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The Death of the Life in Being—The Required Federal Response to State Abolition of the Rule Against Perpetuities

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THE DEATH OF THE LIFE IN BEING—THE REQUIRED FEDERAL RESPONSE TO STATE ABOLITION OF THE RULE AGAINST PERPETUITIES

I. INTRODUCTION

Not long after the idea of private property was first recognized, property owners began seeking ways to maintain control of their property and its use even after death.[1] For nearly as long, governments have sought ways to keep property from being controlled from beyond the grave.[2] The rulers of the past realized that allowing such restraints on the alienation of land would not only hurt the marketability of land,[3] but could also result in violent revolutions caused by land hunger among peasants and the presence of a subservient serf class.[4]

One of the first, and surely the most lasting, of these attempts to avoid "dead hand"[5] control of assets was the Rule Against Perpetuities (the "Rule").[6] The Rule is a product of English law that has been part of American common law since the birth of the Republic. The Rule has also been the bane of many a practicing lawyer, not to mention causing first year law students many sleepless nights.[7] The basic Rule states that "a future interest which, by any possibility, may not vest within twenty-one years after

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1. Property commentators have referred to control of property after the death of the grantor as the "dead hand." *See* Lawrence M. Friedman, *The Law of Succession in Social Perspective, in* DEATH, TAXES AND FAMILY PROPERTY 23 (Edward C. Halbach, Jr. ed., 1977).

2. For a description of the various governmental attempts to stop restraints on alienation and the legal maneuvers used to circumvent these attempts, *see* LEWIS M. SIMES, HANDBOOK ON THE LAW OF FUTURE INTERESTS 362-67 (1951).

3. *See* SIMES, *supra* note 2, at 362. Future interests create divided title requiring agreement among the parties in order to be marketable. This agreement is made more difficult when the future interest is contingent or the future interest is in favor of a person who is unknown at the creation of the interest. *See id.*

4. *See* W. BARTON LEACH & OWEN TUDOR, THE RULE AGAINST PERPETUITIES 15 (1957) (discussing the affect of restraints on alienation).

5. *See* Friedman, *supra* note 1, at 23.

6. For a discussion of the history of the Rule Against Perpetuities, see *infra* notes 16-69 and accompanying text.

7. The complexity of the Rule is so commonly accepted that the Supreme Court of California held that an attorney was not liable for professional malpractice to the intended beneficiaries of a will for placing a provision in the will that violated the Rule and thereby destroyed the distribution scheme intended by the donor. *See* Lucas v. Hamm, 364 P.2d 685, 690 (Cal. 1961). The Rule has been described by one commentator as "a technicality-ridden nightmare" that is a "dangerous instrument in the hands of most members of the bar." W. Barton Leach, *Perpetuities Legislation, Massachusetts Style*, 67 HARV. L. REV. 1349, 1349 (1954).

a life or lives in being at the time of its creation is void in its inception."[8] The Rule has stood for centuries as the primary weapon against restraints on the alienation of property and accumulation of wealth from generation to generation.

More recently, the United States government has attempted to stop the influence of the "dead hand." In order to lessen accumulation of wealth by families from generation to generation, Congress adopted the estate tax, which taxes the transfer of property between generations.[9] In 1978, Congress adopted the generation-skipping transfer tax based on the philosophy that wealth should be subject to the estate tax at least once in each generation.[10] The generation-skipping tax levies a tax on any conveyances of property to a generation more than once removed from the donor. This tax is calculated at the maximum estate tax rate. Therefore, it creates a disincentive to the gifting of future interests, which in turn promotes the free alienation of property.

Until recently, the Rule and the generation-skipping tax have worked in unison to restrict the power of the "dead hand" to control property from beyond the grave. The generation-skipping tax imposed a punitive tax on any conveyance of a future interest to any generation other than the next generation.[11] The Rule also assured that, if any future interest was conveyed, it would be limited in duration. In the last few years, however, a number of states have abolished the Rule.[12] This trend has created an opportunity for estate planners that could result in the exemption of wealth from the estate tax for very long periods of time, possibly forever.[13] The abolition of the Rule also resurrects the "dead hand," allowing it to again control the use and disposition of wealth from beyond the grave. Although at present only six states have abolished the Rule,[14] it is likely that their actions will create a race to the bottom as states attempt to attract trust assets and management for the coincident increase in state taxes and fees. This trend has clearly occurred in the area of corporate law, where states have taken Delaware's lead in a race

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8. CORNELIUS J. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 197 (2d ed. 1988).

9. The estate tax was enacted in 1916. *See* 39 STAT. 777-80, 1002 (1916). The tax was enacted to compensate for the decline in customs duties resulting from World War I and to help pay for the cost of the war effort. *See* H.R. REP. NO. 922, 64th Cong., 1st Sess. 1 (1916). The constitutionality of the tax was upheld in New York Trust Co. v. Eisner, 256 U.S. 345 (1921).

10. For a discussion of the generation-skipping transfer tax, see *infra* notes 70-123 and accompanying text.

11. The generation-skipping transfer tax provides a one million dollar exemption from the value of the estate subject to tax, which allows a significant sum to be given to generations more than once removed from the donor without the imposition of the tax. *See infra* note 112.

12. *See infra* note 124 for a list of state statutes abolishing the Rule.

13. For a discussion of perpetual trusts, see *infra* notes 126-31 and accompanying text.

14. *See infra* note 124.

to the bottom, and there is no reason to assume that momentous changes in trust law, such as the abolition of the Rule, will have any lesser effect.

These recent developments create several problems that must be addressed. First, the federal government must develop new tax laws or modify the existing law to somehow avoid the vast accumulations of wealth that can be created by perpetual trusts, which allow millions of dollars to escape estate taxation from generation to generation in perpetuity. Second, the government must address the effect of the abolition of the Rule on the free alienability of property. Third, the government must find a way to replace the billions in tax revenues that will be lost over the years through the use of perpetual trusts.[15]

Part II of this Note discusses the history of the Rule, the mechanics of the Rule in action, the purposes of the Rule, and how the Rule accomplishes its purposes. Part III discusses the history behind the United States estate and gift taxes. Specifically, Part III examines how and when the generation-skipping transfer tax is applied and the purpose behind that tax. Part IV then discusses recent changes in state law regarding the Rule and the effect these changes could have on the preservation and taxation of wealth that are controlled by the Rule and by the generation-skipping tax. Finally, Part V outlines possible legislative responses to these state law changes and presents a suggestion as to which option is preferable for adoption by Congress.

II. HISTORY OF THE RULE AGAINST PERPETUITIES

A. Early Feudal Property Rules

The Rule has been the primary judicial restraint on the "dead hand" since it was first formulated in 1682.[16] However, the Rule only arose as a final step after years of conflict between courts, trying to maintain the alienability of property, and feudal lords, attempting to amass and control wealth over

15. In 1997, total collections by the Internal Revenue Service were $1,623,272,071,000. Of this amount, $20,356,401,000 was from estate and gift taxes. This represents over one and a quarter percent of total collections. IRS, *1997 IRS Annual Data Book* (Jan. 12, 1999) <http://www.irs.ustreas.gov/prod/tax_stats/soi/other_tc.html>. While this entire amount would not be lost in the absence of the Rule, a large portion of it would be lost, as the majority of taxpayers subject to the estate, gift, and generation-skipping taxes are very wealthy and would have the resources to take advantage of perpetual trusts in order to avoid estate taxes.

16. The Rule was first formulated in the *Duke of Norfolk's Case*, 3 Ch. Cas. 1, 26 (1682), *cited in* LEACH & TUDOR, *supra* note 4, at 14. However, its formulation evolved over the next 150 years until it attained the form we see today after *Cadell v. Palmer*, 1 Cl. & F. 372 (H.L. 1833), *cited in* LEACH & TUDOR, *supra* note 4, at 14.

generations.[17]

The first volley in this feudal tennis match came from the British Parliament with the enactment of the statute Quia Emptores in 1290 A.D.[18] After the statute Quia Emptores, the holder of a tenurial interest could convey his interest to another rather than being limited to passing the interest on to his next generation.[19]

In response to the free alienability provided to tenurial interest holders through the statute Quia Emptores, landholders began conveying land on the condition that the land would pass by inheritance only to the descendants of the donee.[20] With this limitation, the donee could not convey his interest to a third party because it would pass to the donee's own descendants upon his death or revert to the donor if the donee died without descendants.[21]

The courts quickly put an end to this practice by characterizing such a conveyance as a fee simple conditional.[22] Upon the donee having issue, the condition was met, the reversion was eliminated, and the donee could thereafter convey the land in fee simple to a third party.[23] Although this construction clearly did not provide for the true intent of the donor to maintain wealth for future generations, it did hinder the accumulation of wealth by a small number of families and supported the alienability of real property, the main source of wealth in feudal England.[24]

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17. *See* SIMES, *supra* note 2, at 362-67.

18. *See* 18 Edw. ch. 1, *cited in* MOYNIHAN, *supra* note 8, at 19. Quia Emptores is Latin for "because purchasers." The statute is simply named after its two opening words. Latin or French were the languages of English law until the fifteenth century. *See id.* For a general discussion of the effects of the statute Quia Emptores, see HARRY A. BIGELOW, CASES AND MATERIALS ON RIGHTS IN LAND 13-14 (3d ed. 1945).

19. The statute Quia Emptores forbade subinfeudation and provided that all alienation would be by substitution. This added much-needed simplicity to the system of tenures, resulting in the preservation of the feudal rights of wardship, marriage, relief, and escheat, and vastly increasing the power of the lord over his bailiff. *See* THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 30-31, 540-41 (5th ed., Little, Brown and Company 1956). For a general discussion of feudal incidents, see MOYNIHAN, *supra* note 8, at 15-18.

20. *See* SIMES, *supra* note 2, at 10.

21. *See id.* This conveyance took the form, "To B and the heirs of his body." The intent was to create a life estate in the donee with a remainder in his heirs and a reversion in the donor. *See id.*

22. *See* MOYNIHAN, *supra* note 8, at 34-35.

23. *See* PLUCKNETT, *supra* note 19, at 550-51.

> [I]f heirs of the prescribed class are born, they only are called to the succession; and if the feoffee has alienated to someone else, that alienation is good and his heirs will be bound to warrant, since they can claim nothing save by succession and descent from their parents—although some people think that they were enfeoffed at the same time as their parents, which is not true.

Id. The courts did not go so far as to state that this created a fee simple in the donee. If the donee had not conveyed the land before his issue died, the land would still revert to the donor upon the donee's death. *See* MOYNIHAN, *supra* note 8, at 34-35. *See also* PLUCKNETT, *supra* note 19, at 550-51 (discussing courts' interpretations of the conditional fee prior to the Statute De Donis).

24. *See* MOYNIHAN, *supra* note 8, at 34-35. Commentators have speculated that this construction

Parliament quickly responded to the judicial creation of the fee simple conditional and the frustration it caused to the intent of donors.[25] In order to preserve the intent of donors, the Statute De Donis Conditionalibus[26] was passed in 1285. This statute abolished the old common law estate of fee simple conditional[27] and created the fee tail, by which an estate would pass only to the lineal descendants of the original donee and would revert to the donor if no descendants existed.[28]

The fee tail stood as the preeminent rule in land conveyances until 1472, when the courts finally responded to the inalienability of land created by the estate tail.[29] Through the use of common recoveries and the Statute of Fines,[30] the estate tail could be barred and the reversion in the donee and remainder in the lineal descendants destroyed, thereby creating a fully

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was at the urging of the Crown, of whom the courts of the day were agents. The Crown was threatened by the accumulation of land, the real source of power and wealth in feudal England, in the hands of a small number of people. By encouraging the alienability of land, the courts promoted the diffusion of land holdings among a larger number of people, thus ensuring that no one person could ever rival the King in landholdings and, therefore, in power or wealth. *See* Leonard Levin & Michael Mulroney, *The Rule Against Perpetuities and the Generation-Skipping Tax: Do We Need Both?*, 35 VILL. L. REV. 333, 336 n.14 (1990).

25. Historically, Parliament was the representative body of the feudal lords. Therefore, it is not surprising that every time the Crown sought to limit the power of the lords through the courts, Parliament stepped in to restore the powers taken by the courts. *See* Levin & Mulroney, *supra* note 24, at 337.

26. *See* 13 Edw. ch. 1, (1285), *cited in* MOYNIHAN, *supra* note 8, at 35 n.1. The opening words of the statute translate to read "Concerning gifts of land made upon a condition. . .." *See id.* The preamble to the statute provides, in part:

> Concerning tenements which are often given on condition, *viz.* when one gives his land to a man and his wife and the heirs begotten of that man and woman, with an express condition added that if the man and woman die without heir begotten of that man and woman the land thus given shall revert to the donor or his heir . . . [I]t seemed (and still seems) hard to donors and their heirs that the intention expressed in the gift so far has not been (and is still not) observed for in all such cases after the birth of issue to the donees of such a conditional gift, the feoffees have so far had the power of alienating the tenement so given . . . which was manifestly against the form of the gift. Wherefore our lord the King . . . has established that the will of the donor according to the form manifestly expressed in the charter shall henceforth be observed.

PLUCKNETT, *supra* note 19, at 551-52.

27. *See* MOYNIHAN, *supra* note 8, at 35.

28. *See* SIMES, *supra* note 2, at 11. The fee tail estate would last as long as there were lineal descendants of the original donee and prevented the original donee from conveying the property and thereby eliminating the property interest of the heirs or reversioner. The fee tail progressed to allow very specific descriptions of who would take after the life tenant. A donor could create a fee tail male or female, so that only male or female descendants, respectively, could take. He could make the fee tail special or general so that the descendants to take could only be from a specified wife or from any wife. *See* MOYNIHAN, *supra* note 8, at 35-37.

29. *See* Taltarum's Case, Y.B. 12 Edw. 4, 19 (1472), *cited in* MOYNIHAN, *supra* note 8, at 36.

30. For a detailed discussion of the disentailing devices of fines, warranties, and recoveries, see PLUCKNETT, *supra* note 19, at 613-15, 617-22.

alienable fee simple absolute.[31] Because of the ability to bar the tail, the fee tail fell out of use in England and was never significantly followed in American law.[32]

Two other prominent judicial policies that aided in the destruction of remainders and promotion of free alienability of property were the Rule in Shelley's Case and the Doctrine of Worthier Title. Under the Rule in Shelley's Case, if a conveyance creates a life estate in a person, with a remainder in his or her heirs, the life tenant will take the land in fee simple and the heirs will get nothing.[33] Under the Doctrine of Worthier Title, a remainder cannot be created in a donor's heirs. Therefore, the reversion is held by the donor until his death, at which time, the reversion passes to his heirs by descent.[34]

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31. JOHN CHIPMAN GRAY, THE RULE AGAINST PERPETUITIES 14 (4th ed. 1942). An action under common recovery or the Statute of Fines originally only worked to bar the rights of the issue, but it was later determined that common recovery could bar the rights of the reversioner or remainderman as well. *See* SIMES, *supra* note 2, at 11. The requirement for a judicial proceeding to bar the entail was done away with in 1833, and owners of a fee tail could bar the entail simply by conveyance and recording of the deed in the Court of Chancery. *SEE* MOYNIHAN, *supra* note 8, at 36.

32. For a discussion of how the fee tail has been construed in the United States, see RESTATEMENT OF THE LAW OF PROPERTY §§ 78-87 (1936 & Supp. 1989). The only states that still allow the fee tail as it existed at common law are Delaware, Maine, Massachusetts, and Rhode Island (as to deeds only). The states that have created a statutory substitute to the fee tail have generally taken three different approaches. The most common form of statutory substitute converts what is a fee tail by construction into a fee simple estate in the donee. The next most common approach is to convert the fee tail into a life estate in the donee with a remainder in the issue of the donee. The final strategy, used by Connecticut, Ohio, and Rhode Island (as to wills only) allows the fee tail to remain for the donee but provides that the issue will take in fee simple upon the donee's death. *See* MOYNIHAN, *supra* note 8, at 38.

33. *See* LEWIS M. SIMES & ALLAN F. SMITH, THE LAW OF FUTURE INTERESTS 422 (2d. ed. 1956). The Rule in Shelley's Case was first stated by Lord Coke in *Shelley's Case*, 1 Co. Rep. 93b (1579-81), *cited in* SIMES, *supra* note 2, at 64. Lord Coke stated the Rule in Shelley's Case as follows:

> it is a rule in law, when the ancestor by any gift or conveyance takes an estate of freehold, and in the same gift of conveyance an estate is limited either mediately or immediately to his heirs in fee or in tail; that always in such cases, 'the heirs' are words of limitation of the estate, and not words of purchase.

Shelley's Case, 1 Co.Rep. 93b at 104a (1579-81), *cited in* SIMES, *supra* note 2, at 64. The Rule in Shelley's Case has been abrogated, either in whole or in part, by statute in almost two-thirds of American jurisdictions. The abrogating statutes normally create a life estate in the ancestor with a contingent remainder to his heirs from a conveyance to which the Rule in Shelley's Case would previously have applied. In some states, the statutes are worded such that there is a question as to whether the Rule in Shelley's Case may still be applicable in certain situations. Many of the statutes abolishing the Rule in Shelley's Case are fairly recent and, because they do not apply retroactively, it will be a long time before the Rule in Shelley's Case is merely a piece of legal history fit only for debate by academics. *See* MOYNIHAN, *supra* note 8, at 150. For a general discussion of the Rule in Shelley's Case, *see* SIMES & SMITH, *supra*, at 421-90.

34. *See* MOYNIHAN, *supra* note 8, at 151. Under a testamentary transfer, if the devise gives to the heirs the same interest (a remainder) that they would have had by descent (a reversion), they must take by descent rather than by devise. If the transfer is inter vivos, the remainder is void and the reversion stays with the donor until his death at which time it transfers to his heirs by descent. *See id.* The

The tension between the land-owning lords and Parliament on the one hand, who wanted to maintain their lands for future generations, and the courts and Crown on the other, who wished to promote the free alienability of land, produced a number of other lesser rules of conveyance. Prior to the Statute of Uses, which allowed the creation of remainders in persons other than the heirs of the donee,[35] all future interests had to be in favor of the donor or his heirs, unless the future interest was a remainder.[36] Because a remainder required a prior estate, the remainder could be destroyed if the condition on the remainder was not satisfied before the prior estate ended.[37] This principle was often used to allow a life tenant to convey in fee simple. In most cases the eldest son of the donor was both the life tenant and, upon death of the donor, the holder of the reversion. If both the reversion and life estate were conveyed to a third person, the estates would merge into one, thereby destroying the life estate. Once the life estate was destroyed it would no longer support the contingent remainder, resulting in the failure of the remainder and the reversion, and thereby vesting the estate in the third party in fee simple absolute.[38]

The purpose of the above rules regulating the transfer of property was to preserve the feudal incidents owed by feudal vassals to their lords.[39]

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rationale for the Doctrine of Worthier Title was, as stated by Lord Coke, "for the ancestor during his life beareth in his body (in judgment of law) all his heirs, and therefore it is truly said that *haeres est pars antecessoris*." *Id.* at 151 n.1. The phrase *haeres est pars* is translated to mean "the heir is the bridge to the ancestor." For a general discussion of the Doctrine of Worthier Title, *see* SIMES & SMITH, *supra* note 33, at 491-521.

35. *See* 27 Hen. 8, ch. 10 (1536), *cited in* PLUCKNETT, *supra* note 19, at 585-86.

36. *See* MOYNIHAN, *supra* note 8, at 119. To qualify as a remainder, a future interest must meet four requirements: (1) it must be created in a transferee; (2) it must be created simultaneously with a prior estate; (3) it must become a present interest at the termination of the prior estate; and (4) the prior estate must be lesser than the entire estate held by the donor. *See* SIMES, *supra* note 2, at 27.

37. For a general discussion of the destructibility of contingent remainders, see MOYNIHAN, *supra* note 8, at 133-39. A majority of states have abrogated the destructibility rule. *See id.* at 138. As to the states that have not yet decided the issue, it is believed that the position taken in the RESTATEMENT OF THE LAW OF PROPERTY that contingent remainders are not destructible will influence their decisions in the future. *See id.* The only states whose case law still recognizes the existence of the destructibility rule are Florida, Oregon, Pennsylvania, and Tennessee. Even where the destructibility rule has not been abrogated, its effect in modern estate law is negligible due to the fact that the rule only applies to legal interests in real estate, while most estates today consist of securities held in trust. *See* Levin & Mulroney, *supra* note 24, at 338 n.24.

38. *See* SIMES, *supra* note 2, at 49-53. For a discussion of the use of destructibility and the concept of tortious feoffment, see *id.* (discussing Archer's Case, 1 Co.Rep. 66b (1598) and Loddington v. Kime, 1 Salk. 224 (1695)). The English conveyancing bar sought to eliminate a life tenant's ability to destroy remainders by establishing trusts to support the remainder after termination of the life estate. *See* MOYNIHAN, *supra* note 8, at 137-38.

39. *See* MOYNIHAN, *supra* note 8, at 142-43, 153. The difficulty in transferring land, which made it easier for the lords to know who was responsible for the feudal incidents and forced heirs to take by descent rather than devise, preserved the feudal rights which did not apply if the heir took by purchase.

However, these rules continued to govern the law of property long after the feudal incidents ceased to exist.[40] It was only with the diminished importance of land as a source of wealth and power, and the increased importance of personalty, that the effect of these feudal property rules began to diminish.

B. The Rule Against Perpetuities

Despite the demise of the feudal incidents that provided the rationale behind the Rule, the English courts still found social and economic value in discouraging accumulations of wealth from generation to generation. The Rule was designed to revive this policy in the face of the waning authority held by previous rules. Although the Rule evolved over time, it was first stated in the *Duke of Norfolk's Case*.[41] In that case, Lord Chancellor Nottingham defined a perpetuity as:

> the settlement of an estate . . . with such remainders expectant upon it, as are in no sort in the power of the tenant . . . to dock by any recovery . . . but such remainders must continue as perpetual clogs upon the estate; such do fight against God for they pretend to such a stability in human affairs, as the nature of them admits not of, and they are against the reason and the policy of the law, and therefore not to be endured.[42]

The Rule in its final state serves several purposes: (1) to provide a settled law upon which planners can rely; (2) to balance the interest of control of the current property owner with the interest of freedom of use of the future

See id. at 142-43.

40. *See id.* at 143. The continued use of these property rules is explained by the desire of the courts to promote the free alienability of land. Although these rules were constant sources of dispute, some of them persisted in England as late as 1925 when the Rule in Shelley's Case was abolished by the Law of Property Act, 15 & 16 Geo. 5, ch. 20, § 131 (1925). *See id.*

41. 3 Ch. Cas. 1 (1682), *cited in* SIMES, *supra* note 2, at 364.

42. SIMES, *supra* note 2, at 364 n.10. Lord Chancellor Nottingham did not actually state the period of perpetuities in the *Duke of Norfolk's Case*. It was only stated that a contingent interest would be valid if it were to vest within a life in being at the time of creation. *See* SIMES, *supra* note 2, at 365. When asked what period would be invalid, Lord Nottingham stated "I will stop where-ever any visible inconvenience doth appear; for the just bounds of a fee simple upon a fee simple are not yet determined, but the first inconvenience that ariseth upon it will regulate it." PLUCKNETT, *supra* note 19, at 598. It should be noted that, as first used in the law, the word perpetuity had nothing to do with remote future interests. For a discussion of the prior uses of the word "perpetuity," see SIMES & SMITH, *supra* note 28, § 1211 at 91-94. In light of all the difficulties caused by Lord Nottingham's Rule, it is ironic that in defending his decision, he stated "[p]ray let us so resolve cases here, that they may stand with the reason of mankind when they are debated abroad. Shall that be reason here that is not reason in any part of the world besides?" PLUCKNETT, *supra* note 19, at 597. Obviously, Lord Nottingham had no idea of the lasting and confusing effect his words would have on the state of property law for the next three hundred years.

owner; (3) to promote the flow of wealth in society; and (4) to permit use by current owners without being hindered by the uncertain future interests of possibly unascertained persons.[43]

The Rule in its present form states that "[n]o interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the estate."[44] The Rule was applicable to all conveyances, whether made under the old feudal rules or under a trust in equity,[45] regardless of whether the interest in question was a contingent remainder or an executory interest.[46]

The Rule was not applicable, however, when an interest was vested, even though possession was delayed until a future date. The rationale for this distinction was that while a contingent remainder was inalienable, a vested remainder could be conveyed to a third party.[47] Like the rules that came before it, the purpose of the Rule was to promote alienability of property. Since vested interests were already fully alienable, it was not necessary for the Rule to apply to them.[48]

The change in the emphasis of the Rule from one governing only interests in land to one governing all equitable interests seems to have developed over time without any realization that it included a change in the purpose and

43. *See* 1 RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS 8-10 (1981) (Introductory Note to Part I).

44. *See* LEACH & TUDOR, *supra* note 4, at 12. The twenty-one year limitation was not part of the original Rule. The twenty-one year period was drawn from the period or minority during which an estate tail could not be barred. If a life tenant's son was born at the time of the life tenant's death, then the estate tail would be unbarrable for a life in being plus twenty-one years. It was felt that if a person could not bar the tail for this period, then a perpetuity should be allowed for this period as well. *See* SIMES, *supra* note 2, at 365-66. Courts eventually held that the twenty-one year period would apply even absent an actual period of minority. The courts also expanded the Rule to allow for a period of gestation, but this expansion was limited only to instances of actual gestation and did not add to the general time requirement as the twenty-one year limitation did. *See* Cadell v. Palmer, 1 Cl. & F. 372 (1833), *cited in* SIMES, *supra* note 2, at 366 n.19. Finally, courts determined that more than one life could be used as the measuring life and the life need not be of a person with a beneficial interest in the devise, so long as the lives chosen were not so many or so situated such that it would be "almost, if not quite, impracticable to ascertain the extinction of the lives described[.]"Thellusson v. Woodford, 11 Ves. Jr. 112 (1805), *cited in* LEACH AND TUDOR, *supra* note 4, at 46-47 n.2.

45. *See* LEACH & TUDOR, *supra* note 4, at 14-16.

46. *See* GRAY, *supra* note 31, at 316. For a basic discussion of the Rule, *see* W. Barton Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638 (1938). For a modern treatment of the Rule, see ROBERT J. LYNN, THE MODERN RULE AGAINST PERPETUTIES (1966).

47. *See* MOYNIHAN, *supra* note 8, at 121-22.

48. This policy argument for the differing treatment of vested and contingent remainders under the Rule loses much of its force when we observe that the Rule was later applied to interests held in trust in which the trustee had complete power to alienate the property of the trust. *See, e.g.*, Leake v. Robinson, 2 Mer. 363 (Ch. 1817), *reprinted in* LEWIS M. SIMES, CASES AND MATERIALS ON THE LAW OF FUTURE INTERESTS, 609-14 (2d ed. 1951).

approach of the Rule.[49] Therefore, the differing treatment between vested and contingent remainders continued, even though there was no longer a difference in alienability between the two types of interests.[50]

C. Criticism of the Rule

Although the Rule is superior to many other attempts to promote alienability of property, it has been subject to criticism since its inception. Much dissatisfaction comes from the fact that the Rule is rigid and mathematical. These traits result in failure of interests that violate the letter of the Rule but not the spirit of the Rule, and the affirmation of interests that violate the spirit of the Rule simply because they have been crafted within the requirements of the letter of the Rule.[51] Critics have also stated that the complexity of the Rule makes it a trap for practitioners.[52]

One of the major criticisms of the Rule is that it invalidates an interest if there is any possibility, however unrealistic, that the interest may vest outside of the perpetuities period.[53] The primary example of this situation is in the "fertile octogenarian" case, in which the court presumes that an eighty-year-old woman is capable of having children and that, therefore, a gift to her heirs who reach the age of twenty five would violate the Rule.[54] Another example is the case in which an administrative contingency is required for vesting. Even if the contingency will almost surely occur within a limited time, the contingency will be invalid based on the possibility that it could vest outside of the perpetuities period, no matter how small that possibility may be.[55]

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49. *See* Levin & Mulroney, *supra* note 24, at 343.

50. *See* MOYNIHAN, *supra* note 8, at 121-22; *see also* LEACH & TUDOR, *supra* note 4, at 15-16.

51. *See* LEACH & TUDOR, *supra* note 4, at 16. Therefore, under the Rule, a gift "to my daughter for life with the remainder to her children who reach twenty-five" would be invalid, while a gift "to descendants living twenty-one years after the death of all descendants of King Edward VII now living" would be valid. *See id.* at 16 n.8.

52. *See* Levin & Mulroney, *supra* note 24, at 344; *see also supra* note 6 and accompanying text.

53. *See* LEACH & TUDOR, *supra* note 4, at 39.

54. *See* GRAY, *supra* note 31, at 214. The "fertile octegenarian" case is based on the presumption that all people are capable of having issue. Therefore, a gift by an eighty year old woman to her children that reach the age of twenty-five would be invalid on the assumption that all of her then living children could die immediately after the devise, she could have another child immediately after the devise, and then she would die resulting in the failure of the interest to vest within a life in being at the creation of the interest plus twenty-one years. *See* Jee v. Audley, 1 Cox Eq. Cas. 324 (1787), *cited in* LEACH & TUDOR, *supra* note 4, at 39 n.5; *see also* GRAY, *supra* note 31, at 214. It is amazing that in the centuries since the Rule was established, only one judge has seen the insanity involved in this presumption of possibility of issue. *See* Gavan Duffy, J. in Exham v. Beamish, [1939] Ir.R. 336 (Ch.), *cited in* LEACH & TUDOR, *supra* note 4, at 40 n.6.

55. *See* LYNN, *supra* note 46, at 59-60. A small number of courts have been willing to read a

Another aspect of the Rule that is criticized is the fact that a skillful drafter could create an interest that would last for over one hundred years without technically violating the Rule.[56] A drafter could choose a large, readily ascertainable class for the life in being and have the contingent interest vest twenty-one years after the death of the last of the group, thereby creating a valid interest that would not vest for generations.[57] Such a result cannot possibly be within the spirit of the Rule, yet it is perfectly valid under the Rule's application.

The Rule has further been criticized because it does not apply to reversions, remote reverters, or rights of reentry. The Rule does not apply to these interests, even though they could possibly last forever, resulting in major impediments to the alienability of land and marketability of title, thereby propagating large accumulations of wealth.[58] A similar criticism also arises in the case of a vested future interest which is not covered under the Rule. A vested future interest, while already vested in interest, is nevertheless not marketable due to the fact that it will not vest in possession until a much later time. The spirit of the Rule is violated by such an interest, yet the letter of the Rule does not apply.

D. Courts' Reactions to Criticism of Rule

Courts have acted to ameliorate these harsh, aspects of the Rule. For example, the principle that the Rule will remorselessly invalidate any interest which does not meet its requirements[59] has never been followed to its fullest extent. Courts have used a number of methods to promote the valid interests of the donor and to save careless drafters from the mistakes often brought about by the complexity of the Rule.[60] When construction was unclear, the courts favored a construction creating a vested interest, to which the Rule

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reasonable time into some administrative contingencies. *See, e.g.*, Belfield v. Booth, 27 A. 585 (1893), *cited in* LEACH & TUDOR, *supra* note 4, at 75 (holding that the settlement of an estate would occur in a reasonable time and therefore a contingency based on settlement of the estate would not violate the Rule).

56. *See* LEACH & TUDOR, *supra* note 4, at 16. *See generally* SIMES, *supra* note 2, at 370-73 (stating that the life in being can be any person or group of persons so long as the person(s) are ascertainable and not so numerous as to be void for indefiniteness).

57. *See In re* Villar, [1929] 1 Ch. 243, *cited in* SIMES, *supra* note 2, at 370 n.30 (holding that an interest that would not vest until twenty years after the death of the last descendant of Queen Victoria alive at the testator's death was valid).

58. *See, e.g.*, Lowry v. Murren, 236 N.W.2d 627, 630 (Neb. 1975) (holding that the Rule did not apply to a reversion as a vested interest); City of Klamath Falls v. Bell, 490 P.2d 515, 518 (Or. Ct. App. 1971) (holding that the Rule does not apply to a possibility of reverter).

59. *See* SIMES, *supra* note 2, at 368.

60. *See* Levin & Mulroney, *supra* note 24, at 346.

would not apply, rather than a construction creating a contingent interest that could be in violation of the Rule and therefore void.[61] In addition, invalid interests were often severed from other valid interests so that at least some of the transfer could stand, as opposed to declaring the entire transfer void.[62] Invalid transfers were also allowed to stand if they were based on multiple contingencies and at least one of the contingencies would not be in violation of the Rule.[63] Finally, courts held that if the contingency had already occurred between the creation and exercise of a power of appointment, the interest would be valid even if at creation there was a possibility that the interest would not vest until after the end of the allowed perpetuities period.[64] An inter vivos trust in which the donor retained a power of revocation has been similarly treated, based on the actual vesting of the interest, rather than theoretical possibilities of when the interest could vest.[65] This "actual-events" approach has been followed in many instances to reduce the all-or-nothing harshness of the Rule.[66]

Recently, some courts have gone much further than the wait-and-see doctrine embodied in the actual-events test to alleviate some of the harshness of the Rule. These courts use a power based on equitable principles to reform the transfer to comply with the Rule so that the interests do not fail and the intent of the donor is accomplished.[67] Under this power, if, for instance, a

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61. *See* First Nat'l Bank of Atlanta v. Jenkins, 345 S.E.2d 829, 830 (Ga. 1986) (holding that there is a presumption in favor of vested over contingent interests so that the interest will not violate the Rule); Clarke v. Clarke, 116 S.E.2d 449, 453 (N.C. 1960) (same); *In re* McKee's Estate, 108 A.2d 214, 233 (Pa. 1954).

62. *See* Parker v. MacBryde, 132 F.2d 932, 936-37 (4th Cir. 1942) (holding that if the portion of a devise that violates the Rule is severable from the remainder of the devise, the devise will not fail as a whole but the valid portions will be severed from the invalid portions); American Trust Co. v. Williamson, 46 S.E.2d 104, 108 (N.C. 1948) (same). This concept is referred to as vertical severability. *See* McPherson v. First & Citizens Nat'l Bank, 81 S.E.2d 386, 397 (N.C. 1954). However, if allowing only portions of a transfer to stand would be less in line with the intent of the donor than invalidating the entire transfer, the court will declare the entire transfer void. This concept is known as infectious invalidity. *See* Walker v. Bogle, 260 S.E.2d 338, 339 (Ga. 1979) (holding that an executory interest that violated the Rule was an integral part of the dispositive plan and therefore the violation made the entire plan void).

63. *See, e.g.,* Springfield Safe Deposit & Trust Co. v. Ireland, 167 N.E. 261, 263 (Mass. 1929) (holding that a transfer having an alternative contingency that satisfies the Rule is valid).

64. *See, e.g.,* In re Warren's Estate, 182 A. 396 (Pa. 1936); Minot v. Paine, 120 N.E. 167 (Mass. 1918).

65. *See* Nat'l Shawmut Bank v. Joy, 53 N.E.2d 113 (Mass. 1944) (holding that a power of revocation should have the same affect in relation to the Rule as a power of appointment).

66. *See* LEACH & TUDOR, *supra* note 4, at 63-67, 76-78. For a modern discussion of the wait-and-see approach, see 1 RESTATEMENT (SECOND) OF PROPERTY (DONATIVE TRANSFERS) 12-14, 48 (1981) (introductory note to Part I).

67. *See* Edgerly v. Barker, 31 A. 900, 911 (N.H. 1891); *see also* Carter v. Berry, 140 So. 2d 843, 852 (Miss. 1962) (stating that a court may reform a devise to meet the intention of the testator when the devise cannot be implemented as written). This power to reform a transfer to comply with the Rule

grant was made to the children of B who reach the age of thirty, the court would reduce the age requirement to twenty-one years to comply with the Rule.[68] Some courts have gone even further than reformation of a transfer and held that no transfer will be void unless it actually does not vest before the end of the perpetuities period.[69]

Although these attempts at avoiding the harshness of the Rule may look promising at first glance, they bring about additional problems of their own. By reforming transfers or declaring only some of the interests created as invalid, courts create uncertainty for planners in structuring estates to meet the needs and intentions of clients. In addition, the wait-and-see approach, which requires a delay until the perpetuities period expires to determine if interests are good, fails in accomplishing the stated social goals of the Rule, which include promoting alienability of property and avoiding undue concentrations of wealth.

III. HISTORY OF THE GENERATION-SKIPPING TRANSFER TAX

The Internal Revenue Code (the "Code") imposes a tax on gifts made to a generation more than once removed from the donor, in addition to the normal tax imposed on lifetime transfers and transfers at death.[70] This generation-skipping tax performs a similar function to the Rule by discouraging transfers of future interests to generations more than once removed from the donor by making them more expensive to the donor. The added expense frustrates the establishment of control over large amounts of wealth for a long period of time. However, unlike the Rule, the generation-skipping tax has only existed for a relatively short period of time.[71]

The Code taxes the transfer of property between generations in a variety of ways. Transfers at death are governed by the estate tax,[72] and transfers

is commonly known as *cy pres*. *See* LEACH & TUDOR, *supra* note 4, at 183-84. The true *cy pres* power actually only applies to charitable trusts. *See* GEORGE T. BOGERT, TRUSTS 520 (6th ed. 1987); 2 RESTATEMENT (SECOND) OF TRUSTS § 399 (1959) (defining the *cy pres* power). Translated into English, the power's name means "as near as possible." *See* BOGERT, *supra*, at 520.

68. *See In re* Chun Quan Yee Hop's Estate, 469 P.2d 183, 187 (Haw. 1970) (holding that a court could reduce an age requirement in the transfer so as to bring the transfer within the requirements of the Rule). Hawaiian courts have used the term "equitable approximation" to describe the equitable power of courts to reform a transfer to make it valid under the Rule. *See id.* at 187.

69. *See* Fleet Nat'l Bank v. Colt, 529 A.2d 122, 129-30 (R.I. 1987) (applying the wait-and-see approach to perpetuities cases); *In re* Freeman's Estate, 404 P.2d 222, 229 (Kan. 1965) (explaining the wait-and-see approach).

70. *See* I.R.C. §§ 2601-2663 (1998).

71. *See supra* note 11.

72. *See* I.R.C. §§ 2001-2209 (1998).

during the life of the donor are governed by the gift tax.[73] Transfers to a generation more than once removed from the donor, in addition to falling within the estate and/or gift taxes, are also governed by the generation-skipping tax.[74]

At the time of enactment of the estate tax, most states had their own separate systems of inheritance taxes.[75] In order to equalize the effect of the estate tax in each state, the original estate tax was amended to allow a credit for the payment of state inheritance taxes.[76] This credit resulted in uniformity of inheritance tax rates among the states as states set their rates to take advantage of the maximum federal credit and those states that did not have inheritance taxes enacted them to take advantage of the federal credit.[77]

Congress enacted the gift tax in 1924 due to the use of inter vivos gifts by estate planners to eliminate the burden imposed by the estate tax.[78] In order to further promote horizontal equity[79] in the estate tax system, Congress amended the Code in 1942 to equalize the burden between community and separate property states.[80] In addition, Congress added the marital deduction in 1948 to exempt transfers between spouses from the estate tax regime.[81]

Congress reformed the Code in 1976 to create a single tax system for both inter vivos and testamentary gifts in order to make the system more economically neutral.[82] This reform also included the introduction of the

73. *See* I.R.C. §§ 2501-2524 (1998).

74. *See* I.R.C. §§ 2601-2663 (1998).

75. *See* P. ROSS, INHERITANCE TAXATION (1912). Prior to the federal estate tax, 38 states had their own inheritance tax statutes. *See id.* at 391-778. For a listing of these states and a general outline of the provisions in effect, see *id.*

76. *See* Revenue Act of 1924, ch. 234, § 301(b), 43 Stat. 253, 303.

77. *See* Levin & Mulroney, *supra* note 24, at 350.

78. *See* Revenue Act of 1924, ch. 234, §§ 319-324, 43 Stat. 253, 313-16 (previously codified at I.R.C. §§ 1131-1136 (West 1928)). The original gift tax was repealed in 1926. *See* Revenue Act of 1926, ch. 27, §1200, 44 Stat. 9, 125 (repealing I.R.C. §§ 1131-1136 (West 1928)). The gift tax was restored in 1932. *See* Gift Tax Act of 1932, ch. 209, § 532, 47 Stat. 169, 245-59 (previously codified at I.R.C. §§ 550-580 (West 1934)). The current gift tax, enacted in 1954, is codified at I.R.C. §§ 2501-2524 (1998).

79. The principle of horizontal equity requires that people in the same economic circumstances should be treated equally under the tax laws and bear the same tax burden in proportion to their income and wealth. *See* WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 19 (11th ed. 1997).

80. *See* Revenue Act of 1942, ch. 619, §§ 402(z)-(b), 403(a), 404(a), 56 Stat. 798, 941-42, 944 (previously codified at I.R.C. § 811(d)(s), (e)(2), (g)(4) (Supp. 1941-42)). These provisions were repealed in 1948. *See* Revenue Act of 1948, ch. 168, § 351(a), 62 Stat. 110, 116.

81. *See* Revenue Act of 1948, ch. 168, § 361(a), 62 Stat. 110, 117-19 (current version at I.R.C. § 2056 (1998)).

82. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1520, 1846-54 (1976) (codified in scattered sections of the I.R.C. (1998)). The purpose of the reform was to remove the incentive for inter vivos gifting created by the discrepancy in the estate and gift taxes. The new unified system included all taxable inter vivos gifts in determining the value of the estate of the deceased but

generation-skipping tax.[83]

Because the estate tax only applied to transfers at the death of the transferor,[84] the termination of a life estate was not taxable under either the estate or gift tax.[85] This enabled estate planners to postpone the estate tax, while still giving donees the use of their inheritance, by putting property into trust and conveying successive life interests in the trust.[86] This planning technique resulted in significant tax savings for the rich, who could afford to put significant assets into trust and still meet everyday living expenses.[87] In contrast, the upper-middle class was forced to bear the full burden of the estate tax because they could not afford to lose the use of large amounts of wealth.[88]

The generation-skipping tax was enacted to cure this vertical inequity.[89] The tax did not require a transfer at death but rather was imposed on a transfer of any interest to a generation more than once removed from that of the donor.[90] The original generation-skipping tax was ineffective and unadministrable[91] and was therefore refined in both 1986[92] and 1988.[93]

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provided a credit for all gift taxes paid during his or her lifetime. *See* I.R.C. § 2012 (1998). Economic neutrality is the proposition that taxes should not change decisions based on the free market allocation of goods and services. The theory proceeds from the assumption that a free market produces an ideal allocation of resources and that any shift from this ideal allocation, caused by taxation, regulation, or other government interference, is a "deadweight loss" to the economy because it results in resources being used in a less valuable way than they otherwise would be. *See* KLEIN & BANKMAN, *supra* note 79, at 23.

83. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1879-90 (1976) (codified as amended at I.R.C. §§ 2601-2662 (1998)).

84. The estate tax is "imposed on the transfer of the taxable estate of every decedent . . . ." I.R.C. § 2001 (1998). The gross estate includes the value of all property of the decedent at the time of death, whether real or personal, tangible or intangible, and wherever located. *See* I.R.C. § 2031 (1998). The taxable estate is determined by "deducting from the value of the gross estate the deductions provided for . . . ." I.R.C. § 2051 (1998).

85. *See* H.R. Rep. No. 94-1380, at 46 (1976).

86. *See id.*

87. *See* Levin & Mulroney, *supra* note 24, at 351.

88. *See id.*

89. Vertical equity concerns the proportion of tax people pay to the amount of income and wealth they have. The United States' tax system is based on a concept of progressive taxes in which the proportion of a person's income that is paid in tax increases as the income of that person increases. Therefore, vertical equity requires that any tax impose a greater burden on those having a higher amount of taxable income. *See* KLEIN & BANKMAN *supra* note 79, at 19. This principle applies to the estate tax, as that tax requires that persons with greater wealth pay more in estate taxes. This was the end result achieved by the adoption of the generation-skipping transfer tax that eliminated the ability of those with high incomes, who could afford to put assets into trust, to escape tax while those with lesser wealth could not.

90. The tax was imposed on every generation-skipping transfer. *See* I.R.C. § 2601 (1977). A generation-skipping transfer included taxable distributions, taxable terminations, and direct skips. *See* I.R.C. § 2611 (1977).

91. *See* Levin & Mulroney, *supra* note 24, at 352.

The federal estate tax rates range from eighteen percent to fifty-five percent of the taxable estate.[94] The taxable estate is the amount remaining after all allowable deductions.[95] No amount transferred from the decedent to a surviving spouse is subject to the estate tax.[96] Qualified charitable gifts are also exempt from the estate tax.[97] A unified credit of $192,800 is allowed against the estate tax.[98] Although the estate tax generally only covers transfers of property at death, interests that are transferred by inter vivos[99] gift will be included if the deceased maintained control over the assets during his or her lifetime.[100]

The federal gift tax imposes tax at the same rates as the estate tax.[101]

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92. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

93. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

94. *See* I.R.C. § 2001(c)(1) (1998) The top rate of fifty-five percent is reached when the total value of the taxable estate reaches three million dollars. *See id.* However, there is a phase-out of the progressive rate structure, such that for estates with taxable values in excess of ten million dollars, the estate tax is levied at a flat fifty-five percent rate. *See* I.R.C. § 2001(c)(2) (1998).

95. *See* I.R.C. § 2051 (1998). The deductions allowed for estates are similar to those allowed for individuals, including deductions for expenses, interest, taxes, losses, and charitable gifts. *See* I.R.C. §§ 2053-2055 (1998).

96. *See* I.R.C. § 2056 (1998). This exclusion for amounts passing to the spouse at death only applies if the property could be included in the spouse's estate at the time of his or her death. *See id.* The typical case in which this exclusion would not be available is when the interest given to the spouse is one that will terminate due to the passage of time or the occurrence or nonoccurrence of a contingency, and the termination would cause the rights and benefits of the interest to pass to another person. *See* I.R.C. § 2056(b)(1) (1998). All inheritable interests and any interest that the executor elects to treat as inheritable will qualify for the exclusion. *See* I.R.C. § 2056(b)(7)(B)(V) (1998).

97. *See* I.R.C. § 2055 (1998) The deduction allowed for charitable gifts is limited to the value of the property that would have been includable in the gross estate. *See* I.R.C. § 2055(c) (1998).

98. *See* I.R.C. § 2010 (1998). The credit is determined based on an exclusion amount provided in the Internal Revenue Code and is calculated as "the amount of the tentative tax which would be determined under the rate schedule set forth in I.R.C. § 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount." I.R.C. § 2010(c) (1998). The Internal Revenue Code was recently amended to provide for an increase in the amount of the unified credit to be phased in between the years 1998 and 2006 from the present amount, based on an exclusion amount of $600,000, to $348,800, based on an exclusion amount of $1,000,000. *See id.*

99. An inter vivos gift is a gift made during the lifetime of the donor that will take effect while the donor is living, as opposed to a testamentary transfer which will take effect only at the death of the donor, even if the gift is made during the donor's lifetime. *See* BLACK'S LAW DICTIONARY 821 (6th ed. 1990).

100. An inter vivos gift will be included in the taxable estate when the deceased retained: (1) a life interest; (2) a reversion worth over five percent of the total gift along with an interest effective at death; (3) a power to revoke; or (4) rights over insurance or annuity payments. *See* I.R.C. §§ 2036-2039, 2042 (1998). When assets are held jointly, the property is taxed to the person who contributed the assets to purchase the property, unless a gift was made at the time of purchase. It is presumed that the first joint owner to die purchased the assets, placing the burden on the surviving owner to show that he or she purchased the assets. *See* I.R.C. § 2040 (1998).

101. *See* I.R.C. § 2502 (1998). The rate schedule is applied based on cumulative taxable gifts, with the gift tax for any one year being the excess of the tax calculated on all taxable gifts over the tax calculated on taxable gifts from all preceding years. *See id.*

However, the gift tax base is exclusive of tax due, meaning the tax paid is not considered a gift, while the estate tax base is inclusive of tax due meaning the tax paid is added to the gross estate to determine the taxable estate.[102] The same exclusions for gifts to the surviving spouse and to charities that apply in determining the taxable estate[103] are also available in determining the amount of taxable gifts.[104] The gift tax also allows an annual exclusion from taxable gifts of ten thousand dollars for each gift made by a particular donor to a particular donee.[105] The unified credit[106] is available to reduce taxable gifts during the donor's lifetime.[107] Inter vivos gifts are not included in the taxable estate but are included in determining the graduated tax rates applicable to the taxable estate.[108]

The final step in the tax on wealth transfers was the generation-skipping tax.[109] The tax, as its name indicates, is imposed on any generation-skipping transfer.[110] A generation-skipping transfer is any taxable distribution, taxable termination, or direct skip between persons classified into different generations.[111] Similar to the unified credit available against the estate tax, the generation-skipping tax provides for an exemption from taxation on generation-skipping transfers of up to one million dollars of property that

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102. The amount of the gift tax due is not added to the amount of the gift in determining the amount of the taxable gift. The estate tax due, however, is added to the gross estate in determining the amount of tax. *See* I.R.C. § 2001(b), § 2501(a) (1998).

103. *See supra* notes 94-96 and accompanying text.

104. *See* I.R.C. §§ 2522, 2523 (1998). The exclusions for gifts to spouses and charities are subject to similar restrictions as the estate tax exclusion. *See id.*

105. *See* I.R.C. § 2503(b) (1998). The gift tax exclusion now contains a provision for adjustments for inflation. *See id*. If the spouse of the donor consents, a twenty thousand dollar gift can be made without payment of gift taxes. The gift by one spouse will be treated as being made one-half by each spouse. *See* I.R.C. § 2513 (1998). In order for a gift to qualify for the exclusion, the gift must be a present interest with no restrictions as to use by the donee. *See* I.R.C. § 2503 (1998).

106. *See supra* note 98 and accompanying text.

107. *See* I.R.C. § 2505 (1998). The credit is "unified" in the sense that any amounts used to reduce taxable gifts made during the decedent's lifetime are not available to reduce the taxable estate at the time of death. *See* I.R.C. §§ 2001, 2010, 2505 (1998).

108. *See* I.R.C. § 2001 (1998).

109. *See* I.R.C. §§ 2601-2663 (1998).

110. *See* I.R.C. § 2601 (1998).

111. *See* I.R.C. § 2611 (CCH 1998). A taxable distribution means ". . . any distribution from a trust to a skip person." I.R.C. § 2612(b) (1998). A taxable termination means "the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust." I.R.C. § 2612(a) (1998). Direct skip means "a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person" I.R.C. § 2612(c) (1998). A skip person is "a natural person assigned to a generation which is [two] or more generations below the generation assignment of the transferor, or a trust if all interests in such trusts are held by skip persons." I.R.C. § 2613(a) (1998). The actual tax due will vary as the amount included in the taxable transfer varies depending on what form the generation-skipping transfer takes. *See* I.R.C. §§ 2621, 2622, 2623 (1998).

would otherwise be included as a taxable transfer.[112] Once property has been designated by the donor as exempt from the generation-skipping tax, any future appreciation in the value of the exempt property is also exempt from the generation-skipping tax.[113]

The generation-skipping transfer tax was meant to achieve a result similar to that of the Rule.[114] Congress was concerned with the use of generation-skipping trusts by the extremely wealthy to avoid the impact of the estate tax.[115] When formulating the generation-skipping tax, Congress noted the effectiveness of the Rule in limiting the duration of trusts.[116] Thus, both the Rule and the generation-skipping tax seek to force property owners to transfer their property at death rather than tying it up with restrictions long after death.

While both the Rule and the generation-skipping tax seek to accomplish the same end, each does so through different means. The generation-skipping tax treats deemed transfers as actual transfers and thereby reduces the amount of wealth flowing to the future generation.[117] The Rule, on the other hand,

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112. *See* I.R.C. § 2631 (1998). For calendar years after 1998, the amount of the generation-skipping exclusion will be adjusted for inflation. Any increases in the exemption amount can only be allocated against transfers made after the year in which the increase applies. The one million dollar exemption is available to each individual who makes a generation-skipping transfer. *See id.*

113. *See* STAFF OF JOINT COMMITTEE ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1265 (Joint Comm. Print 1987). If a grandparent allocates the entire exemption to a one million dollar gift in trust made to his or her grandchildren, the trust will never be subject to the generation-skipping tax, even though the amount in the trust could multiply to many times the actual one million dollar exemption amount. *See id.* This exemption amount is clearly at odds with the generation-skipping tax's policy of discouraging accumulations of wealth. Because only the very wealthy in society can afford to take advantage of the full one million dollar exclusion, this accumulation of wealth will occur in a very few individuals and thereby further consolidate the distribution of wealth. The Rule alone prevents these accumulations, allowed by the generation-skipping exclusion, from being completely unlimited. Although a one million dollar exemption may seem paltry, it is anything but; the exclusion could grow ten-fold in twenty-four years at a ten percent compound rate of return. Furthermore, consider a case in which the exclusion is allocated to a trust with five beneficiaries and the one million dollar exemption amount is used to buy a five million dollar life insurance policy on an elderly relative. When this relative dies, the one million dollars distributed to each individual can be put into trust in the same manner as in the prior trust, resulting in accumulations of wealth limited only by the number of elderly relatives in which the trust would have an insurable interest. *See* Levin & Mulroney, *supra* note 24, at 355-56.

114. *See* Levin & Mulroney, *supra* note 24, at 353-54.

115. *See* S. REP. NO. 94-938, pt. 2, at 19-20 (1976).

116. In the legislative history of the generation-skipping tax, the Senate noted:

> Currently, all states . . . have a rule against perpetuities which limits the duration of a trust . . . . [I]n general, such laws require that the ownership of property held in trust must vest in the beneficiaries not later than the period of the lifetime of any "life in being" on the date of the transfer, plus twenty-one years . . . thereafter.

Id. at 19.

117. *See* I.R.C. §§ 2601, 2611(a), 2621-2623 (1998). For a general discussion of generation-skipping transfers, see *supra* notes 109-13 and accompanying text.

simply voids these types of transfers.[118] The combination of these provisions results in a grant of successive life estates being subject to tax at the death of each life tenant, even though the interest would not have been subject to the estate tax.[119] Further, the combination results in the termination of the successive life estates once they reach the end of the perpetuity period.[120] The generation-skipping tax is applied even when there is no life interest given to a prior generation, but the gift is made directly to a generation more than once removed from the donor.[121] The tax will be applied at the maximum estate tax rate[122] each time a successive generation has a right to receive the property.[123]

IV. CURRENT DEVELOPMENTS REGARDING THE CONTINUED APPLICATION OF THE RULE

Recently, a number of states have abolished the Rule, either entirely or in part.[124] This does not so much create new estate planning opportunities as make the existing methods of estate planning effectively unlimited in their ability to generate vast accumulations of wealth.[125]

Since the turn of the century, wealthy families have used trusts to pass on

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118. *See* SIMES, *supra* note 2, at 368-69. Many modern formulations of the Rule do not void the transfer but merely reform the transfer to fit within the Rule. *See supra* notes 59-69 and accompanying text.

119. *See* I.R.C. §§ 2601-2662 (1998).

120. *See* SIMES, *supra* note 2, at 368-69.

121. *See* I.R.C. §§ 2611-2613 (1998). For a discussion of the applicability of the generation-skipping transfer tax, see *supra* notes 109-13 and accompanying text.

122. *See* I.R.C. § 2641 and § 2001(c) (1998).

123. *See* I.R.C. §§ 2611(a)(1), 2612(b) (1998).

124. *See, e.g.,* ALASKA STAT. § 34.27.050(a) (Lexis 1998) (abrogating the common law Rule so long as part of the income or principal may be distributed to a person living at the creation of the trust); DEL. CODE ANN. tit. 25, § 503 (1998) (abolishing the common law Rule except with regard to real estate which must be distributed after being held for 110 years as if the trust had terminated); IDAHO CODE § 55-111 (1999) (abolishing the Rule allowing assets to be placed into trust for longer than the perpetuities period but imposing a requirement that the power of alienation cannot be suspended for longer than a life in being plus twenty-five years); 765 ILLINOIS COMP. STAT. Ann. 305/4 (West 1999) (providing limited exclusions from the common law Rule, one of which is for a qualified perpetual trust); S.D. CODIFIED LAWS § 43-5-8 (Michie 1998) (abolishing the Rule so long as the trustee has the power to sell the assets of the trust, thus preserving the alienability and marketability of the assets); WIS. STAT. ANN. § 700.16 (West 1999) (stating a trust does not violate the Rule if the trustee has the power to sell all of the assets of the trust or if an unlimited power to terminate the trust is held in one or more persons).

125. Although the Rule has been abrogated for some time in Idaho and Wisconsin, use of the perpetual trust was limited due to the high individual and trust tax rates in both states. Of the states that have recently abrogated the Rule, Alaska and South Dakota have no individual or trust income taxes and Illinois taxes the income at low rates. Therefore, the use of perpetual trusts in the states recently abolishing the Rule is likely to be high.

their wealth to future generations.[126] The use of family trusts, now known as Dynasty Trusts,[127] allowed these families to avoid paying estate taxes when property passed from generation to generation.[128] These trusts provided for the health, education, welfare, and support of the beneficiaries for their lives. Upon the beneficiaries' deaths, the trusts provided for the support and maintenance of the next generation of beneficiaries until their deaths, and so forth until the Rule's limit was reached.[129] Because no legal interest existed at the death of each beneficiary to pass down to the following generation, the trust assets were not part of the beneficiary's taxable estate, and therefore no estate tax was impossed on the assets in the trust.[130] These trusts continued until all the property was distributed, there were no living descendants of the trust grantor, or the trust terminated under principles of state law, normally either the common law Rule or the Uniform Statutory Rule.[131]

Congress instituted the generation-skipping tax in an effort to halt this practice and the appurtenant accumulations of wealth by a small number of families.[132] However, one million dollars worth of assets may be earmarked as exempt from the generation-skipping tax.[133] While this amount may seem small, it could result in the exemption of large sums from the generation-skipping tax because once assets are earmarked as exempt, any appreciation of the initial assets is also exempt from the generation-skipping tax.[134]

Even though the generation-skipping exemption provided a loophole for accumulations of wealth, the Rule still limited the duration of Dynasty Trusts.[135] At some point, the trust would terminate, either under the Rule or

126. *See* Al W. King III et al., *Dynasty Trusts: What the Future Holds for Today's Technique*, TR.& EST., Apr. 1996, at 28.

127. *See id.*

128. *See id.*

129. *See id.*

130. *See supra* notes 84-87 and accompanying text for further description of avoidance of estate taxes.

131. *See* King, *supra* note 126, at 28.

132. See *supra* notes 113-16 and accompanying text for a discussion of the purpose behind the rule.

133. See *supra* notes 111-12 and accompanying text for an explanation of the generation-skipping exclusion.

134. Assuming that a trust is established using the one million dollar generation-skipping exemption thirty years before the death of the transferor, and the trust grows at a 12% annual rate, nearly thirty million dollars would escape the generation-skipping tax at the death of the transferor. *See* Jonathan G. Blattmachr et al., *New Alaska Trust Act Provides Many Estate Planning Opportunities*, 24 EST. PLAN., OCT. 1997, AT 347, 350. With the use of combined gifts by both spouses, allowing a total two million dollar exemption from the generation-skipping tax, and leveraging the assets placed into the trust, this amount could be increased even more. *See* King, *supra* note 126, at 28. The new indexing of the exemption for inflation will further increase the amounts that can be protected by using the exemption from the generation-skipping transfer tax. *See supra* note 112.

135. *See supra* notes 44-46 and accompanying text.

by other state laws limiting the allowable duration of trusts, and the assets would be distributed to the beneficiaries of the trust.[136] At that point, the property would again be subject to the estate tax at the death of the recipient.[137]

The abolition of the Rule eliminates this final restraint on the untaxed accumulation of wealth over multiple generations. The payment of the gift tax upon the creation of the trust will be the last estate or gift tax that is ever paid on the assets put into trust.[138] Structured properly, the one million dollars contributed to a perpetual trust will result in almost two billion dollars of value after eighty-five years, value that will be exempt from the estate, gift, and generation-skipping taxes and continue to grow in perpetuity.[139]

The elimination of the Rule will also result in a significant decrease in tax revenues. Take, for example, the two billion dollar accumulation described above.[140] Absent the Rule, this amount will remain untaxed for generations. Under the former limitations imposed by the Rule, the trust would have already terminated (or soon would), and the assets of the trust would again be subject to the estate tax system.[141] At the current estate tax rates,[142] absence of the Rule would result in lost tax revenues of over one billion dollars on this single trust alone.[143] Although the income of the trust and any distributions to beneficiaries would be subject to the income tax,[144] these distributions can be limited.[145] Furthermore, these income taxes would be

136. For a discussion of the application of the Rule in terminating or modifying interests that vest at remote points in time, see *supra* notes 59-69 and accompanying text.

137. *See* King, *supra* note 126, at 28.

138. *See* Thomas H. Foye, *Using South Dakota Law for Perpetual Trusts*, PROB. & PROP., Jan./Feb. 1998, at 17, 18. Even this gift tax will be reduced to zero as the amount of the unified credit available to reduce the gift tax due is increased from six hundred thousand dollars in 1997 to one million dollars in 2006 and thereafter. *See supra* note 98. The trust would still be subject to income tax on any income that is retained by the trust. *See* I.R.C. § 641 (1998). Any income that is distributed from the trust to beneficiaries will also be subject to taxation as income of each beneficiary. *See* I.R.C. § 61(a)(15) (1988). However, due to the fact that gains on investments are not realized until the investment is sold, *see* I.R.C. § 1001 (1998), significant gains could accrue within the trust and never be subject to the estate tax when they pass between generations.

139. Assuming a current yield of 5%, appreciation at 7%, and sale and reinvestment at a 20% rate, one million dollars would grow in eighty-five years to about one billion nine hundred million dollars. *See* Foye, *supra* note 138, at 18.

140. *See supra* note 139.

141. *See* King, *supra* note 126, at 28.

142. *See* I.R.C. §§ 2601, 2641 (1998).

143. The significance of this number is apparent when it is compared to the $2.7 billion budgeted by Congress in the 2000 fiscal year for the entire Legislative Branch of Government. *Budget of the United States Government Fiscal Year 2000* tbl. S-10 <http://u3.access.spa.gov/usbudget/fy2000/pdf/budget.pdf>. If this effect were multiplied over numerous trusts, the effect over time on the revenues of the Federal Government could be significant.

144. *See supra* note 138.

145. *See* King, *supra* note 126, at 28. Rather than having the trust make distributions so that

collected even if the trust were limited in duration by the Rule, so the taxes would not serve to make up the lost revenues from the assets in trust not falling under the estate, gift, or generation-skipping taxes after the abolition of the Rule.

A final problem with the abolition of the Rule is that it allows the "dead hand"[146] to have an impact on people and property for an unlimited duration. Although the "dead hand" no longer operates to hinder the alienability of property,[147] it can have an effect on the beneficiaries. A trust can be structured to allow for payments to beneficiaries based on the attainment of certain goals or the occurrence of certain contingencies, either by the beneficiary or others, set out by the transferor at the time the gift is made into trust.[148] The possible income from the trust will create a huge incentive for beneficiaries to achieve these goals or make the contingencies occur. This incentive is not problematic, so long as the duration of the trust is limited. However, with a trust that is unlimited in duration, one can envision a situation arising in which the trust would encourage its beneficiaries to achieve goals that were set many, perhaps hundreds, of years prior and that are no longer desirable for the beneficiary or in the best interests of society.

V. HOW SHOULD THE FEDERAL GOVERNMENT RESPOND TO THE PROBLEMS CAUSED BY STATE ABOLITION OF THE RULE AGAINST PERPETUITIES?

A number of options are available to cure the problems presented by abolition of the Rule and the resulting absence of any limit on the duration of trusts and contingent interests. The first and most obvious solution is the establishment of a Federal Rule Against Perpetuities. This new Rule could take the form of either the common law Rule[149] or the Uniform Statutory Rule Against Perpetuities,[150] applicable to transfers of non-vested contingent interests in all of the states. This Federal Rule would result in a return to the status quo, in which trusts are limited to either the life in being plus twenty-

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beneficiaries can purchase assets for their maintenance and support, the trust could purchase the assets and allow the beneficiaries only the use of the assets, thereby avoiding the tax on the distribution and maintaining the accumulated wealth in the estate. *See id.*

146. *See* Friedman, *supra* note 1, at 23.

147. All jurisdictions that have abolished or limited the applicability of the Rule have statutory provisions requiring that the trustee have the ability to buy and sell assets of the estate in fee simple, or at least requiring that real estate held in the trust must be distributed within a certain period of time, thus upholding the free alienability of land. *See supra* note 124.

148. *See supra* text accompanying note 116.

149. *See supra* notes 16-69 and accompanying text.

150. UNIF. PROBATE CODE § 2-901 (1990), 8 U.L.A. 226 (1998).

one years or a flat ninety-year duration. A Federal rule would result in uniformity among the states, as the same Rule would apply to a transfer regardless of the state in which the transfer occurs.

A return to the status quo would be particularly beneficial in this area of the law because established law and precedent are available to assist the courts in ruling on transfers of property. A Federal Rule would also provide certainty to planners who are accustomed to dealing with the Rule and are confident of how certain transfers will be treated under it. Unfortunately, all of the criticisms of the Rule, debated by politicians and practitioners since its inception, will also persist.[151] Furthermore, a rule that promotes the free alienability of property, one of the major purposes of the Rule,[152] is no longer needed because the states that have abolished the Rule either require that the trustee be able to freely sell the assets of the trust[153] or impose a limit on the duration of inalienability of real estate held in trust.[154] The establishment of a federal perpetuities law would also present problems relating to federalism.[155] Governance of property transfers has typically been a state function. In addition, a rule attempting to control the law of property would be difficult to justify as within Congress' enumerated powers in the Constitution.[156]

Another option to address the recent state abolition of the Rule is an amendment of the estate tax to apply to all interests as successive generations are entitled to the beneficial use of the interest. Under this proposal, the life estates commonly created by perpetual trusts would be subject to tax upon the termination of the each life estate, at which time the successive generation will begin receiving the benefits of the trust. The difficulty with this solution would be valuation. It would be difficult, if not impossible, to

151. *See supra* notes 51-58 and accompanying text.

152. *See supra* note 39 and accompanying text.

153. *See, e.g.,* ALASKA STAT. § 34.27.050 (Lexis 1998); S.D. CODIFIED LAWS § 43-5-8 (Michie 1998); *see also supra* note 124.

154. *See, e.g.,* DEL. CODE. ANN. Tit. 25 § 503 (1998). *See also supra* note 124.

155. Any power not given to the federal government in the Constitution is reserved for the states. U.S. CONST. amend. X.

156. The main sources of enumerated power for the federal government, under the Constitution, are (1) the taxing power, in Article I, Section 8, Clause 1; (2) the commerce power, in Article I, Section 8, Clause 3; (3) the spending power, in Article I, Section 8, Clause 1; and (4) the "necessary and proper" power, in Article I, Section 8, Clause 18. See U.S. CONST. art. I, § 8, cl.1, 3, 18. A federal Rule would not fall under the spending power because it is not an expenditure of funds. It would probably not fall under the commerce power because it does not involve goods in, or intermediaries of, interstate commerce. The Rule would also not fall within the taxing power, because the Rule would govern property transfers and not the tax imposed on these transfers. The best argument that a federal Rule is within the enumerated powers of Congress in the Constitution would be that it is necessary and proper for the collection of taxes, since without the Rule, large amounts of assets would evade imposition of the estate, gift, and generation-skipping taxes.

place a value on a life interest in property held in trust. This difficulty arises because most perpetual trusts subject distributions to the discretion of the trustee for the maintenance and support of the beneficiary, and the beneficiary has no absolute right to take distributions of any kind.[157] Imposing the tax in this way would require litigation upon the passing of every life estate, as experts for the taxpayer and the Internal Revenue Service haggle over what the proper value of the property should be. This requirement would clearly render the tax unadministrable and result in a wholesale lack of compliance.

The best solution to the problems created by abolition of the Rule is to eliminate the generation-skipping exemption.[158] If the exemption were eliminated, there would be no exempt amount that could appreciate in value and result in enormous sums that are exempt from the generation-skipping tax. If none of the assets in the trust are exempt, the entire value of the trust passed on to the successive generation would be taxed upon the termination of the prior life estate.[159] This taxation would have a similar effect as the application of the estate tax to life interests, but without the concurrent valuation problem. The entire trust would be subject to tax rather than just the value of the life interest actually received by the beneficiary. The elimination of the exemption would not have any adverse effects on most taxpayers, since most taxpayers cannot afford to lose access to the one million dollars that would be earmarked for the exemption under the current law. This proposal would only affect wealthy taxpayers trying to accumulate and perpetuate large concentrations of wealth in contravention of public policy.[160] The estate tax exemption exists to allow some amount of wealth, such as that in a family business, to be passed on to a subsequent generation without requiring items of that wealth, such as the family farm, to be sold to pay the tax.[161]

A different rationale applies to the generation-skipping exemption. The main purpose in transferring property to a generation more than once removed is to reduce taxes and accumulate concentrations of wealth. Congress has clearly stated that this purpose is against public policy by enacting the generation-skipping tax in the first place, and, therefore, the loophole in the tax created by the exemption should be eliminated. Any other purposes for transferring wealth to generations more than once removed

157. *See supra* text accompanying note 116.
158. *See supra* note 112 and accompanying text.
159. *See supra* notes 119-21 and accompanying text.
160. *See supra* notes 3-4 and accompanying text.
161. Find Footnote of Congressional intent behind estate tax exemption.

could still be achieved through lifetime gifts to the later generation (which would still be tax free), or by gifting to the parents of the later generation on the condition that the proceeds be used for the benefit of their children. This system would better accomplish the purpose of the tax and eliminate the problems of wealth accumulation, loss of tax revenues, and control of the "dead hand" that have been exacerbated by the abolition of the Rule.

CONCLUSION

The Rule Against Perpetuities and the generation-skipping transfer tax have long served the public policies of promoting the free alienability of property and discouraging the accumulation of wealth in a small number of family groups. In addition, the generation-skipping tax is a large source of revenue for the federal government. The abolition of the Rule in a number of states has eliminated the ability of the law to accomplish these policies and could cause a substantial reduction in tax revenues. In the absence of the Rule, perpetual trusts can be created that can grow to values in the billions of dollars, none of which are subject to estate, gift, or generation-skipping taxes. Because of the absence of any tax consequences, the wealth that can be accumulated by those with the means to take advantage of perpetual trusts will far exceed that of most members of society. In addition, the perpetual trust may create incentives for beneficiaries that do not remain in line with the goals of society.

Although at present only six states have abolished the Rule, there is little doubt that this will start a race to the bottom as various states compete for resident trusts.[162] Therefore, Congress must step in to alleviate the problems created by perpetual trusts. The best response would be the elimination of the generation-skipping tax exclusion. This result leaves the current system in place, which promotes stability and consistency of application, while at the same time eliminating the ability to remove large sums of money from the purview of the Internal Revenue Service. It would also deny perpetual trusts the tax advantages that allow them to accumulate excessive amounts of wealth, advantages that are not available to the general public.

162. Although perpetual trusts are not subject to the federal estate, gift, and generation-skipping taxes, they are still subject to state income taxes. *See supra* note 137. Therefore, the more trusts that are resident in a state, the more tax that can be collected by that state government. This tax is even more attractive to states because it normally will come from residents of other states who have established trusts in the states that have abolished the Rule, thereby allowing for higher revenues for those states without increasing the tax burden on state voters. This can be equated with the race to the bottom that has occurred in state incorporation laws as states vie for the fees and taxes created when businesses incorporate under their laws.

Whatever response Congress chooses in this area, swift action is required. Because of a need for certainty in estate tax planning and the long time frames often involved, it will be difficult for Congress to make any change apply retroactively to trusts created before legislation can be enacted. Therefore, each day of delay will result in the creation of additional perpetual trusts that are forever out of the reach of the Internal Revenue Service.

John G. Shively