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Subject: **Lawyers Ask Treasury to Set Two-Generation Limit on GST Exemption**

Major References: ***Letters (and Attachments) to Treasury by Law Professors Gregory Alexander, John Langbein and Lawrence Waggoner, and Attorney Raymond Young Respecting Proposed Two Generation Limit on Generation Skipping Tax***

Prior AALU Washington Reports: *08-33*

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AALU has learned that at least four attorneys in academia and private practice have written to the Treasury Department asking that a durational limit - suggested to be two generations - be placed on trusts that qualify for the generation-skipping transfer (GST) tax exemption, thus eliminating the incentive to establish so-called "perpetual dynasty trusts" in jurisdictions that have abolished the common law "rule against perpetuities." The Treasury correspondence was submitted by Gregory S. Alexander of Cornell University Law School, Raymond H. Young of Young & Bayle (a Boston law firm), John H. Langbein of Yale Law School, and Lawrence W. Waggoner of the University of Michigan Law School.

Congress enacted the GST tax in 1986 to prevent the transmission of wealth from one generation to the second generation below the transmitting generation without the imposition of federal estate or gift taxes on the intervening "skipped" generation. At the same time, Congress granted a limited exemption from the GST tax that, over time, grew to $3.5 million per person, or $7 million per couple, where it remained on December 31, 2009, immediately prior to the highly publicized one year "repeal" of the GST

tax for 2010. Theoretically, a trust funded with the maximum amount of GST exemption could continue until its required termination, which, in 1986, was generally at the close of the statutorily imposed "rule against perpetuities" period in the state in which the trust was created. Under the common law as it had existed for centuries, the period was understood, for the most part, to be "lives in being plus 21 years." This formulation often computed to be about 100 years, more or less, given existing life expectancies and assuming that one of the "lives in being" was an infant.

In short order, however, individual states - in part to attract trust business - began to modify or eliminate altogether their perpetuities limitations to allow trust settlors to create trusts that can last for centuries, or even forever, at great cost - in forgone transfer taxes - to the federal fisc. The abolition of the rule against perpetuities also arguably leads to the concentration of wealth in the hands of a few families. As set forth in a "Message to Congress" prepared by Professor Waggoner:

> "Although a GST-exempt trust of a few million dollars represents a small portion of the net worth of the truly wealthy, the exemption can be leveraged so that the amount exempted significantly exceeds the exemption's cap by utilizing various estate planning techniques. For example, the trustee can be authorized to purchase or retain assets such as second-to-die life insurance, start-up businesses, and minority interests in existing family businesses at discounted values. The trustee can also be authorized to purchase or retain property such as vacation homes and private airplanes for the use of the beneficiaries. In addition, the trustee, which can be a family trust company, can be authorized to hire sophisticated investment managers and invest in assets not traded in the public securities markets, assets such as hedge funds, private equity, venture capital funds, and real estate. Finally, generation after generation can have their interests insulated from creditors through the use of spendthrift clauses. Potentially, the perpetual or near-perpetual trust movement could, over time, lead to large concentrations of wealth within a relatively small number of family dynasties and financial institutions, contrary to longstanding federal tax policy."

Professor Alexander quotes from a recent *New York Times* article ("America Builds an Aristocracy," *NYT* 7/12/10) by *Professor* Ray Madoff that attempts to illustrate the issue with the following example involving life insurance:

> "A couple can . . . put $7 million . . . into a life insurance policy owned by the trust. They apply their exemption at the start, and the trust is free of taxes - even when, after the death of the second spouse, the life insurance policy pays off at $100 million."

In our Bulletin No. 08-33, we reported that the Staff of the Joint Committee on Taxation, in its report "*Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform"* (JCX-23-08, April 2, 2008), suggest that the allocation of the generation skipping tax exemption to a "perpetual dynasty trust" should be prohibited, except to the extent that the trust provides for distributions to beneficiaries in the generations of the transferor's children or grandchildren**.** In addition, the American Law Institute, at it meeting in May 2010, unanimously adopted Professor Waggoner's recommendation of a 2-generation limit on the rule against perpetuities, so that the interests of trust beneficiaries have to come into possession within the time limit. The recent letters to Treasury add to this chorus.

Thus far AALU has not taken a position on the issue of a durational limit on the GST exemption. While the ability to leverage the exemption to establish dynasty trusts funded by life insurance can be a useful planning opportunity, the existence of the dynasty trust also can be viewed as removing assets from the reach of the estate tax essentially forever. In the long term, the insulation of these assets from tax may be viewed as the equivalent of "repeal" with respect to them -- an issue (i.e., repeal) on which AALU has taken a position.

Indefinite removal of assets from the reach of our estate and gift tax systems (i.e., repeal by another name) can, of course, be coupled with tax advantageous leveraged use of life insurance, as suggested above. Alternatively, seen from the long term vantage of the life insurance community, the future need for newly placed life insurance policies could be thought of as being impacted negatively -- at least to the extent that future assets and their transfer through multiple generations will, by the use of dynasty structures, permanently avoid estate and gift tax.

AALU welcomes your comments on this subject and specifically the two generation proposal.

Any AALU member who wishes to obtain a copy of Letters by Law Professors Gregory Alexander, John Langbein and Lawrence Waggoner, and Attorney Raymond Young may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* with your last name and birth date and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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