique characteristics of the family, determine the family's tax and nontax goals, and obtain a qualified valuation expert before creating a FLP).

[128] Oshins & Blattmachr, *supra* note 40, at 740-41. Settlors should strongly consider spendthrift provisions because of the increase in lawsuits, "business and personal exposure to creditors and other litigants." *See,* Smith, *supra* note 128, at 269. Because of the ever-increasing divorce rate, a discretionary trust with a spendthrift

If the beneficiary is entitled to income from the trust, the beneficiary's creditors may be able to attach that income interest. However, if the trustee has the power to suspend distributions, the creditors should not be able to attach the trust assets.[131] Therefore, all drafters should explain to their clients the importance of spendthrift provisions and how such a provision will protect their beneficiaries in the future. The discretionary trust achieves the dual goals of transfer tax avoidance and creditor protection.[132]

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provision is important to protect the trust assets from the settlor's descendants' spouses. Oshins & Blattmachr, *supra* note 40, at 740.

[129] *Id.* When using a clause authorizing the trustee to use absolute discretion over distributions and/or a spendthrift clause, the drafter must analyze whether such an expansive provision will be respected by federal and state law (including bankruptcy). Nelson & Carr, *supra* note 78, at 254. For an analysis of spendthrift trust, *see e.g.,* Ronald R. Volkmer, *Tort Creditor's Access to Spendthrift Trusts*, 25 EST. PLAN. 187, 187 (1998)(describing the well-entrenched rule that a "spendthrift limitation on the beneficial interest of a trust income beneficiary, is valid"); MERTENS, *supra* note 116, at _49E.35; Gerald P. Moran, *A Radical Theory of Jurisprudence: The "Decisionmaker" as the Source of Law--The Ohio Supreme Court's Adoption of the Spendthrift Trust Doctrine as a Model,* 30 AKRON L. REV. 393 (1997)(analyzing in detail the policy considerations behind spendthrift trusts and how Ohio, one of the last jurisdictions to recognize spendthrift trust, finally capitulated in 1991); Eun C. Han, Note & Comment*, Premature Judicial Termination of Non-Spendthrift Trusts: Reconciling a Dead Settlor's Intent with a Living Beneficiary's Needs,* 3 TEX. WESLEYAN L. REV. 191, 207 (1996)(recognizing that in general a spendthrift trust cannot be terminated early because the settlor's intentions would be defeated, but that such an inflexible rule permits dead-hand control even though no one connected with the trust wants it to continue); Ronald R. Volkmer, *Spendthrift Trusts and Discretionary Trusts,* 19 EST. PLAN. 58 (1992) (noting that at least one jurisdiction, Colorado, has held that income from a discretionary trust is a gift, not a divisible marital asset subject to division).

[130] Nelson & Carr, *supra* note 78, at 254.

[131] *See e.g.,* RESTATEMENT (SECOND) OF TRUSTS _152 (1959); ERWIN N. GRISWOLD, SPENDTHIRFT TRUSTS _1 (2d ed. 1947); SCOTT & FRATCHER, THE LAW OF TRUSTS _151(4th ed., 1989). However, exceptions exist where a creditor can attach an interest in a spendthrift trust:

a) by the wife or child of the beneficiary for support, or by the wife for alimony;

b) for necessary services rendered to the beneficiary or necessary supplies furnished him;

c) for services rendered and materials furnished which preserve or benefit the interest of the beneficiary;

d) by the United States or a State to satisfy a claim against a beneficiary.

RESTATEMENT (SECOND) OF TRUSTS _157 (1959). Until 1991, Ohio was in the minority of states which did not recognize spendthrift trust. Moran, *supra* note 130, at 435. In

IV. GSTT CONSIDERATIONS

When planning for a perpetual dynasty trust, the practitioner must determine the method of transferring property to the trust which will create the least amount of transfer taxes. In a non-perpetual dynasty trust, the settlor would make use of the annual exclusion, Crummey powers and the 5&5 exception.[133] However, more complexity exists in trusts where the GSTT is implicated, which includes all perpetual dynasty trusts. Therefore, the drafter must be careful not to unintentionally trigger the GSTT's special rules.

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that year, the Ohio Supreme Court decided that discretionary trusts were valid and could shield the beneficiary's interest from her creditors. Scott v. Bank One Trust Co., 577 N.E.2d 1077 (Ohio 1991). Because *Scott* permitted discretionary trusts, spendthrift trusts were also valid. Moran, *supra* note 130, at 435. Two years later, the Ohio Supreme Court extended *Scott* and held that

Error! Main Document Only.. A spendthrift provision is valid in Ohio by reason of Scott;

Error! Main Document Only.. A beneficiary has only that interest given to him by the settler; and

Error! Main Document Only.. A creditor can not attack that which the beneficiary does not have.

Moran, *supra* note 137, at 438 (summarizing Domo v. McCarthy, 612 N.E.2d 706 (Ohio 1993)). The specific rules applying to spendthrift trusts are state dependent. Therefore, an estate planner should consult the law of the jurisdiction which will govern the spendthrift (and/or discretionary) trust before drafting it.

[132] Oshins & Blattmachr, *supra* note 40, at 741.

[133] "The federal gift tax annual exclusion allows a donor to give $10,000 per calendar year to an unlimited number of individuals free of gift tax. The exclusion is unavailable for gifts of 'future interests.'" *See,* Bradley E.S. Fogel, *The Emperor Does Not Need Clothes--the Expanding Use of "Naked" Crummey Withdrawal Powers to Obtain Federal Gift Tax Annual Exclusions*, 73 TUL. L. REV. 555, 555 (1998)(concluding that naked Crummey powers, rights given to powerholders who have no interest, present or future, in the trust, should be valid unless there was an agreement between the donor and the naked powerholder not to withdraw). For a general explanation of Crummey withdrawal powers, *see infra* notes 148-50 and accompanying text. For a general explanation of the 5&5 exception, *see infra* note 150 and accompanying text. To familiarize yourself with them, *see, e.g.,* Edward A. Hauder, *Not-so-Crummey Gifts*, 86 ILL. B.J. 388 (1998)(advocating the use of Crummey gifts to purchase life insurance within an irrevocable trust and urging every attorney to become familiar with the basics of Crummey withdrawal rights); Sean P. Kearney, *Preventative Maintenance: Avoiding Multiple Crummey Power Lapses*, 12 PROB. & PROP. 54 (1998)(discussing the unintended tax consequences involved with multiple Crummey lapses and suggesting potential solutions to the problems); Christopher Steenson, *A Reluctant Stance By the Internal Revenue Service: The Uncertain Future of the Use of the Section 2503(B)*

A. Lifetime Use of the GSTT Exemption

Some practitioners suggest that settlors exhaust their GSTT exemption as soon as possible to maximize compounding and growth potential.[134] There are several advantages to using the GSTT exemption during life. Lifetime use locks in the value of the asset and ensures that the assets will not be subject to adverse GSTT tax changes.[135] Appreciation and income from the transferred property will not be included in the settlor's estate.[136] If the settlor's spouse elects to split the gift, the settlor can protect $2 million from the GSTT.[137] This will assure that both spouses' exemptions have been fully utilized no matter which spouse dies first.[138]

Annual Gift Exclusion Following Crummey and Cristofani, 38 SANTA CLARA L. REV. 589 (1998)(establishing requirements based on prior case law to successfully utilize the annual exclusion and avoid running afoul of the current IRS position); Rocco J. Labella & Sean M. Aylward, *Despite IRS Disagreement, TC Confirms Approval of Crummey Powers*, 24 EST. PLAN. 475, 480 (1997)(concluding that the IRS substance-over-form doctrine concerning the annual exclusion will generally fail because the Service will not have enough evidence to establish that an agreement existed not to exercise the power or that the powerholder's legal ability to demand payment was limited by the donor); Jonathan D. Reiff, *Using Crummey Powers in Trusts for Annual Giving*, 58 TAX'N for ACCT. 150 (1997)(advocating the use of Crummey powers within insurance trusts, but discouraging the use of hanging powers because of the potential adverse tax consequences); Michael J. Savinelli, Note*, Three Strikes and the IRS is Out!?!: Crummey, Cristofani, and Kohlsaat Firmly Entrench Crummey Powers*, 12 QUINNIPIAC PROB. L.J. 67 (1997)(arguing that the IRS has failed to prevail in its attacks on Crummey powers, but recognizing that Service will continue to challenge such powers).

134 *See e.g.,* L Henry Gissel, Jr., *Selected Comments on Lifetime Giving in Trust and Crummey Powers for 1998*, SC60 A.L.I. - A.B.A. 107, 150 (1998)(noting that in addition to the transfer tax-free compounding effect, immediate use of the exemption begins the three year statute of limitations); John A Miller & Jeffrey A. Maine, *Fundamentals of Estate Tax Planning*, 32 IDAHO L. REV. 197, 250-51 (1996) (urging an attorney who merely dabbles in the estate planning arena to steer her clients to a specialist when considering a perpetual dynasty trust because of the complexities involved); Lawrence Brody, *Split-Dollar Life Insurance Arrangements*, C960 A.L.I. - A.B.A. 473, 540-41 (1994)(stating that allocation of one's exemption to a gift is the only effective way of protecting the asset from the GSTT); Lawrence Brody, *Sophiticated Uses of Life Insurance in Estate Planning*, C960 A.L.I. - A.B.A. 553, 574 (1994)(recognizing that significant advantages exist for lifetime allocation).

135 Brody, *Sophisticated Uses, supra* note 135, at 574. "Increases in the $1,000,000 GST tax exemption for inflation after 1998… offer more opportunities for additional funding." *See,* Gissel, *supra* note 135, at 150. The exemption will increased for

Although compelling reasons exist for lifetime use of the GSTT exemption, the settlor may not choose to allocate her exemption during life because disadvantages also exist.[139] The settlor may not have a long-term view of what should happen to her property or may not want to relinquish her property during life.[140] The settlor may not want to exhaust her unified credit or pay gift tax during life.[141] Finally, the settlor may not choose to allocate her GSTT during life because the allocation is irrevocable.[142] However, using the GSTT exemption may be the simplest, if not the only, method of creating a perpetual dynasty trust for reasons discussed *infra*.[143]

B. The Annual Exclusion and Crummey Powers

1. The Use of the Annual Exclusion

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inflation in increments of $10,000, rounding to the next lowest multiple of $10,000. I.R.C. §2631(c).

[136] Brody, *Sophisticated Uses, supra* note 135, at 574.

[137] Brody, *Split-dollar, supra* note 135, at 540-41.

[138] Brody, *Sophisticated Uses, supra* note 135, at 574.

If the couple had not allocated any of their combined $2 million GSTT exemption during life and one spouse owned all of the property, the couple may not have the opportunity to take full advantage of the GSTT exemption. This could occur if the first spouse to die owned no property at death. This spouse would have no property to transfer to "skip generations." This spouse will have effectively lost his entire GSTT exemption.

[139] *Id.*

[140] *Id.*

[141] *Id.* at 575. The terminology for the Unified Credit has changed since the 1997 Act to the "applicable credit amount" and will be indexed to $1 million dollars in 2006. I.R.C §2010. Therefore, if a taxpayer chooses to create a perpetual dynasty trust which completely exhausts her GSTT exemption ($1 million), she will incur gift tax liability if she creates the trust before 2006 because the GSTT is separate from the gift and estate tax.

[142] The settlor may choose to create the trust upon her death when there is more certainty. The settlor or her executor will have the opportunity to analyze whether to create a perpetual dynasty trust, its structure, and which assets to include to maximize the GSTT exemption.

[143] Brody, *Split-dollar, supra* note 135, at 542.

The use of the $10,000 annual exclusion is an extremely important weapon in the estate planner's arsenal.[144] Because of the ability of the donor to give $10,000 to any donee, the donor can quickly remove a significant amount of assets from her estate.[145] Many estate planners make use of the annual exclusion to reduce the client's estate without exhausting the client's unified credit. However, most clients do not want to part with their property outright at a young age for several reasons.[146]

So the astute estate planner will create a trust in which the beneficiaries have Crummey withdrawal powers.[147] There will be no adverse estate or gift tax consequences to the settlor if the transfer for each beneficiary does not exceed $10,000.[148] There will not be transfer tax consequences to the beneficiary if 1) the beneficiary with the Crummey withdrawal power is the only beneficiary of the trust or 2) the amount which the beneficiary permits the Crummey power to lapse is less than the greater of $5,000 or 5% of the trust corpus.[149] Crummey trusts are used often and can be extremely useful for estate planning purposes.

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[144] Jonathan G. Blattmachr, *Some New Opportunities in Transfers to Grandchildren*, 267 PRAC. L. INST. 715, 745 (1998). The annual exclusion will be indexed for inflation after 1998 in increments if $1,000, rounding to the next lowest multiple of $1,000. I.R.C. §2503(b)(2).

[145] Blattmachr el al, *supra* note 81, at 348.

> For example, assume a woman is married and has two children and four grandchildren. She could annually transfer up to $130,000 to a Crummey trust by granting her husband the right to withdraw $10,000 each year and granting each of her children and grandchildren the right to withdraw $20,000; each withdrawal would come from and at the time of contributions to the trust.
>
> Over time, the amount that can be excluded from the grantor's estate through the use of annual exclusions, together with the income and interest thereon, can be quite significant. Over a 20-year term, for example, over $5.5 million would be excludable from the grantor's estate if $100,000 is transferred each calendar year to the trust under the protection of the annual exclusions and if the trust produces income and/or growth of 10% each year.

Id.

[146] *See* Blattmachr, *supra* note 145, at 743. The settlor may feel that the beneficiary is not mature enough to manage the property. *Id.* The settlor may only want to provide for specific needs, such as the beneficiary's education. *Id.* Or the settlor may not feel comfortable with her own financial situation and may wish to retain the assets for her lifetime in which case a trust would not be advisable. *Id.*

[147] "A Crummey withdrawal power is a general power of appointment over the property subject to withdrawal." *See,* Julius H. Giarmarco, *The Tax Consequences of Crummey Clauses in Irrevocable Life Insurance Trusts,* 75 MICH. B.J. 1278, 1281

(1996). A gift in trust that is subject to a Crummey power qualifies for the annual exclusion to the extent the power could be exercised even though the beneficiary allows the power to lapse annually. Blattmachr, *supra* note 145, at 746 n.6. Such a power qualifies for the annual exclusion even if the beneficiary is a minor. Commissioner v. Crummey, 397 F.2d 82 (9th Cir. 1968). Because the lapse, exercise or release of a general power of appointment creates a taxable event for gift tax purposes, the drafter must be careful not to create an unintended taxable gift. Blattmachr, *supra* note 145, at 746 n.6. *See also, infra* note 150.

The effectiveness of Crummey powers was expanded in 1991. The Tax Court ruled that a person given a Crummey withdrawal power is not required to have a present interest in the trust to qualify for the annual exclusion as long as the powerholder has a legal right to withdraw which cannot be restricted by the trustee. Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), *action on decision*, 1992-009 (Mar, 23, 1992)(acquiescing in result only). Although the settlor's intention is that the powerholder not exercise the withdrawal power, there can be no previous agreement between the settlor and the powerholder that the powerholder not exercise the power. *See e.g.,* Estate of Kohlsaat v. Commissioner, 73 T.C.M. (CCH) 2732, 2734 (1997)(holding that an agreement between transferor and beneficiary would invalidate annual exclusion, but refusing to infer such an agreement merely from the nonexercise of the power); Estate of Holland v. Commissioner, 73 T.C.M. (CCH) 3236, 3237-10 (1997)(holding that an agreement between transferor and beneficiary not to exercise will not result in loss of the annual exclusion unless the agreement is legally enforceable).

Although the use of Crummey withdrawal powers being given to persons who have no present or future interest in the trust, so called "naked rights," has not been tested, such a use would comply with the technical holding of *Cristofani*. Fogel, *supra* note 134, at 617. However, the conservative approach would be to give Crummey powers to beneficiaries (income or remainderman) and have the beneficiaries exercise the power periodically (even if not for the full amount) to avoid the appearance of collusion.

[148] I.R.C. _2503(b). But unless the trust qualifies under §2642(c), which is not likely, there will be adverse GSTT consequences unless part of the settlor's $1 million exemption is allocated to the trust. *See infra* Section IV.B.2.

[149] I.R.C. _2514(c).

> Because the lapse of a power of withdrawal may cause the powerholder to be treated as making a gift to the extent the power exceeds the greater of 5 percent of the value of the trust or $5,000 per calendar year, Crummey powers are typically limited to a grant of no more than that threshold or lapse at that threshold each calendar year. See I.R.C. Secs. 2514(c) and 2041(a). In PLR 8901004 (not precedent), the Internal Revenue Service took the position that certain "hanging" and later lapsing powers violated the policy set forth in Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944) cert. denied. 323 U.S. 756 (1944).

2. The Use of the Annual Exclusion to Obtain GSTT Exemption

However, if the trust is a perpetual dynasty trust, which involves "skip persons," the use of the gift tax annual exclusion becomes much more complex.

> [F]or transfers in trust, the exemption from generation- skipping transfer tax by reason of the annual exclusion will be allowed only if: 1) the beneficiary is assigned to a generation younger than that of the children of the donor, 2) the beneficiary is the exclusive beneficiary of the trust, 3) the trust is structured so its assets are includible in the beneficiary's estate, and 4) no one other than the beneficiary may receive a benefit from the trust during the beneficiary's lifetime.[150]

This becomes very important to a wealthy settlor who wants to protect more than $1 million from the GSTT. The conventional Crummey trust will not meet the stringent requirements of I.R.C. _2642(c) because Crummey trusts usually benefit multiple beneficiaries.[151] Even if the trust has a single beneficiary, and that beneficiary has a special power of appointment, the trust will fail under _2642(c) and be subject to the GSTT because not all of the trust assets will be includible in the beneficiary's estate.[152]

See, Blattmachr, *supra* note 145, at 746 n.6. Hanging powers allow the "rights of withdrawal over successive annual gifts to continue in existence ('hang') and accumulate until they gradually lapse and disappear without adverse consequences." *See,* Jane Ann Schiltz, SA84 A.L.I. - A.B.A. 1193, 1219 (1996). This technique attempts to avoid the 5&5 limitation by attaching a condition subsequent that the *Crummey* power cannot be exercised except to the extent to which the exercise will not create a taxable gift. *Id.* at 1220. If in future years, the current year's transfer to the trust does not exceed the 5&5 limitation, the powerholder will be permitted to allow the "hanging" amount to lapse to the extent to which it will not create a taxable gift. *Id.*

The practitioner must be aware that if the powerholder dies with a "hanging" amount unexercised, "the amount subject to withdrawal at the holder's death will be includible in [the powerholder's] estate under Section 2041(a)(2)." *See,* Boyle, *supra* note 103, at 463. The other problem with hanging powers is that the IRS will not recognize conditions subsequent for gift tax purposes. *Id.* Because of the uncertainty of hanging powers, drafters should arguably not use them. *Id.* If a drafter fails to heed this caution, she should at a minimum not make reference to the term "lapse." Schiltz, at 1220.

[150] *See,* Blattmachr, *supra* note 145, at 745-46 (summarizing the requirements set forth in I.R.C. _2642(c)).

[151] Virginia G. Coleman, *Allocation of GST Exemption to Inter Vivos Transfers*, SB13 A.L.I. - A.B.A. 301, 308 (1996). If the settlor chooses to make use of the GSTT

However, because _2642(c) allows only one beneficiary, a Crummey withdrawal power does not have to be limited to the 5&5 exception.[153] If a powerholder is the only beneficiary and the power lapses, no taxable event occurs because the lapse creates a transfer to the sole beneficiary.[154] A person cannot make a gift to herself. The withdrawal power which the beneficiary holds may be limited to a short time period so that the settlor need not worry that the beneficiary has a "continuing right to withdraw all property from the trust."[155] To ensure that the property will be includible in the beneficiary's estate, the beneficiary must hold a general power of appointment over all the trust property or the trust must terminate in favor of the beneficiary's estate.[156] Consequently, §2642(c) trusts cannot be "dynasty" trusts as that term is commonly understood because a dynasty trust is intended to endure indefinitely with no further transfer tax consequences.

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annual exclusion, the trust instrument should create two identical trusts for the amount covered by the annual exclusion and for the balance. Blattmachr, *supra* note 145, at 744. The annual exclusion trust will have a zero inclusion ratio, while the other trust will have an inclusion ratio of one. For a discussion of the inclusion ratio, *see infra* note 146. The trust instrument should direct the trustee to hold the assets in separate trusts, but manage all assets together. Blattmachr, *supra* note 145, at 744.

[152] Coleman, *supra* note 152, at 308. The lapse of a special power of appointment is not includible in one's estate and the "portion of the 5-or-5 exception will not be includable" (sic) in the beneficiary's estate. *See id.* Therefore, such an arrangement would fail under _2642(c).

[153] Blattmachr, *supra* note 145, at 744.

[154] *Id.* Therefore, if the settlor transfers $10,000 to such a trust for the gift tax annual exclusion, the amount will also be exempt from the GSTT even though $10,000 may exceed 5% of the trust.

[155] *See id.* The settlor's intent should be clear because the settlor chose to transfer the assets to the trust instead of giving it outright to the beneficiary. *Id.* The IRS's position with respect to withdrawal rights is that the powerholder must have a reasonable time to exercise the power. *Id.* at n.16. Otherwise, the power is "illusory" and the settlor's transfer will not qualify for the gift tax annual exclusion. *Id.* *Cristofani* upheld a fifteen day withdrawal period, but a three day period was held not to be reasonable. Rev. Rul. 81-7, 1981-1 C.B. 474.

[156] Blattmachr, *supra* note 145, at 744. The IRS has ruled that a general power of appointment is sufficient to cause inclusion in the beneficiary's estate even if the beneficiary is a minor (incapable of exercising the power) as long as the trust instrument states that the beneficiary holds the power even if incapable of exercising it. *Id.* If the settlor chooses to have the trust terminate in favor of the beneficiary's estate, the property will pass by intestate succession if the beneficiary lacked legal capacity to exercise the power. *Id.* This could cause the trust property to pass to someone whom the settlor would not wish to receive the property. *Id.* For example, the beneficiary is the settlor's grandchild, the beneficiary's parents divorce, the

C. Alternative Not Utilizing the GSTT Annual Exclusion

If a settlor does not wish to create a trust for one beneficiary, all is not lost. If the settlor creates a perpetual dynasty trust for multiple beneficiaries, she cannot make use of the GSTT annual exclusion, but must allocate a portion of her GSTT exemption to the trust. Therefore, Crummey powers are typically inappropriate for perpetual dynasty trusts because there will be no transfer tax-free compounding if the assets will be includible in the beneficiary's estate.[157]

There are other possibilities which have the same principle foundation: create a perpetual trust which has a zero inclusion ratio.[158] It is much simpler from a tax and administrative viewpoint to administer a perpetual dynasty trust which is fully exempt from the GSTT than to administer such a trust that is only partially exempt.[159] By utilizing the GSTT exemption, these trusts will also avoid the problem of a Crummey lapse exceeding the 5&5 limitation, which would force the Crummey powerholder to allocate a portion of her GSTT exemption to the lapse.[160]

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beneficiary dies, and the settlor's former son in-law takes under the jurisdiction's intestacy statute. *Id.* Although this scenario is unlikely, the thorough estate planner must discuss this possibility with the client if the client chooses to implement this approach. To prevent the beneficiary from exercising the power in a manner which the settlor deems inappropriate, the settlor could require that the power "be exercised only with the consent of a non-adverse trustee." *Id.* However, the settlor must not be the trustee. *Id.* at 744.

[157] Coleman, *supra* note 152, at 316-17. If a settlor is wealthy enough to fund a perpetual dynasty trust, she is probably wealthy enough to use the annual exclusion through other transfers. *Id.* at 317. The settlor may also be giving money outright to the beneficiaries of the trust for living expenses. This does not apply to Crummey powers with a 5&5 limitation. However, such a power would not shelter as much as a married couple's annual exclusion ($20,000) until the trust had a value of $400,000. *Id.*

[158] Erik E. Beick & Bradford P. Bauer, *Life Insurance Can Maximize the Generation-Skipping Tax Exemption*, 18 EST. PLAN. 36, 38 (1991); Schilken & Schilken, *supra* note 114, at 38; Coleman, *supra* note 152, at 315. The GSTT is imposed on the portion of the trust assets which was not exempt from the GSTT when the GSTT exemption was allocated. Beick & Bauer, *supra*, at 36. If the GSTT exemption allocated is equal to the value of the transfer to the trust, the entire value of the trust will be exempt from the GSTT and such a trust have an inclusion ratio of zero. Schilken & Schilken, *supra* note 114, at 38 (citing I.R.C. _ 2642).

For a discussion of the complexities and intricacies of the inclusion ratio, *see e.g.,* Arthur D. Sederbaum & David J. Wray, *Planning for the Generation-Skipping*

Transfer Tax, 267 PRAC. L. INST. 685 (1998)(describing the inclusion ratio in detail, its complexities, and the mechanics of applying the inclusion ratio); Jay D. Waxenberg, *Preparation of the Federal Estate Tax Return,* 265 PRAC. L. INST. 233, 308-11 (1998)(summarizing the application of the inclusion ratio); Jeffrey N. Pennell, *Marital Deduction Planning Potpourri*, SC75 A.L.I. - A.B.A. 351, 424-33 (1998)(analyzing in depth the amount of one's GSTT exemption that one must allocate to obtain a zero inclusion ratio under the Treasury Regulations and the valuation issues that arise as a result); Jeffrey N. Pennell, *Tax Payment Provisions and Equitable Apportionment,* SC75 A.L.I. - A.B.A. 529 (1998)(discussing the constructive addition approach and whether the donor must allocate her GSTT exemption in an amount equal to the transfer plus the transfer tax paid on the transfer); Pam H. Schneider & Lloyd Leva Plaine, *TRA '97 and the Generation-Skipping Transfer Tax*, 87 J. TAX'N 341, 349 (1997)(noting that no statute of limitations exists for the inclusion ratio, but that a timely allocation on a gift tax return will establish the value of the transfer upon expiration of the gift tax statute of limitations and remove a substantial portion of uncertainty with respect to the inclusion ratio); Michael D. Mulligan, *Allocating a Client's GST Exemption Most Effectively*, 24 EST. PLAN. 147, 155 (1997)(recognizing that the inclusion ratio applicable to direct skips is not final until no additional GSTT may be assessed, but that the inclusion ratio for a taxable distribution or taxable termination can be established without regard to the GSTT being "final"); W. Birch Douglass, III, & Kristen E. Smith, *Generation-Skipping Planning is Essential When Using Split-Interest Trusts,* 85 J. TAX'N 245 (1996)(discussing the possibility of planning with charitable remainder trusts for multiple generations and the effects of such planning on the inclusion ratio); Philip H. Suter & Susan L. Repetti, *Trustee Authority to Divide Trusts*, 6 PROB. & PROP. 54, 57-58 (1992)(recommending that the trustee have the authority to divide trusts into multiple trusts to maintain a zero inclusion ratio and an inclusion ratio of one, thereby avoiding the problem of administering a trust which is only partially exempt); John F. Meigs, *Asministering GST Exempt and Nonexempt Trusts*, 6 PROB. & PROP. 28 (1992)(discussing the alternatives at a trustee's disposal for a trust which has an inclusion ratio other than one or zero and discussing the trustee's duties with respect to the GSTT).

[159] Bieck & Bauer, *supra* note 159, at 38.

[160] Giarmarco, *supra* note 148, at 1281. The final Treasury Regulations state that the settlor is the transferor for GSTT purposes if a *Crummey* power lapses unless and to the extent that the lapse exceeds the 5&5 limitation. Coleman, *supra* note 152, at 318 (citing Reg. _26.2652 - 1(a)(5) Example 5). To the extent that the *Crummey* lapse exceeds the 5&5 limitation, the powerholder must allocate her GSTT exemption to maintain a zero inclusion ratio because the powerholder becomes the transferor for GSTT purposes. Giarmarco, *supra* note 148, at 1281. However, the settlor must also allocate her GSTT exemption for the full amount of the transfer to the trust to maintain a zero inclusion ratio. *Id.* Therefore, the portion of the settlor's GSTT exemption which is attributable to the *Crummey* lapse which exceeds the 5&5 limitation will be wasted due to the "doubling up" of both the powerholder's and the settlor's GSTT exemption. *Id.* at 1282. In addition, the transferor must consider the gift tax

A possibility to have a GSTT exempt perpetual dynasty trust without complying with the _2642 requirements is a two-trust agreement.[161] Under this arrangement, the settlor will establish a $1 million perpetual dynasty trust for the benefit of the settlor's children[162] for life and for the respective lives of successive generations.[163] The settlor will allocate her entire GSTT exemption to this trust.[164] With the remainder of the settlor's wealth, the settlor will fund a trust during life and/or upon death to benefit only the settlor's children.[165] Under this arrangement, the settlor has completely avoided the GSTT.[166]

V. LIFE INSURANCE AND PERPETUAL DYNASTY TRUSTS

consequences of making a gift limited to the 5&5 limitation because such a gift may exceed the annual transferor's annual exclusion and necessitate allocation of the transferor's unified credit.

161 Schilken & Schilken, *supra* note 114, at 38.

162 Another possibility is to create a single trust for the grandchildren's benefit. Blattmachr, *supra* note 145, at 745. The trustee will hold the contributions in a separate trust for all of the grandchildren, while the settlor retains the right to "advise" the trustee as to what proportion should be held for each grandchild. *Id.*

163 Schilken & Schilken, *supra* note 114, at 38.

164 *Id.* This trust will have an inclusion ratio of zero and will not be includible in the child's estate for estate tax purposes or subject to the GSTT. *Id.*

165 *Id.* This trust will be included in the childrens' estates, but will not be subject to the GSTT because the settlor's children are not skip persons. *Id.* This trust will have an inclusion ratio of one. *Id.*

166 *Id.* at 38.

Life insurance is generally used in estate planning to create liquidity for the beneficiaries of the estate.[167] However, other advantages exist. If the insured does not have any incidents of ownership over the policy within three years of the insured's death, the proceeds of the policy will not be includible in the insured's estate.[168] In addition, the proceeds are not subject to income tax when received by the trust.[169] Finally, when a settlor contributes property to an irrevocable life insurance trust (ILIT) for the payment of premiums, it is the policy premiums, not the proceeds of the policy, which are subject to gift tax.[170]

The same concepts hold true when an ILIT is placed in a perpetual dynasty trust for GSTT purposes.[171] To the extent that the premiums are not subject to the GSTT, the proceeds, the "appreciation" on the property, are also not subject to the GSTT.[172] An ILIT allows the settlor to create an "instant" perpetual dynasty trust, thereby permitting the settlor to leverage her GSTT exemption.[173]

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[167] Lawrence Brody, *Life Insurance in Estate Planning*, SB22 A.L.I. - A.B.A. 523, 554 (1996).

[168] Lawrence Brody, *Sophisticated Life Insurance Planning for the '90s*, C863 A.L.I. - A.B.A. 561, 563 (1993). Incidents of ownership include owning the policy and the ability to change the beneficiaries. I.R.C. __2035(a)(2) and 2042. The insured should avoid holding any incidents of ownership to avoid inclusion for estate tax purposes. Brody, at 563.

[169] Boyle, *supra* note 103, at 452 (citing I.R.C. _101(a)(1)).

[170] Brody, *supra* note 168, at 525. The settlor transfers the property to the trust. *Id.* Then the trustee has the authority to use the contributions to pay the policy premiums. *Id.*

[171] The maximum possible length of such a trust depends on the situs of the trust. *See* Section II for a discussion of the common law RAP jurisdictions, USRAP jurisdictions and jurisdictions which effectively have abolished their RAP. For a discussion of the factors to consider when determining the amount of insurance to purchase, *see* Josheph R. Breen et al, *Charitable Trusts are an Alternative to Qualified Plans*, 20 TAX'N FOR LAW. 26, 31 (1991).

[172] Schiltz, *supra* note 150, at 1229; Beick and Bauer, *supra* note 159, at 39. This could be accomplished by using the GSTT annual exclusion or the GSTT exemption. Schiltz, *supra* note 150, at 1229. For a discussion of whether the settlor should fund the trust by using the GSTT annual exclusion or the GSTT exemption, *see* Section IV. However if the transfer is not exempt, the proceeds will be subject to the GSTT. *Id.*

[173] Brody, *supra* note 168, at 555-56.

> Gifts of $200,000 for ten years result in $15 million of life insurance proceeds paid to [the trust] upon the death of both the grantor and spouse insured. . . . [G]ift taxes are imposed, and there is full use of the GSTT exemption. [The trust] takes full advantage of both spouses' unified credit and GSTT exemption and establishes a tremendous estate and GSTT-free legacy for descendants. Consider

An arrangement to accomplish this goal is a two-trust agreement.[174] The first trust is established for the children's benefit, making use of the gift tax annual exclusion.[175] The second trust, which will be the perpetual dynasty ILIT, will take advantage of the leveraging and will benefit the grandchildren and descendants from more remote generations.[176] To simplify recordkeeping and provide tax certainty, the second trust should exhaust the settlor's GSTT exemption instead of using *Crummey* withdrawal powers.[177]

> the asset accumulation over just the grandchildren's lives. Assume that [the trust] requires income to be paid to each generation and that the $15 million corpus appreciates at 6%. Trust corpus will grow to $48 million after 20 years and to $154 million after 40 years. This huge legacy illustrates why life insurance trust planning has become widely accepted as one of the main GSTT planning strategies.
>
> This so-called 'dynasty trust' plan. . . assumes the age of the husband is 65 and the wife is 62. The premium and death benefit are based on a joint life insurance policy issued by a major insurance company. No Crummey withdrawal right is used in this scenario, so the unified credits of both spouses are zero after six years. This results in a total of $305,000 of gift taxes being paid for gifts in years seven through ten.

See, Beick & Bauer, *supra* note 159, at 40. It may also be possible that the premiums in this example will be completely exempt from gift taxes as the unified credit is indexed to $1 million.

[174] Beick & Bauer, *supra* note 159, at 39. This arrangement is similar to the two-trust agreement discussed in greater detail *infra* Section IV.C.

[175] *Id.* This trust should be structured to not trigger gift tax liability because the settlor's unified credit will probably be exhausted through funding of the other trust. *Id.* There will not be GSTT imposed because the settlor's children are not skip persons. This could be an ILIT, but does not have to be. If the trust is an ILIT, the proceeds could be used to pay estate taxes and administrative costs before distributing the balance to the beneficiaries. *Id.*

[176] *Id.*

[177] *Id.* at 40.

To continue leveraging the perpetual dynasty ILIT, the beneficiaries could reinvest the proceeds collected on the settlor's life in a new policy.[178] Perpetual dynasty trusts could invest in both life insurance and other investment assets.[179] This is known as a "split-funded" trust.[180] Sophisticated use of perpetual dynasty ILIT planning, such as split dollar arrangements and survivorship policies, can further leverage one's GSTT exemption.[181] These

[178] Brody, *supra* note 168, at 556. The trust can only invest in a policy in which the trust had an insurable interest. *Id.* The beneficiaries must also be careful that none of them hold any incidents of ownership in the new policy. Therefore, the trust should purchase and own any new policies.

[179] *Id.* After a trust is established, the trustee could choose to purchase a policy with the income from the other investment assets. *Id.* This would avoid forcing the settlor to make gifts to create an ILIT. *Id.* This also provides an opportunity to a settlor, who has already exhausted her GSTT exemption through creating a non-ILIT perpetual dynasty trust, to take advantage of the leveraging effect of life insurance.

[180] *Id.*

[181] Brody, *supra* note 169, at 566.

> Split-dollar is a premium payment arrangement approved in Rev. Rul. 64-328. The basic arrangement allows two parties to split premium costs and the death benefit payable in the policy…. [T]he two trusts enter into an agreement whereby the dynasty trust (for the grandchildren) collaterally assigns to the children's trust the right to a return of any premium contributions. The agreement also states that the dynasty trust is responsible for paying the term portion of each premium and the children's trust is responsible for the balance of the premium.

See, Bieck & Bauer, *supra* note 159, at 40. This "increases the leverage potential of the transaction by lowering the value of the gift of the insurance provided to the trust each year for gift tax purposes from the full policy premium to the 'economic benefit' of the arrangement to the insured for income tax purposes." *See,* Brody, *supra* note 168, at 566. Use of a joint split-dollar policy, insuring the settlor and settlor's spouse, can further leverage the GSTT exemption: reduced cost of insurance, reduced premium payments, reduced gift necessary to fund policy, allows a reduced allocation of the settlor's GSTT exemption. *Id.*

However, if a split dollar policy is employed, the settlor must consider the disadvantages. "Upon the death of either spouse, the term portion of each premium increases dramatically because the calculation is based on one life instead of two. A portion of the death benefit is paid to the third party contributor and decreases cash flowing into the dynasty trust." *See,* Bieck & Bauer, *supra* note 159, at 41. If a split dollar policy is not used, the use of second-to-die, survivorship, policies, may be beneficial to leverage a couple's GSTT exemption. Boyle, *supra* note 103, at 468. The premiums are considerably less because the insurer only pays once, upon the second insured's death, not upon the death of both. *Id.*

arrangements are referred to as "trust packing."[182] However, such arrangements are extremely complex and must be drafted by a specialist with a thorough understanding of this area of the law.[183]

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182 Brody, *supra* note 169, at 566.

183 Brody, *supra* note 169, at 579. For a discussion of split dollar life insurance, *see e.g.,* Charles L. Ratner, *Split Dollar Life Insurance*, SD10 A.L.I. - A.B.A. 325, 353-55 (1998)(describing the common uses and structure of split-dollar, and the GSTT consequences for termination) ; Lawrence S. Branton, *Using Private Reverse Split-Dollar to Avoid Gift Tax Liability-IRS Shows the Way*, 88 J. TAX'N 216 (1998)(suggesting that "[t]he split-dollar arrangement should be terminated when the spread between premiums paid by the insureds and cash surrender value is the maximum"); *Split-Dollar Agreement Gives Rise to no Transfer Tax*, 60 TAX'N FOR ACCT. 61 (1998)(discussing the use of a complex ILIT plan and how the IRS agreed in Ltr. Rul. 9745019 that the proceeds were not includible); Brad M. Kaplan, *IRS Imposes Unexpected Tax on Split-Dollar Insurance*, 26 TAX'N FOR LAW 90(1997)(analyzing how technical advice memorandum 9604001 reversed decades of precedent by taxing an employee on the cash value build-up in excess of employer premium payments); Diana S.C. Zeydel, *IRS Provides New Opportunities for Using Private Split-Dollar in a Family Context*, 86 J. TAX'N 300, 300 (1997)(describing the traditional split-dollar arrangement as "splitting" the control between an "investment" element and a "risk" element); *Split-Dollar Policy Approved for Family Trust*, 22 TAX'N FOR LAW. 306, 306-307 (1997)(describing how the favorable tax treatment of split-dollar insurance can be extended beyond the business context to a spouse-trust arrangement or partner-partnership arrangement); Thomas C. Bilello, *Reverse Split-Dollar Life Insurance: What are the Tax Effects?*, 24 EST. PLAN. 27, 28-31 (1997)(explaining the typical reverse split-dollar arrangement and the tax consequences of transferring an existing split-dollar policy into an irrevocable trust).

For a discussion of survivorship policies, *see e.g.,* Howard J. Saks, *Survivorship Life Insurance Products and Their Use in Estate Planning in 1994*, 21 EST. PLAN. 183, 185 (1994)(recommending including a Policy Split Option to allow division of the policy into individual policies in the event of divorce or a change in transfer tax laws); Howard J. Saks, *A Detailed Analysis and Reexamination of Survivorship Insurance Use and Planning*, 19 EST. PLAN. 376, 376 (1992)(suggesting that "the use of split-dollar survivorship insurance applied for, for example, by the trustee of an irrevocable life insurance trust who collaterally assigns the policy to the insureds' closely-held corporation, can yield dramatic personal cash flow advantages"); Burke A. Christensen, *An Introduction to Survivorship Insurance*, 5 PROB. & PROP. 28 (1991)(describing the factors an estate planner must analyze to determine whether a joint survivorship policy is in her client's best interest); Lawrence Brody, *The Use of Life Insurance (Including Survivorship Life Insurance) in Estate Planning, Focusing on its Use in Irrevocable Insurance Trusts*, 197 PRAC. L. INST. 347, 420-36 (1990)(describing the planner's obligation to fully explain the tax and non-tax consequences and describing the drafting alternatives with respect to ILIT's holding life insurance in general and survivorship policies); David A. Perkins, *Survivorship Life*

V. CONCLUSION

Dynasty trusts are not limited to millionaires, but are limited by a $1 million exemption. If a client expresses an interest in benefiting her grandchildren or descendants in more remote generations, a perpetual dynasty trust may be the most effective tool to accomplish this goal due to the tax (transfer tax-free compounding) and non-tax (creditor protection) benefits of such a trust. With the current trend of jurisdictions abolishing their respective Rules Against Perpetuities, perpetual dynasty trusts are becoming more attractive.

Extensive planning can also greatly increase the leverage of the settlor's GSTT exemption by transferring discounted property, such as FLP's, and assets with significant appreciation potential, such as life insurance. However, this area of the law is evolving very quickly, so the estate planner must thoroughly understand the client's situation and methodically research the applicable law. Perpetual dynasty trusts seem to be one of the most powerful weapons in the estate planner's arsenal as we approach the turn of the century.

Brian Layman

Insurance Offers Many Advantages for Estate Planning, 15 EST. PLAN. 296, 302 (1988)(concluding that survivorship policies provide cost advantages, can produce the necessary liquidity required and favorable tax results if properly used).