Dynasty Trusts and the Rule Against Perpetuities

By Stephen M. Margolin and Mitchell D. Weinstein

This article shows Illinois estate planners how they can use popular dynasty trusts in a way that avoids the rule against perpetuities and sidesteps a federal estate-tax pitfall.

Dynasty trusts are an increasingly important estate planning device. They enable clients not only to avoid federal estate tax, but also to protect assets from creditors, divorce, and the like, and to preserve them for descendants and beneficiaries for successive generations.

Generally, dynasty trusts continue to the expiration of the common law rule against perpetuities — a life in being plus 21 years. When they do, the practical problem is determining the multigenerational beneficiaries: Which grandchild gets what property? Clients can solve this by bestowing a nongeneral power of appointment on children, grandchildren, etc.[1] Doing so enables the children or other descendants to determine the appropriate successor beneficiary.

The question then becomes how long property can remain in trust subject to a power of appointment. Can a dynasty trust be a perpetual trust? The answers involve the interaction among the rule against perpetuities ("the rule"), powers of appointment, and multigenerational trust property transfers.

Powers of appointment are described in section 2041 of the Internal Revenue Code.[2] Generation skipping transfers (GST) are described in chapter 13 of the Code, while the rule is defined by the laws of each state. For this dis-

1. A general power bestowed on a person causes federal estate tax on his or her death under Internal Revenue Code of 1986, section 2041(a)(2), so a nongeneral power is utilized to avoid this result.

2. All section references are to the Internal Revenue Code of 1986, unless otherwise stated.

cussion, assume that the GST tax is avoided by appropriate exemption allocation. Even so, section 2041(a)(3), which is described below, presents a formidable tax obstacle to multigenerational transfers of property in trust.

The following discusses the interplay between the rule and Section 2041. If that interplay is planned for properly, a richly funded trust can provide estate tax avoidance and asset protection with full flexibility of operation for descendants and beneficiaries in perpetuity.

I. The Rule

The rule is a common law proscription against suspending the power of alienation over property and against the remoteness of vesting.[3] The power of alienation is suspended when there are no persons living who can collectively transfer complete ownership of property.[4] The rule voids any such suspension in excess of the permissible period. It also voids future interests that may not vest within the permissible period. The most common permissible period is measured by a life or lives in being at the time the interest is created plus 21 years.[5]

II. Powers of Appointment

In the case of an interest in property appointed under a nongeneral (a limited or special) power of appointment, the permissible period generally is computed from the date of the creation of the power.[6] This point, although seemingly minor, is crucial in determining whether or not property will be included in the gross estate of a decedent holding a power of appointment over that property.

Section 2041(a)(3) includes in the gross estate the value of all property:

To the extent of any property with respect to which the decedent —

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.[7]

The ostensible intent of this section is to prevent avoidance of wealth transfer taxes by successive exercises of nongeneral powers of appointment to extend the term of trusts beyond the original period of the rule.[8]

In fact, it works more broadly in that the first power holder (or his or her estate) is subject to tax when that power is exercised to create another power of appointment — whether general or nongeneral — for a period ascertainable without regard to the date of creation of the first power.

III. An Illustration

Assume that father (F) establishes a trust for the benefit of his daughter (D). F grants D a special power of appointment over trust assets. D in turn exercises her special power by will and creates a new trust for her husband (H) and children, over which H is granted a special power of appointment. Assume under local law this last power of appointment is for a period without regard to the creation of the first power.

Under these facts, section 2041 requires the value of the property subject to D's power of appointment to be included in D's estate. This is a dangerous tax trap for an unknowing taxpayer.

D has a life estate in property subject to a special power of appointment. If D dies without exercising the power, or if D appoints the property into a trust for H and children, section 2041(a)(3) does not apply, and the property is not in her estate. If, however, D appoints the property into a trust for H, and gives H a fresh power of appointment over the property, whether general or nongeneral, section 2041 operates, and the property is included in D's estate.

IV. The *Murphy* Case

The above example was essentially the fact scenario in the *Estate of Murphy v Commissioner*.[9] In that case, the tax court, looking at Wisconsin law regarding the rule, concluded that the exercise of the special power of appointment by D did not violate section 2041, because under Wisconsin law, the suspension of the power of alienation had due regard to the date of creation of the first power (by F). Therefore, the property was not included in D's estate.[10]

3. 4 Restatement, Property, § 370 (1944).
4. Id, comment i.
5. R. Powell, *Real Property* 537, et seq (1977). Section 21207 of the California Probate Code provides this variation:

> § 21207. Nongeneral power of appointment; general testamentary power of appointment; validity; conditions. A nongeneral power of appointment or a general testamentary power of appointment is invalid unless one of the following conditions is satisfied:
> (a) When the power is created, it is certain to be irrevocably exercised or otherwise to terminate no later than 21 years after the death of an individual then alive.
> (b) The power is irrevocably exercised or otherwise terminates within 90 years after its creation. *(Added by Stats 1991, c 156 (AB 1577), § 24.)*

6. 29 ILP Perpetuities § 12; Leach, *Perpetuities in a Nutshell*, 51 Harv L Rev 638 (1938) ("*Leach*").
7. The companion gift tax section is 2514(d).
8. Blattmachr, *Adventures in Generation Skipping, etc.*, 24 Real Property Probate and Trust Journal 75, 84 (1989) ("*Blattmachr*").
9. 71 TC 671 (1979).
10. Id.

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In Wisconsin, the common law rule has been modified by statute.[11] In the *Murphy* case, D exercised the power by creating another power which could, under Wisconsin law, suspend the power of alienation of such property for a long period. The Wisconsin statute states:

> (1)(a) A future interest or trust is void if it suspends the power of alienation for longer than the permissible period. The permissible period is a life or lives in being plus a period of 30 years....(c) If a future interest or trust is created by exercise of a power of appointment...the permissible period is computed from the time the power is created....[12]

Remember, for section 2041(a)(3) to be effective and for the property subject to the power of appointment to be included in the estate of the decedent, the suspension of the power of alienation must be "for a period ascertainable without regard to the date of the creation of the first power."[13] Since the Wisconsin statute computes the permissible period from the time the power is created, section 2041 does not include the property in the estate of the decedent.[14]

In contrast to Wisconsin, in those states in which the common law rule is still in effect, the result may differ.

V. Illinois Law

For example, in Illinois, the Statute Concerning Perpetuities[15] modifies the common law rule, which, except as modified, remains in full force and effect. It is important to note, however, that there have been important modifications to the Illinois rule, which are discussed later.[16]

Because the Illinois statute does not modify the measuring period at common law for nongeneral powers of appointment, the measuring period for each power is the creation of the first power.[17] Thus, in Illinois, the second power created by D in favor of H is likely to be for an ascertainable period measured from the date of the creation of D's power, and, as such, is not within the reach of section 2041(a)(3).

However, because of the relation back to the date of creation of the first power, the property could be appointed to persons unborn on the death of the original grantor (F), so the gift could be void under the Illinois rule depending on the circumstances. As one source states:

> Where an appointment is made under a special power, the appointment is read back into the instrument creating the power (as if the donee were filling in blanks in the donor's instrument) and the period of perpetuities is computed from the date the power was created.[18]

This would be the same result in all states retaining the common law rule.

> **"If the interplay [between the rule against perpetuities and IRC section 2041] is planned for properly, a richly funded trust can provide estate tax avoidance and asset protection with full flexibility of operation for descendants and beneficiaries in perpetuity."**

VI. General Powers: No Relating Back

Conversely, if D creates a general power of appointment in favor of H during her lifetime by exercising her special power, she may trigger section 2041(a)(3). If so, the trust property is includible in her estate. This is because, for general powers of appointment, the common law rule likely runs anew without regard to the creation of the first power.[19]

VII. Planning Opportunity: Laws of Wisconsin and Illinois

A. Wisconsin

Wisconsin law offers an interesting planning opportunity for trust drafters. Local law controls, and the Wisconsin statute[20] says that if a trustee has the power to sell the property, then even though the trust continues in perpetuity it does not violate the rule. The *Murphy* court stated:

> [S]ection 2041(a)(3) taxes the exercise of any power of appointment if the donee exercises the power by creating a second power which, under the applicable local rule against perpetuities, can be validly exercised to effect the appropriate condition of title for longer than the permissible period. Accordingly, if the local rule against perpetuities is expressed in terms of remoteness of vesting, under section 2041(a)(3) we must determine if vesting of appointed property may be postponed for a period ascertainable without regard to the date of the creation of the first power.[21]

In *Murphy*, the commissioner's position is as follows. The Wisconsin rule governs the suspension of the power of alienation. Under the Wisconsin statute, an interest is void if it suspends the power of alienation for longer than life in being plus 30 years.[22] However, the statute also states that the power of alienation is not suspended if the property interest is held in a trust and a trustee has the power to sell trust assets.[23]

In the *Murphy* case, D exercised her power by creating in her husband another power that he in turn could validly exercise by placing the property subject to the power in a multigenerational trust (for the benefit of his descendants). By giving the trustee of the newly created trust a power of sale of the corpus, the Wisconsin rule is not violated, even though ownership of the property may never vest in anyone.

From this, the commissioner argued that section 2041(a)(3) applies to the decedent's exercise of her power of appointment. The tax court holding for the taxpayer stated:

> He argues that Congress intended sec-

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11. Wis Stat Ann 700.16.
12. Id.
13. Treas Reg § 20.2041-3(e)(1)(ii).
14. *Murphy*, 71 TC 671 (1979).
15. 765 ILCS 305/1 et seq.
16. 765 ILCS 305/3, 305/4 and 315/1 are effective generally August 17, 1997, but "qualified perpetual trusts" are effective January 1, 1998.
17. 29 ILP Perpetuities § 12; *Leach* at 652 (cited in note 6).
18. *Leach* at 653 (cited in note 6); See also, Casner, 3A Estate Planning (5th Ed 1986).
19. *Blattmachr* at 84 (cited in note 8).
20. "There is no suspension of the power of alienation by a trust or by equitable interests under a trust if the trustee has the power to sell, either expressed or implied...." Wis Stat Ann § 700.16(3).
21. *Murphy*, 71 TC at 680.
22. Wis Stat Ann § 700.16(1)(a).
23. Wis Stat Ann § 700.16(2) and (3) and *In Re Walker's Will*, 258 Wis 65, 45 NW2d 94 (1950).

tion 2041(a)(3) to function independently of State law. He maintains that the statute unequivocally indicates that if a power violates any one of three conditions of title, viz, (1) postponement of vesting, (2) suspension of the powers of alienation, or (3) suspension of absolute ownership, then the property subject to the power must be included in the gross estate. Therefore, he concludes, because the decedent exercised her power by creating in her husband another power which could be validly exercised to indefinitely postpone the vesting of any interest in such property, section 2041(a)(3) is applicable to include the appointed property in her gross estate.[24]

The tax court rejected the commissioner's arguments and, holding for the taxpayer, stated that any potential abuse in this area would better be curbed by Congress.

Therefore, in Wisconsin, a trust could be perpetual without violating its rule and without violating section 2041(a)(3).

B. Recent Illinois Law

The Illinois law, effective August 17, 1997, states:

> (a) The rule against perpetuities shall not apply:
>
> ...(8) to qualified perpetual trusts created by will or inter-vivos agreement executed or amended on or after January 1, 1998, or to qualified perpetual trusts created by exercise of a power of appointment granted under instruments executed or amended on or after January 1, 1998."[25]

The law defines a "qualified perpetual trust" as follows:

> "Qualified perpetual trust" means any trust
>
> (i) to which, by the specific terms governing the trust, the rule against perpetuities does not apply; and
>
> (ii) of which the trustee (or other person to whom the power is properly granted or delegated) has the power in the trust document or under any provision of law to sell, lease, or mortgage property for any period of time beyond the period of the rule against perpetuities.[26]

The following treasury regulation provides the condition for includibility in a decedent's gross estate:

> (ii) If the power is exercised by creating another power of appointment which, under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (a) postpone the vesting of any estate or interest in the property..., or (b)...suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.[27]

In our example, D exercises her power by creating a second power in H. The Murphy court stated: "Hence, the question is whether the...law of perpetuities, the applicable local law..., measures the period of perpetuities from the time a general or special power is exercised or from the time it was created."[28]

The Wisconsin statute, however, is more specific than the new Illinois statute. The Wisconsin statute with respect to nongeneral powers states: "If a future interest or trust is created by exercise of a power of appointment, the permissible period is computed from...the time the power is created...."[29]

The recently enacted Illinois law makes the rule inapplicable to Illinois "qualified perpetual trusts." Unlike the Wisconsin statute, the Illinois statute does not specifically measure the period of perpetuities from the time the original power was created, although common law supports this.[30] Therefore, the Illinois statute is not as certain as the court-tested Wisconsin statute in avoiding the grasp of section 2041(a)(3).

VIII. A Pitfall: The Meaning of "Exercise"

In our example, D exercises her power by creating a second power in H. Under common law, in Illinois and elsewhere, the rule with respect to special powers relates back to the creation of the first power, so section 2041(a)(3) is not violated.

What is the result in event of default of exercise? Regulation 20.2041-1(d) states:

> Whether a power of appointment is in fact exercised may depend upon local law. For example, the residuary clause of a will may be considered under local law as an exercise of a testamentary power of appointment in the absence of evidence of a contrary intention drawn from the whole of the testator's will. However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment.

Thus, if D inadvertently structured her will to come within the ambit of the above regulation, and if that "exercise" creates a general power of appointment in H, section 2041(a)(3) may cause includibility in D's estate. This is because creation of a general power under local law may not relate back to the creation of the first power.

IX. Delaware Law

The holding in *Murphy* does not apply in all states that have modified the common law rule. In Delaware, for instance, the period of perpetuities for an interest under a special power of appointment is computed from the date of exercise of the special power rather than its creation.[31] Accordingly, if *Murphy* had been decided under Delaware law, the property presumably would be included in the decedent's estate.

The Delaware law was instrumental in the enactment of sections 2041(a)(3) and 2514(d).[32] The most recent amendments to Delaware law regarding the rule did not change the measurement period in Delaware and, as such, the outcome under Delaware law would be the same even if decided today.

X. Summary

The rule and section 2041(a)(3) dovetail. The rule limits the period for which absolute property ownership can be held in trust. Delaware law avoids the limit by starting the running of the rule after each transfer. Section 2041(a)(3) answers Delaware law by taxing the decedent power holder who creates a second special power of appointment to the extent of trust property value.

The new Illinois statute on qualified

24. *Murphy*, 71 TC at 678.
25. 765 ILCS 305/4(a)(8).
26. 765 ILCS 305/3(a-5)
27. Treas Reg § 20.2041-3(e)(1)(ii).
28. *Murphy*, 71 TC at 680-81.
29. Wis Stat Ann 700.16(1)(c).
30. See notes 18 and 19.
31. Del Code Ann Tit 25, § 501 (1974).
32. S Rept 382, accompanying HR 2084 (Pub L 82-58) 82d Cong, 1st Sess (1951). See also Nenno, *To Bridge or Not to Bridge the Generation-Skipping Gap*, 33 U Miami Inst on Estate Planning § 12 (1999).

perpetual trusts is a positive development. Because it follows common law. the Illinois rule relates a special power back to the creation of the first power, so it is not ensnared by section 2041(a)(3). However, that section may operate when the second power created is a general power, since it may not relate back to the creation of the first power.

The Wisconsin rule presents a court-tested planning opportunity; although the creation of the second power relates back to the creation of the first power, the permissible period of the trust is indefinite. Thus, a Wisconsin trust can be multigenerational without violating the Wisconsin rule or section 2041(a)(3).

XI. Conclusion

Because of the accelerated pace of litigation filings and the dramatic increase in divorce rates, many grantors seek asset, bankruptcy, and divorce protection for descendants and beneficiaries in trusts of long term duration. A perpetuity trust meets this need. If handled properly it escapes the catastrophic tax snare of Internal Revenue Code section 2041(a)(3).

Reprinted from the *Illinois Bar Journal*
Vol. 87, # 3, March 1999.