TRUST LAW BASICS

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I. Rule Against Perpetuities (RAP)

"The Rule attempts to limit dead hand control by prohibiting the remote vesting of contingent interests." [i]

A. **Rule**

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.

B. **History**

1. Established in England during the 17th century

   a. Created as a compromise between the interests of wealthy landowners and judges trying to prevent the dead from controlling the future.

   b. Property can be tied up in contingent interests for lives in being plus 21 years, but not longer.

2. In 1986 the National Conference of Commissioners on Uniform State Laws approved the Uniform Statutory Rule against perpetuities (USRAP)[ii]

   a. Analysis under the common-law rule

   b. A ninety (90) year "wait and see" period for interests that violate the common-law rule

c. Deferred reformation for interests that fail to vest within the ninety (90) year period

C. **RAP Applies to:**

1. Executory interests
2. Vested remainders subject to open
3. Contingent Remainders

D. **Exceptions to RAP**

1. Does not apply to gifts of future interests to charities when the prior interests are also charities.
2. Does not apply generally to options for the purchase of land.
3. Does not apply to restraints on alienation if they are not otherwise invalid.
4. Does not apply to any interest retained by the grantor.

E. **Validating Life**

1. A life in being is someone who is alive at the time the interest was created.
2. A fetus is considered alive from the child is conceived, but only if the child is later born alive.
3. Any living person is considered capable of having more children, regardless of age.

F. **Strategy for Determining RAP Under Common Law**

1. Determine validating lives;
2. Kill off the lives in being;
3. Determine the first point at which the future interest must vest;
4. Determine whether the interest vest within 21 years, or if it will never vest:
   a. If the interest must vest within 21 years, RAP is not violated
   b. If the interest will definitely never vest, RAP is not violated.

G. **Current State Applications of RAP**

Each state approaches RAP differently, for example[iii]:

1. Twenty-five states and Washington DC have adopted the USRAP:

   Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Utah, Virginia, and West Virginia.

2. Louisiana has never had RAP.

3. Seventeen states have retained RAP but allowed certain trusts to continue without application of the rule:

   Arizona, Washington DC, Hawaii, Illinois, Maine, Maryland, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Virginia, and Wyoming.

4. Eight states have repealed RAP either entirely or in some specific fashion:

   Alaska, Delaware, Idaho, Kentucky, New Jersey, Pennsylvania, Rhode Island, and South Dakota.

5. Nine states have adopted longer fixed periods for RAP:

   Alabama, Arizona, Colorado, Delaware, Florida, Nevada, Tennessee, Utah, and Washington.

6. Three states (Alabama, New York, and Texas) continue to use the common law rule.

7. Three states (Iowa, Mississippi, and Oklahoma) use the common law rule with the "wait and see" modification.

H. <u>Potential Pitfalls of RAP in Five States</u>

1. Trusts created under the laws of Arizona, Nevada, North Carolina, Tennessee, and Wyoming may be invalid by reason of a prohibition on "perpetuities" under the State constitutions of those five states. [iv]

2. These five states allow perpetual trusts, yet each of their State constitutions include little noticed provisions that forbid "perpetuities."[v]

3. Three overlapping functional rationales for the constitutional bans[vi]:

   a. Ensuring marketable title;

   b. Protecting against changed circumstances; and

c. Avoiding concentrations of wealth and power.

4. Practitioners whose clients have created long-term trusts in these five states may wish to consider whether they have an obligation to advise them of the potential invalidity of the trusts' duration.[vii]

I. <u>Power of Appointment Issues with RAP</u>

1. One issue arises when a nonfiduciary special power of appointment (first power) is being exercised to create, or newly subject property to, another power of appointment (second power) in a jurisdiction whose perpetuities reform creates a need for, but does not actually provide, a competent anti-"Delaware tax trap" provision. [viii]

   a. In this scenario, the risk is that if future interests created by exercise of the *second power* will be subject to a reformed perpetuities regime, the power-spawning (or power-enabling) exercise of the first power may cause the value of assets subject to the second power to be included in the transfer tax base of the holder of the *first power* under the so-called "Delaware tax trap."[ix]

   b. The "Delaware tax trap" occurs when assets subject to a power of appointment (first power) are included in the power holder's (*H*'s) transfer tax base (gift tax base or gross estate depending on whether the triggering exercise is effectively testamentary) to the extent *H exercises* the power by creating another power over the assets in question (second power) that "under the applicable local law can be validly exercised so as to postpone the vesting of [future interests in the assets], or suspend the absolute ownership or power of alienation of such [assets], for a period ascertainable without regard to the date of creation of the first power." If local perpetuities reform will enable the second power (the power created, or to which property is subjected, by *H*) to be exercised so as, for example, to postpone the vesting of future interests in the subject assets for a period *without end*, that period will be "ascertainable," if at all, "without regard to the date of creation of [*H*'s] power," and the Trap will be sprung. [x]

2. Another issue arises when a special power of appointment (fiduciary or nonfiduciary) is being exercised over trust assets "grandfathered" from the federal generation-skipping transfer (GST) tax in a jurisdiction whose perpetuities reform does not expressly exclude such assets. [xi]

   a. Here the risk in the Grandfathered Assets Situation is that owing to perpetuities reform, the exercise of a fiduciary or nonfiduciary special power of appointment to move assets of a grandfathered trust to another trust will bring it about that the vesting of future interests in, or absolute ownership of, those assets may be postponed or suspended beyond the Regulatory RAP testing period and will thereby forfeit grandfathered status. [xii]

3. The last issue (GST Exemption Situation) arises when the holder of a fiduciary or nonfiduciary special power of appointment wants to play safe with assets of a pre-perpetuities-reform trust to which "GST exemption" has been allocated in a jurisdiction in which, apart from any exclusion for GST tax grandfathered assets, it is possible to appoint into the reformed perpetuities regime. [xiii]

   a. The risk in this situation is that the exercise of a fiduciary or nonfiduciary special power of appointment over GST-exemption-sheltered assets will bring it about that the vesting, absolute ownership, or power of alienation of an interest in the assets may be postponed or suspended beyond the Regulatory RAP testing period, thereby taking the case out of a safe harbor the IRS seems to have invented and bruited about for preserving the efficacy of prior allocations of GST exemption.[xiv]

II. Doctrine of Worthier Title

A. **Rule**

An owner of real property can transfer land to heirs only through the "worthier" method of descent (intestate succession), not by means of devise or conveyance.

B. **Illustrated**

If A deeds property to B for life, and then to the heirs of A, the effect of the doctrine is that A has a reversion, while B has a life estate. *If the heirs of A are to receive an interest, it will only be at the death of A, not at the death of B.*

C. **History**

1. English Law

   a. Originally a mandatory rule of law nullifying a transfer of a future interest to transferor's heirs.

   b. Established as part of the English feudal law.

   c. Created to force assets to pass by descent, thus triggering an inheritance tax.

   d. In early stages only applicable to transfers of land.

e. Abolished in England by the Inheritance Act in 1833.

2. American Law

a. *Doctor v. Hughes*[xv], recast the American version of the doctrine as a rule of construction.

i. The doctrine does not survive as an absolute prohibition limiting the power of a transferor.

ii. But in order to transform into a remainder what would ordinarily be a reversion, such intention must be clearly expressed.

iii. Some states however continued to apply the doctrine as a mandatory rule of law.

b. Construction applied to both land and personalty.

c. Cases after *Doctor v. Hughes* allowed contrary intent against the doctrine to be shown from the instrument as a whole or from surrounding circumstances.

D. **Modern Application**

1. The Restatement of Property provides that the doctrine of worthier title is not recognized as part of American law, neither as a rule of law nor as a rule of construction [xvi].

2. The original rationale for the doctrine is no longer applicable

a. Intent-defeating

b. Can produce negative tax consequences

c. Against public policy

3. The Uniform Probate Code also provides that the doctrine is abolished both as a rule of law and as a rule of construction[xvii].

III. <u>Ademption</u>

A. **Rule**

When specifically devised property is no longer in the testator's estate, the beneficiary's gift fails.

1. Applies whether the property was intentionally or unintentionally removed from the testator’s estate.

    a. If a car was left to an individual under a Last Will but such car was given to someone else during testator’s lifetime (intentional).

    b. If a car was left to an individual under a Last Will but such car was repossessed (unintentional).

2. Applies if the item substantially changes in character; so if a block of marble was left to someone under a Last Will and during the Testator’s lifetime, a statute was carved out of that marble, the gift would fail.

B. **Exceptions**

1. Does not apply to cash gifts.

2. Does not apply if the testator’s estate receives insurance proceeds derived from the loss of the property.

3. Does not apply to bequests where the testator names the source for a cash bequest, even if that source is no longer in the testator’s estate at death; so if $100,000 from account at Bank of America is left to someone under a Last Will, even if the Bank of America account doesn’t exist, the $100,000 is still owed from a different source.

IV. <u>Abatement</u>

A. **Rule**

When an estate does not contain enough assets to satisfy the bequests, some or all of the bequests will be reduced or eliminated in a set order by class of bequest. This will ensure specific distributions are funded and achieved before more general ones.

B. **Most common pattern of abatement under a Last Will:**

1. Intestate property

2. Residuary devises

3. General devises (cash gifts)

4. Demonstrative devises (gifts from a specific account)

5. Specific devises (specific items of property)

V. <u>Rule in Shelley's Case</u>

A. **Rule**

If a conveyance creates a life estate in a transfer and also creates a remainder in that transferee's heirs, then the future interest belongs to the transferee, not the heirs.

B. **Illustrated**

To A for life then to A's heirs. The remainder interest belongs to A, not A's heirs. *Essentially, merges the interests and the life estate is irrelevant; A holds the entire interest.*

C. **History**

1. Rule of feudal origin, coining its name from the case of *Wolfe v. Shelley*, although its origins date prior to the case.

2. Purpose of the rule was to generate taxes from land passing by inheritance, rather than as an inter-vivos transfer.

3. In 1925, the Rule in Shelley's Case was abolished in England.

4. The Rule in Shelley's Case has been abolished in an overwhelming majority of states in the United States.

VI. <u>Reciprocal Trusts</u>

A. **Rule**

If two trusts exist, the trusts will be "uncrossed" if they meet three criteria:

1. They have substantially identical terms

2. They were created at the same time

3. They are part of the same transaction

Reciprocal trusts will be treated as if it benefits the person from whom it came.

B. **History**

1. Doctrine first arose in *Lehman v. Commissioner*[xviii], when the court uncrossed trusts and included the entire amount as part of the decedent's estate.

2. In 1969 in the case of *United States v. Grace*[xix], the Supreme Court held that "the reciprocal trust doctrine requires only that the trusts be

interrelated, and that the arrangement, to the extent of mutual value, leave the settlors in approximately the same economic position as thy would have been in had they created trusts naming themselves as life beneficiaries." The motive for creating the trusts was not relevant.

3. In *Estate of Herbert Levy*[xx], only one of the trusts, the husband gave the wife a power of appointment, exercisable during her life, in favor of anyone but herself, her creditors, her estate, or the creditors of her estate. The court held that the husband and wife had markedly different interests in, and control over, the trusts created by each other and the reciprocal trust doctrine didn't apply.

C. **Ways to Avoid the Reciprocal Trust Doctrine**[xxi]

1. Draft the trusts pursuant to different plans.

2. Don't put a husband and wife in the same economic position following the establishment of the two trusts.

3. Use different distribution standards in each trust.

4. Use different trustees or co-trustees.

5. Give one spouse a non-cumulative 5x5 power, but not the other.

6. Give one spouse a special power of appointment, but not the other.

7. Give one spouse the broadest possible special power of appointment and the other spouse a special power of appointment exercisable only in favor of a narrower class of permissible appointees.

8. Give one spouse a power of appointment exercisable both during lifetime and by Last Will and the other spouse a power of appointment only by Last Will.

9. Create different vesting provisions for each trust.

10. Instead of mandating distributions, give the beneficiaries control, or a different degree of control, at different ages.

11. Vary the beneficiaries.

12. Create the trusts at different times.

13. Contribute different assets to each trust.

[i] *Death By A Thousand Cuts: The Rule Against Perpetuities*, 25 J. Legis. 141, 142

[ii] *STUDENT WORK: Equitable Modification: Ameliorating the Harsh Consequences of the Common-Law Rule Against Perpetuities While Eliminating the Uncertainty of the Uniform Statutory Rule Against Perpetuities*, 102 W. Va. L. Rev. 221, 222

[iii] *The Rule Against Perpetuities: A Survey of State (AND D.C.) Law*, https://www.actec.org/assets/1/6/Zaritsky_RAP_survey.pdf

[iv] Estate Planning Newsletter #2263 (December 18, 2014) at www.leimbergservices.com

[v] *Symposium: The Role of Federal Law in Private Wealth Transfer: Unconstitutional Perpetual Trusts*, 67 Vand. L. Rev. 1769, 1821

[vi] *Id.*

[vii] Estate Planning Newsletter #2263 (December 18, 2014) at www.leimbergservices.com

[viii] *Means to an End: Electively Forcing Vesting to Suit Tax Rules Against Perpetuities*, James P. Spica, ACTEC Law Journal Vol. 40:347, 348.

[ix] *Id.*

[x] *Id*. at 349

[xi] *Id.*

[xii] *Id.* at 351

[xiii] *Id.*

[xiv] *Id.* at 351-352

[xv] *Doctor v. Hughes*, 122 N.E. 221 (N.Y. 1919)

[xvi] *Restat 3d Property*: Wills and Other Donative Transfers, § 16.3.

[xvii] Uniform Probate Code (UPC) § 2-710

[xviii] *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940)

[xix] *United States v. Grace*, 395 U.S. 316 (1940)

[xx] *Estate of Herbert Levy*, T.C. Memo, 1983-453 (1983)

[xxi] *Beware of the Reciprocal Trust Doctrine*, Bruce D. Steiner and Martin M. Shenkman, Estate Planning & Taxation, April 2012