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How Long For Dynasty Trusts?

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In recent years, interest by planners and others in so-called “dynasty” trusts has increased. Enactment of the revised generation skipping transfer tax in 1986 has apparently not dampened enthusiasm for such trusts. One interesting development in state property law, the repeal by a few states of the common law or statute-based Rule Against Perpetuities, promises to add to the interest level in dynasty trusts.

Nature of dynasty trusts

As the name suggests, “dynasty” trusts are designed to hold property in trust for a relatively long period of time, with the duration typically constrained only by the Rule Against Perpetuities. The $1,000,000 exemption from the generation skipping transfer tax acts as a second constraint on the creation of a dynasty trust. The exemption may be allocated to any one or more transfers and has the effect of exempting, from the outset, all or part of the property involved. Allocation of the exemption is made automatically by statute if not allocated otherwise by the transferor. Once allocated to a transfer, the exemption, in effect, shields all direct skip transfers, taxable distributions, and taxable terminations resulting from that transfer for its entire duration.

Under a typical dynasty trust, a tract of land approaching $1,000,000 in value is transferred to a trust formed specifically for that purpose. The trust usually specifies that beneficiaries in the first generation following the grantor are to receive income from the trust with beneficiaries in the second or later generations following that of the grantor holding the remainder interest. Frequently, land which has been in the family for a relatively long time is selected for inclusion in the trust.

Limits on duration

The duration of a dynasty trust or other generation skipping trust is generally limited by the Rule Against Perpetuities. Under the common law version of the Rule, all interests in a trust must vest within the term of a class of lives in being plus 21 years.

The Rule was developed in response to the creation by property owners several centuries ago of successive life estates which would have reduced dramatically the transferability of land. The courts reasoned that creation of successive life estates for very long time periods or into perpetuity would cut down on the amount of land available for transfer.

The common law version of the rule is still followed in 22 states. Those states include Alabama, Arkansas, the District of Columbia, Illinois, Iowa, Kentucky, Maine, Maryland, Mississippi, Missouri, New Hampshire, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Texas, Utah, Vermont, Virginia, Washington, and Wyoming.

The Uniform Statutory Rule Against Perpetuities (USRAP) has been adopted in 24 states. Under USRAP, an interest is valid if—(1) it will necessarily vest or fail within lives in being plus 21 years (basically the common law rule) or (2) the interests actually vest within 90 years of creation of the interests.

Four states—South Dakota, Wisconsin, Delaware, (as to personal property in trust) and Idaho—have repealed the Rule Against Perpetuities for trusts in which the trustee has the power to sell trust assets. In states which have repealed the Rule, there is no apparent limitation on the term of dynasty trusts. Those states essentially permit perpetual private trusts.

Which state law governs

The repeal in some states of the Rule Against Perpetuities raises the question of which law governs trusts established as dynasty trusts. While repeal may well represent a calculated effort to attract trust business to the state, trusts holding land are generally governed by the law of the state where the land is located.

Tax consequences of perpetual trusts

Under the regulations, if a trust is extended beyond the period allowed by the Rule Against Perpetuities, the GSTT exemption is lost and the transfer is subject to federal gift or estate tax. The regulations do, however, permit the exercise of a power of appointment to convert the term of a dynasty trust from the common-law...
perpetuities period to 90 years without adverse tax consequences.\textsuperscript{21} The regulations do not address the situation of perpetual trusts. Some believe that trusts governed by the law of a state which has abolished the Rule continue to be free of generation skipping tax as well as estate and gift tax so long as a donee does not exercise a special power of appointment.\textsuperscript{22}

In conclusion

For those wishing to take steps to assure that assets remain within the family, a dynasty trust may be an appealing alternative. Additional states are expected to join the ranks of those that have acted to permit the organization of trusts on a perpetual basis.

FOOTNOTES
\textsuperscript{3} See ns. 11-15 infra.
\textsuperscript{5} See I.R.C. § 2632.
\textsuperscript{6} See Treas. Reg. § 26.2632-1(a).
\textsuperscript{7} See I.R.C. § 2612(c).
\textsuperscript{8} I.R.C. § 2612(b).
\textsuperscript{9} I.R.C. § 2612(a).
\textsuperscript{10} See Gray, Rule Against Perpetuities (4th ed. 1942).
\textsuperscript{11} Leach, “Perpetuities in a Nutshell,” 51 Harv. L. Rev. 638, 639 (1938); Leach, “The Rule Against Perpetuities and Gifts to Classes,” 51 Harv. L. Rev. 1329 (1938).
\textsuperscript{13} S.D. Code Laws Ann. §§ 43-5-1, 43-5-8.
\textsuperscript{14} Wis. Stat. Ann. § 700.16.
\textsuperscript{15} Del. Code § 503(a).
\textsuperscript{16} Id.
\textsuperscript{17} Idaho Code § 55-111.
\textsuperscript{18} See ns. 11-15 supra.
\textsuperscript{19} See, e.g., Spindle v. Shreve, 111 U.S. 542 (1884). See also Restatement (Second) of Conflict of Laws § 280 (1971).
\textsuperscript{22} See Dukeminier, supra n. 1 at 423.

CASES, REGULATIONS AND STATUTES
by Robert P. Achenbach, Jr.

BANKRUPTCY

FEDERAL TAXATION-ALM § 13.03[7].

AUTOMATIC STAY. The taxpayer was a corporation which had filed for Chapter 11 on June 1, 1990. The debtor alleged that the IRS violated the automatic stay in filing levies against the debtor’s assets and the debtor was entitled to damages, including attorney fees. The court held that, under Section 362(h), only individuals were entitled to sue for damages for violations of the automatic stay. In addition, the court held that the debtor failed to show any violation of the automatic stay. \textit{In re Material Corp., Inc., 97-1 U.S. Tax Cas. (CCH) ¶ 50,296 (Bankr. N.D. Ill. 1997).}

DISCHARGE. The debtor filed a Chapter 13 case on May 10, 1993. The debtor had filed an income tax return for 1991 in November 1992. The Chapter 13 case was dismissed 85 days later, prior to confirmation of the plan or any payments to creditors. The debtor filed the current Chapter 7 case on January 25, 1996, more than three years after the filing of the tax return for 1991. The IRS argued that the three year period of Section 507(a)(8) was tolled during the first Chapter 13 case, such that less than three years passed before the Chapter 7 filing, for the purposes of Section 507(a)(8). The court noticed a conflict in the courts on this issue and held, with the majority of courts, that the Chapter 13 case tolled the limitation period of Section 507(a)(8). The court reasoned that a literal interpretation of Section 507(a)(8) would allow debtors to manipulate the process to remove a tax liability by filing one case, waiting for a sufficient period and filing a second case more than three years after the tax return. The court did not discuss the opposing view that the IRS still has sufficient time to make an assessment and preserve the priority of the claim during the more than two years between the bankruptcy filings in this case. \textit{In re McMillan, 204 B.R. 835 (Bankr. M.D. Ga. 1996).}

The debtor originally filed a Chapter 13 case which was converted to Chapter 11. The case was dismissed after the court revoked the Chapter 11 plan. The debtor later filed a Chapter 7 case more than three years after the timely filing of a tax return for 1987. The debtor failed to pay the 1988 taxes, however. After the debtor received a discharge in Chapter 7, the IRS applied against the 1987 taxes a refund claimed by the debtor. The debtor argued that the taxes were discharged in the Chapter 7 case because the return was filed more than three years before the Chapter 7 petition. The IRS argued that the Chapter 13/11 case tolled the three year limitation period of Section 507(a)(8). The court held that the limitation period was tolled by the Chapter 13/11 case because Section 507(a)(8) was intended by Congress to give the IRS three full years to make a collection of taxes. \textit{In re Waugh, 97-1 U.S. Tax Cas. (CCH) ¶ 50,304 (8th Cir. 1997), aff’d, 95-2 U.S. Tax Cas. (CCH) ¶ 50,576 (D. Minn. 1995).}

The debtor had filed a previous Chapter 7 case in which the IRS had filed a secured claim for taxes,