

University of Michigan Law School
Program in Law and Economics

Year 2012

Paper 54

”Perpetual Trusts: The Walking Dead” and
“Congress Should Effectively Curb GST
Exemption for Perpetual Trusts.”

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”Perpetual Trusts: The Walking Dead” and “Congress Should Effectively Curb GST Exemption for Perpetual Trusts.”

Lawrence W. Waggoner and Calvin H. Johnson

Abstract

In separate but complementary letters to the editor of Tax Notes, Calvin Johnson (University of Texas School of Law) and Lawrence Waggoner (University of Michigan Law School) respond to an article by Dennis Belcher and seven other practicing attorneys that defend the GST exemption for perpetual trusts. In *Federal Tax Rules Should Not Be Used to Limit Trust Duration*, 126 Tax Notes 832 (Aug 13, 2012), the attorneys argue that the duration of a trust is a state law issue. Their article is actually a response to a Shelf Project article: Lawrence W. Waggoner, *Effectively Curbing the GST Exemption for Perpetual Trusts*, 125 Tax Notes 1267 (June 4, 2012), Doc 2012-9442, 2012 (TNT 110-14, available electronically at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2083804”).

In *Perpetual Trusts: The Walking Dead*, 126 Tax Notes 1215 (Sept. 3, 2012), Johnson argues that the harm to the national wealth done by perpetual trusts is a federal responsibility. Trusts reduce the value of wealth, and settlors could figure that out if they were not seduced by the tax exemption. Specific settlor instructions get out of date and become an impediment after a generation. Delegating to trustees accountable to no one means trusts are managed primarily for the benefit of the trustees. Perpetual trusts become monsters, the walking dead. The federal exemption is motivating the harm; federal law is responsible for the harm that perpetual trusts cause.

In *Congress Should Effectively Curb the GST Exemption for Perpetual Trusts*, 126 Tax Notes 1216 (Sept. 3, 2012), Waggoner reaffirms his Shelf Project proposal and his criticism of the Treasury Department’s proposal for dealing with

perpetual trusts. The Treasury Department's proposal would leave many trusts and much wealth GST exempt for much longer than Congress originally intended. The Waggoner proposal, if enacted, would be much more effective. Belcher and the other attorneys argue that Congress should do nothing (a position refuted by Johnson), but if Congress is to do something, the attorneys essentially embrace the Treasury proposal.

Perpetual Trusts: The Walking Dead

To the Editor:

In their *Tax Notes* viewpoint, “Federal Tax Should Not be Used to Limit Trust Duration” (*Tax Notes*, Aug. 13, 2012, p. 832, *Doc 2012-16277*, 2012 TNT 158-5), the authors make the claim that limits on perpetual trusts should be left to the individual states. Duration of a trust, they say, is an issue of state property law.

The leave-it-to-the-states claim is in error. It is well settled that “state law creates legal interests and rights,” but federal tax law determines how the “interests or rights, so created, shall be taxed.”¹ Federal tax law, even beyond the doctrine, is responsible for the harm that it does, and in inducing perpetual trusts, federal tax law is doing harm or will over time. Perpetual trusts are like zombies, the walking dead, and over time they will reduce the value of the wealth of the nation. The tax exemption from the generation-skipping trust (GST) tax given for perpetual trusts and 100-year trusts provides a strong, even undeniable incentive to form them, and federal tax should stop the exemption.

The eight authors of the viewpoint, listed alphabetically, are all distinguished estate tax planners: Dennis I. Belcher, Carol A. Harrington, Ellen K. Harrison, Amy E. Heller, Beth Shapiro Kaufman, Julie K. Kwon, Carlyn S. McCaffrey, and Pam H. Schneider. Their statement is in opposition to a shelf project proposal by professor Lawrence Waggoner of Michigan Law School. Professor Waggoner is the reporter of the *Uniform Statutory Rule Against Perpetuities* and also of the *ALI Restatement (Third) of Property on Wills and Other Donative Transfers*, so he is himself a serious participant in these debates.

Professor Waggoner’s proposal would modify the \$10.24 million exemption from the GST tax. Under current law, there are no limitations on the duration of a trust qualifying for the exemption. As modified, the exemption would apply only to trusts

that end under one of three rules, chosen beforehand: (1) 21 years after the death of lives in being; (2) 90 years after creation; or (3) the death of the last living beneficiary who is no more than two generations younger than the settlor.² Trusts already in being would bear tax if they are not modified to qualify for the modified exemption.

The GST tax, in general, imposes a tax at estate-tax rates so that transfers of serious wealth are subject to estate tax at least once every generation. The exemption, however, is now at \$10.24 million per couple and over the hundreds of years allowed by current law, the exemption amount can grow into serious money: After 100 years, for instance, at for example, 5 percent, \$10.24 million becomes \$1.3 billion, which is serious enough.³ After 350 years, the decedents of one couple would reasonably expect to make up 117,000 beneficiaries of the family trust, more than enough to fill up Michigan’s Big House football stadium. Each beneficiary will have a disparate interest as to risks and time of cash flows that is plausibly adverse to everyone else. A trustee cannot simultaneously satisfy 117,000 different desires. The perpetual trusts formed to avoid the GST tax have only been in existence at most since 1986, but give them time and generations, and their monstrous characteristics will reveal themselves. Except for the exemption from federal transfer taxes, no one would create such a monster; the money would be distributed out to beneficiaries who choose their own paths for consumption, risk, and investment of the money.

A perpetual trust is also misgoverned over time. The settlors have two choices: they can create detailed rules that will get out of date and then become serious impediments as the world turns. Or they can give broad discretion to future, eventually not-yet-born managers of the trust. The difficulty with broad discretion is that the trustees are unelected and unreviewable. There is no legal standard that can tell them what risk to undertake or whether to favor the young or the old. Over time, unreviewable managers of a large pot of money come to believe that the first purpose of the pot is to

¹*Morgan v. Commissioner*, 309 U.S. 78, 80-81 (1940), cited in “Federal Tax Should Not Be Used to Limit Trust Duration,” at n.6. See Boris Bittker and Lawrence Lokken, “Federal Taxation of Income, Estates and Gifts,” para. 4.1 (digital edition, Aug. 24, 2012) (describing the interplay of state property rights and federal tax law).

²Waggoner, “Effectively Curbing the GST Exemption for Perpetual Trusts,” *Tax Notes*, June 4, 2012, p. 1267, *Doc 2012-9442*, 2012 TNT 110-14.

³\$10 million * (1+5%)¹⁰⁰ = \$1,347 million, or \$1.3 billion.

provide for their own well-being. Even a rule like conservatism of investment serves the managers by keeping the pot as a healthy source of fees. If trustees would distribute the funds, each individual beneficiary could allocate the funds to maximize individual needs and desires.

We also should not be tying up serious capital in long-term trusts. Entrepreneurs need to be willing to gamble if they want — going for broke to develop their wonderful new idea. Trustees, by contrast, cannot and should not be going for broke. The great capital of the nation needs to get out from under the trust management and out to the beneficiaries, so that they can act like capitalists.

It also makes sense to limit the reach of the dead hand of the settlors to a generation that they might understand. The couple does need to understand the world of their children. But grandchildren live in a different world. The settlors will not even understand their taste in music. For generations beyond, the future is a different planet, so unlike our own that none of the wisdom of the settlors is going to be of any reliably knowable help. The speed of change is also accelerating and just as changes speed up, so the exemption is creating many new perpetual trusts, oblivious to the changes. The decisions about the future need to be made by the future beneficiaries.

Settlors can figure that tying up capital is not a good idea, except that their judgments get warped by the tax avoidance available to them if they will set up a very long-term trust that is immune from the once-a-generation estate tax. End the tax exemption for the perpetual and many-generation trusts, and they will inevitably disappear on their own.

Deciding the rules for the *federal* GST tax on the *federal* level is also in accord with the deep structure of federalism in our Constitution. The states can do whatever they want with their own taxes. Our 1787 Constitution is a very nationalist document, written in righteous anger at the wicked states.⁴ Preventing the federal GST tax from giving tax exemptions that would encourage the evil of perpetual trusts — the walking dead — is fully consistent with the overall constitutional design.

Calvin H. Johnson
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Aug. 28, 2012

⁴Calvin H. Johnson, *Righteous Anger at the Wicked States: The Meaning of the Founders' Constitution* (Cambridge University 2005).

Congress *Should* Effectively Curb GST Exemption for Perpetual Trusts

To the Editor:

In “*Effectively Curbing the GST Exemption for Perpetual Trusts*,”¹ I criticized the Treasury Department’s proposal for dealing with perpetual trusts.² My objection is that Treasury’s approach would leave many trusts and much wealth GST-exempt for much longer than Congress originally intended. For perpetual trusts created before enactment, Treasury’s approach would allow them to continue to be unburdened by a durational limit. For perpetual trusts created after the effective date of enactment, Treasury’s approach would still allow them to qualify for the GST exemption, but would have the exemption expire 90 years after the trust was created.

I then advanced a solution that would be far more effective than the Treasury approach. For new trusts, my proposal would deny the GST exemption *ab initio*, unless the trust must terminate no later than: (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) the death of the last living beneficiary who is no more than two generations younger than the settlor. For existing trusts, my proposal would allow a grace period during which the trusts can be modified to terminate within the allowed period, but absent modification, the trusts would lose their GST exemption at the end of the grace period. The solution I advanced is consistent with the original intent of the GST exemption, for it would truly end the perpetual-trust movement and its associated perpetual GST exemption for both new and existing trusts.

Dennis Belcher and seven other practicing attorneys have questioned my proposal.³ “In our view,” the authors stated, “discouraging perpetual trusts is simply not an appropriate use of federal tax law, regardless of the arguments one can legitimately make about their evils. . . . The tax benefits of the GST exemption should not be used to try to force taxpayers to create trusts with a federally mandated termination date or to modify existing [perpetual]

¹See *Tax Notes*, June 4, 2012, p. 1267, *Doc 2012-9442*, or *2012 TNT 110-14*.

²See Treasury, “General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals,” 81-82 (Feb. 2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf> (last visited Feb. 24, 2012).

³See Dennis I. Belcher et al., “Federal Tax Rules Should Not Be Used to Limit Trust Duration,” *Tax Notes*, Aug. 13, 2012, p. 832, *Doc 2012-16277*, or *2012 TNT 158-5*.

trusts to shorten their duration." Calvin Johnson has more than adequately answered this argument.⁴

The authors have an alternative argument. If Congress *is* to do something, the authors prefer the Treasury approach, although for new trusts they would be more comfortable with a period of "100 years, 110 years, or even 120 years" rather than 90 years. As noted above, the Treasury approach would leave many trusts and much wealth GST-exempt for much longer than Congress originally intended.

The authors believe that my proposal regarding new trusts would deny the GST exemption for trusts that might actually terminate earlier than the allowable perpetuity period. The answer to that argument is easy: If Congress adopts my proposal, lawyers will quickly adapt and go back to their time-honored practice of incorporating a perpetuity saving clause in trusts they draft, especially in trusts that are intended to qualify for the GST exemption.

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⁴See Johnson, "Perpetual Trusts: The Walking Dead," p. 1215.

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