

SB

162

1-LS0485M
Chenoweth
3/6/00

HOUSE CS FOR CS FOR SENATE BILL NO. 162()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FIRST LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): SENATE JUDICIARY COMMITTEE BY REQUEST

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the rule against perpetuities, nonvested property interests, and
2 powers of appointment; and providing for an effective date."

3 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

4 * Section 1. AS 13.12.702(d) is amended to read:

5 (d) Survival by 120 hours is not required if

6 (1) the governing instrument contains language dealing explicitly with
7 simultaneous deaths or deaths in a common disaster and that language is operable
8 under the facts of the case;

9 (2) the governing instrument expressly indicates that an individual is
10 not required to survive an event, including the death of another individual, by a
11 specified period or expressly requires the individual to survive the event by a specified
12 period, [;] but survival of the event or the specified period must be established by clear
13 and convincing evidence;

14 (3) the imposition of a 120-hour requirement of survival would cause

1 a nonvested property interest or a power of appointment to fail to qualify for validity
 2 under AS 34.27.051 or 34.27.100 [AS 34.27.050(a)(1), (b)(1), OR (c)(1)] or to become
 3 invalid under AS 34.27.051 or 34.27.100, [AS 34.27.050(a)(2), (b)(2), OR (c)(2);] but
 4 survival must be established by clear and convincing evidence; or

5 (4) the application of a 120-hour requirement of survival to multiple
 6 governing instruments would result in an unintended failure or duplication of a
 7 disposition, [;] but survival must be established by clear and convincing evidence.

8 * Sec. 2. AS 13.36.157(a) is amended to read:

9 (a) Unless the terms of the instrument expressly provide otherwise, a trustee
 10 who has the absolute discretion under the terms of a testamentary instrument or
 11 irrevocable inter vivos agreement to invade the principal of a trust for the benefit of
 12 the beneficiary who is eligible or entitled to the income of the trust may exercise
 13 without prior court approval the trustee's discretion by appointing part or all of the
 14 principal of the trust in favor of a trustee of a trust under an instrument other than that
 15 under which the power to invade was created if the exercise of this discretion

16 (1) does not reduce any fixed income interest of an income beneficiary
 17 of the trust;

18 (2) is in favor of the beneficiary of the trust; and

19 (3) does not violate the limitations on validity under AS 34.27.051 or
 20 34.27.100 [AS 34.27.050(a)].

21 * Sec. 3. AS 34.27 is amended by adding new sections to read:

22 **Sec. 34.27.051. Statutory rule against perpetuities.** (a) A general or
 23 nongeneral power of appointment not presently exercisable because of a condition
 24 precedent is invalid unless, within a period of 1,000 years after its creation, either the
 25 power is irrevocably exercised or the power terminates. For purposes of this
 26 subsection, the period in which the power must be exercised or the power terminated
 27 is computed from the time of creation of the original power of appointment under
 28 which a subsequent general power of appointment not presently exercisable or a
 29 subsequent nongeneral power of appointment not presently exercisable was created.

30 (b) If a nongeneral power of appointment is exercised to create a new general
 31 power of appointment, all property interests subject to the exercise of that new general

1 power of appointment are invalid unless, within 1,000 years after the creation of the
2 new general power of appointment, the property interests that are subject to the general
3 power of appointment either vest or terminate.

4 (c) If a nongeneral power of appointment is exercised to create a new or
5 successive nongeneral power of appointment, all property interests subject to the
6 exercise of that new or successive nongeneral power of appointment are invalid unless,
7 within 1,000 years from the time of creation of the original instrument or conveyance
8 creating the original nongeneral power of appointment that is exercised to create a new
9 or successive nongeneral power of appointment, the property interests that are subject
10 to the nongeneral power of appointment either vest or terminate.

11 **Sec. 34.27.053. Savings provision.** A property interest that, under
12 AS 34.27.051, becomes invalid shall, upon the expiration of the 1,000-year period set
13 out in AS 34.27.051,

14 (1) if income from the property interest is payable

15 (A) to one person, be distributed to the person to whom the
16 income is then payable;

17 (B) to more than one person, be distributed to the persons to
18 whom the income is then payable

19 (i) in the shares to which the persons are entitled to the
20 income; or

21 (ii) equally among all persons who are entitled to the
22 income if shares are not specified;

23 (2) if income from the property interest is payable in the discretion of
24 a trustee and is payable

25 (A) to one person, be distributed to the person then eligible to
26 receive the income; or

27 (B) to more than one person, be distributed to the persons then
28 eligible to receive the income

29 (i) in the shares to which the persons are entitled to the
30 income; or

31 (ii) equally among all persons who are entitled to the

1 income if shares are not specified; or

2 (3) when there is no person then living to whom the property interest
3 may be distributed under (1) or (2) of this section, be payable to one or more
4 organizations described in 26 U.S.C. 2055(a) (Internal Revenue Code), or to one or
5 more organizations described in any successor provision to 26 U.S.C. 2055(a), in the
6 shares or proportions that the trustee or trustees then acting may determine.

7 * Sec. 4. AS 34.27.070 is amended to read:

8 **Sec. 34.27.070. Application [PROSPECTIVE APPLICATION].** (a) Except
9 as extended by (b) of this section, **the former provisions of AS 34.27.050 - 34.27.090**
10 **apply to a nonvested property interest or a power of appointment that is created on or**
11 **after January 1, 1996, and before April 2, 1997.** For purposes of this **subsection**
12 **[SECTION], a nonvested property interest or a power of appointment created by the**
13 **exercise of a power of appointment is created when the power is irrevocably exercised**
14 **or when a revocable exercise becomes irrevocable.**

15 (b) If a nonvested property interest or a power of appointment was created
16 before January 1, 1996, and is determined in a judicial proceeding, commenced on or
17 after that date, to violate this state's rule against perpetuities as that rule existed before
18 January 1, 1996, **or if a nonvested property interest or a power of appointment**
19 **was created on or after January 1, 1996, but before April 2, 1997, and is**
20 **determined in a judicial proceeding, commenced on or after that date, to violate**
21 **this state's rule against perpetuities as that rule existed, on or after January 1,**
22 **1996, and before April 2, 1997,** a court, upon the petition of an interested person,
23 may reform the disposition in the manner that most closely approximates the
24 transferor's manifested plan of distribution and is within the limits of the rule against
25 perpetuities applicable when the nonvested property interest or power of appointment
26 was created. **For purposes of this subsection, a nonvested property interest or a**
27 **power of appointment created by the exercise of a power of appointment is**
28 **created when the power is irrevocably exercised or when a revocable exercise**
29 **becomes irrevocable.**

30 * Sec. 5. AS 34.27.070 is amended by adding a new subsection to read:

31 (c) The provisions of AS 34.27.051 apply to a trust instrument or conveyance

1 executed on or after April 2, 1997, if the trust instrument or conveyance creates a
2 contingent power of appointment or nonvested property interest subject to the exercise
3 of a power of appointment that creates a new or successive power of appointment.

4 * Sec. 6. AS 34.27.075 is amended to read:

5 **Sec. 34.27.075. Relationship to [SUPERSESSSION OF] common law rule.**
6 **AS 34.27.051 - 34.27.100** [AS 34.27.050 - 34.27.090] supersede the rule of the
7 common law known as the rule against perpetuities. **The common law rule against**
8 **perpetuities does not apply in this state.**

9 * Sec. 7. AS 34.27 is amended by adding a new section to read:

10 **Sec. 34.27.100. Perpetuities and suspension of the power of alienation. (a)**

11 A future interest or trust is void if, as to property subject to the future interest or trust,

12 (1) the future interest or trust suspends the power of alienation of the
13 property, the suspension of the power is for a period of at least 30 years after the death
14 of an individual alive at the time of the creation of the future interest or trust, and the
15 suspension of the power of alienation occurs in the document creating the future
16 interest or trust;

17 (2) the future interest or trust suspends the power of alienation of the
18 property and the suspension of the power is for a period of at least 30 years after
19 termination of a power to revoke the trust;

20 (3) the future interest or trust suspends the power of alienation of the
21 property, the future interest or trust is created by the exercise of a general power of
22 appointment, whether by will or otherwise, and the suspension of the power is for a
23 period of at least 30 years from the time the power of appointment is exercised; or

24 (4) the future interest or trust suspends the power of alienation of the
25 property, the future interest or trust is created by the exercise of a power of
26 appointment that is not a general power of appointment, and the suspension of the
27 power is for a period of at least 30 years from the time of creation of the original
28 instrument or conveyance creating the original power of appointment that was
29 exercised to create a new or successive nongeneral power of appointment.

30 (b) For purposes of (a) of this section, the power of alienation

31 (1) is suspended if there is no person alive who, alone or in

1 combination with others, can, as to property that is part of the future interest or trust,
2 convey

3 (A) title to real property in fee; or

4 (B) complete ownership of personal property.

5 (2) is not suspended by a future interest or trust or by an equitable
6 interest in a trust if

7 (A) the trustee of the trust has power, either express or implied,
8 to sell the property; or

9 (B) at least one person alive at the time the trust was created
10 has an unlimited power to terminate the trust.

11 (c) The provisions of (a) of this section do not apply to a transfer

12 (1) made outright or in trust for a charitable purpose;

13 (2) to a literary or charitable organization;

14 (3) to a veterans' memorial organization; or

15 (4) to a cemetery corporation, society, or association.

16 * Sec. 8. The uncodified law of the State of Alaska is amended by adding a new section
17 to read:

18 **RETROACTIVE EFFECT.** AS 34.27.070(c), added by sec. 5 of this Act, is retroactive
19 to April 2, 1997, and applies to a trust instrument or conveyance executed on or after that date
20 upon the conditions set out in that subsection.

21 * Sec. 9. AS 34.27.050, 34.27.055, 34.27.060, 34.27.065, and 34.27.090 are repealed.

22 * Sec. 10. This Act takes effect immediately under AS 01.10.070(c).

of
Alaska's
trust
law

In April of ~~1997~~ ^{the legislature} ~~1997~~, ~~trust law~~ ^{AS} amended AS 34.27.050(a) to include (3) which states that the RAP is inapplicable to those trusts where a trustee has the ability to make a distribution to a person who is living when the trust is created.

In adding this language the AK. Legislature ~~is~~ ^{has} abolished the RAP.
ineffect

This follows from the fact that ~~it~~ in almost every case a trustee can make the above-described distribution.

This abolition is a significant reason for the growth of our states trust business since 1997.

By rendering RAP ineffective as applied to trusts it is possible to create a trust which can continue forever.

With careful drafting perpetual trusts can avoid all federal estate tax and continue to grow for the use of successive generations.

- This tax advantage has caused ~~many~~ 10 states to abolish the RAP, ~~to~~ and 5 more have pending legislation that would abolish the RAP.
- This legislation seeks to fix a ~~problem~~ problem that was discovered with the way section (3) was drafted.
- The problem which is affectionately known as the "Delaware tax trap" would be fatal to a large number of perpetual trusts that have been created since 1997.
- In a nutshell, and our resident expert Steve Greek will be able to explain this in more detail, the problem is that anyone who creates a perpetual trust usually wants to give the trust beneficiaries a power to direct the disposition of assets at their deaths as a means of making the trust more flexible. Under present law →

if a beneficiary exercises a special power of appointment by directing that the trust assets be continued in trust for the benefit of an individual & that individual is also given a special power of appt. then the trust's assets will be subjected to either estate or gift tax liability

• The fix to this problem is included in the language of SB 1102 and ^{would} enable AK trust to avoid the trap by requiring that in the limited circumstance where a spec. power of appt. is exercised to create a successive power of appt, the trust term must rest 1000 yrs from the date of the creation of the original trust instrument.

• A trust which can last 1000 yrs is, practically speaking akin to being perpetual

Sponsor Statement

SB 162

In April of 1997, our legislature amended AS 34.27.050(a) by including (3) which states the RAP is inapplicable to those trusts where a trustee has the ability to make a distribution to a person who is living at the time the trust is created. Because in almost every case a trustee can make the above-described distribution, it was generally accepted we had abolished the RAP, if not explicitly, at least implicitly. Abolishing the RAP is a significant reason for the growth of our state's trust business since 1997. By rendering the RAP ineffective as applied to trusts, it is possible to create a trust, which can continue forever. These trusts are frequently referred to as "perpetual trusts" or "dynasty trusts." With careful drafting and the proper allocation of generation skipping tax exemption "perpetual trusts" can avoid all federal estate tax and continue to grow and made available for the use of successive generations. As a result many states have seen it in their interest to abolish the Rule Against Perpetuities. Arizona, Delaware, Idaho, Illinois, Maine, Maryland, Ohio, Rhode Island, South Dakota, and Wisconsin have seen it in the interest to abolish the Rule Against Perpetuities. Colorado, Florida, Iowa, New Jersey, Nevada all have pending legislation to abolish the Rule Against Perpetuities.

However, after we "abolished" the RAP in April of 1997 it was discovered we had also inadvertently stumbled into a potential estate or gift tax problem under sections 2041(a)(3) or 2512(d) of the Internal Revenue Code, also known as the "Delaware Tax Trap." The tax problem is very difficult to understand but it exists with any perpetual trust in which a beneficiary is given a special power of appointment. Anyone who creates a perpetual trust usually wants to give the trust beneficiaries a power to direct the disposition of the trust assets at their deaths as a means of making the trust flexible and adaptable so the needs of future generations can be adequately served. This power to direct the disposition of trust assets at death is referred to as a special, limited or non-general power of appointment. Under our present law if a beneficiary exercises a special power of appointment by directing that the trust assets be continued in trust for the benefit of an individual and that individual is also given a special power of appointment then the trust assets will be subjected to either estate or gift tax liability. A large number of perpetual trusts created in Alaska since 1997 are vulnerable to this problem. It should

10
states
have
abolished

5 others
are

be noted that many other states that have abolished the Rule Against Perpetuities also stumbled into the Delaware Tax Trap. The technical nature of the problem makes it truly a trap.

Fortunately a relatively simple solution is at hand. The mechanics of the Delaware Tax Trap can be avoided by requiring that in the limited circumstance where a special power of appointment is exercised to create a successive power of appointment the trust property must eventually vest. This Bill states that in the limited circumstance described above, the date in which trust property must eventually vest is 1000 years from the date of creation of the original trust instrument. A trust, which can last 1000 years, is practically speaking akin to being perpetual. For all other purposes the Rule Against Perpetuities can be abolished and this Bill does exactly that.

Passage of this Bill is necessary if Alaska is to remain a suitable place for all individuals, resident and non-resident alike, who have or would want to create a perpetual trust. On the other hand, failure to pass this Bill not only puts existing perpetual trusts at risk but would eliminate Alaska as a suitable place to create perpetual trusts. This would prove harmful to not only our own citizens but also this legislature's effort to build a viable trust industry in this state. Lastly failure to pass this Bill could also have the unintended consequence of drawing Alaskan capital away from this state, as many wealthy Alaska citizens desiring to create perpetual trusts would invariably seek out other states where they are not exposed to the dangers of the Delaware Tax Trap.

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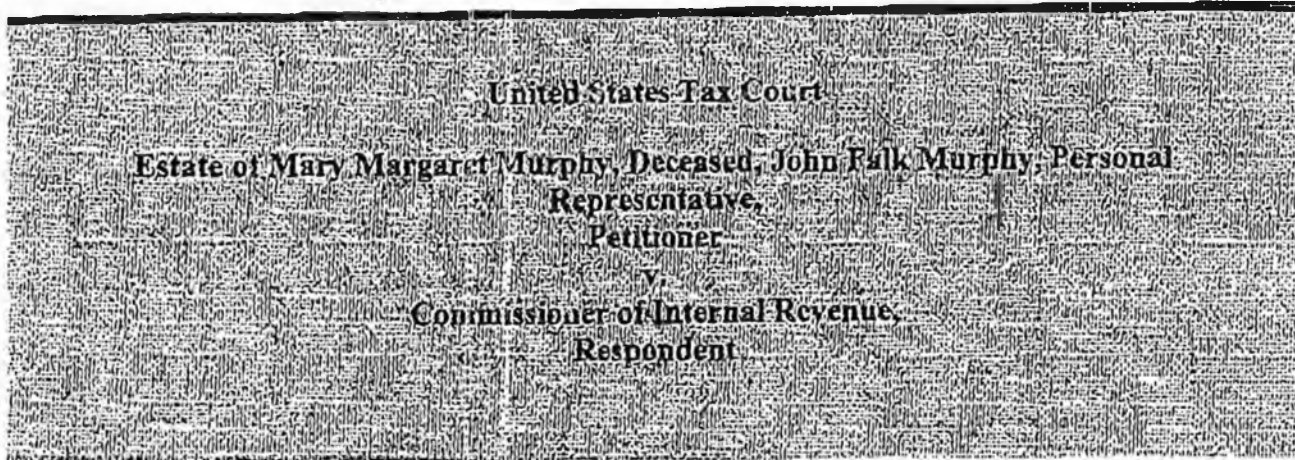
United States Tax Court
Estate of Mary Margaret Murphy, Deceased, John Falk Murphy, Personal Representative, Petitioner
Commissioner of Internal Revenue, Respondent

Docket No. 3880-76
Date of Decision: January 29, 1979
Judge: Fay.
Parallel Citations: 71 T.C. 671

Summary
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The decedent was the donee of a special power of appointment over certain property. At her death, she exercised this power by creating in her husband a second power of appointment with respect to the same property. *Held:* Under Wisconsin's rule against perpetuities, the perpetuities period for an interest appointed under a special power is computed from the date of the power's creation rather than from its exercise. Thus, under these facts, sec. 2041(a)(3), I.R.C. 1954, does not apply to the decedent's exercise of her special power.

Full Text link to
Murphy, Mary Margaret, Estate of v. Comm.
on the Court Opinions Disc
(If you do not already subscribe to this disc and would like to do so, please call 1-800-955-2444.)



United States Tax Court

Estate of Mary Margaret Murphy, Deceased, John Falk Murphy, Personal
Representative,
Petitioner

V.
Commissioner of Internal Revenue,
Respondent

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Full Text

Decision will be entered for the petitioner.

Thomas G. Ragatz, for the petitioner. Scott R. Cox, for the respondent.

PAGE 670

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PAGE 671

OPINION

Respondent determined a deficiency of 39,254.45 in the Federal estate tax of the Estate of Mary Margaret Murphy. The issue presented is whether the value of certain property over which the decedent possessed a power of

PAGE 671

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PAGE 672

appointment is includable in her gross estate under section 2041(a)(3). /1/

All of the facts have been stipulated and are so found.

Petitioner John Falk Murphy (hereinafter referred to as petitioner or John) is the duly appointed personal representative of the Estate of Mary Margaret Murphy. At the time of filing his petition herein, petitioner resided in Madison, Wis.

Under the terms of his will, /2/ Ross W. Harris (Ross), the father of Mary Margaret Murphy (the decedent), transferred certain property to the First National Bank of Madison, Madison, Wis., as trustee. The beneficiaries of the trust thus established (hereinafter referred to as the Harris Trust) were Ross' wife, Maude Johnson Harris (Maude), and the couple's two daughters, Josephine H. Schuele (Josephine) and the decedent. The terms of the Harris Trust provided that the trust income was to be paid in approximately equal shares to each beneficiary for her life. /3/ The trust was to continue until the earlier of the death or remarriage of Maude. Upon the occurrence of either of these events, the trust would be terminated and the corpus distributed as follows:

One-half thereof to each of my daughters, Mary Margaret Murphy and Josephine H. Schuele if living, but if either of them shall not then be living the share of such Trust Estate to which she would have been entitled if living shall be paid and set over to such person or persons (not, however, including her own estate, her creditors, or the creditors of her estate), in such shares, and in such manner as my said daughter, by her last will, therein making specific reference to the provisions hereof, shall appoint and direct; but in the absence of her exercise of such power of appointment in the manner herein provided such share of the Trust Estate shall be paid and set over to those persons who, under the laws of the State of Wisconsin, would be entitled to take such property in the event of her death intestate on that date.

Prior to the termination of the Harris Trust, the decedent, on May 9, 1972, died testate. Under the provisions of her will, the decedent exercised the power of appointment over her portion of the Harris Trust. In so doing, she appointed one-half of her income interest in the Harris Trust to her husband, John, and

PAGE 672

PAGE 673

one-half to a new trust established by her will which was styled "MMM Family Trust." /4/ She also appointed her corpus interest in the Harris Trust to the MMM Family Trust.

The dispositive provisions of the MMM Family Trust were also contained in the decedent's will. In this connection, the income from the MMM Family Trust was distributable to John as needed by him "to maintain himself in the manner of living to which he has become accustomed;" to the decedent's issue, under the discretion of the trustee; or, if not needed by John or the decedent's issue, the income was to be

accumulated. /5/ The MMM Family Trust was to continue for John's life and thereafter until the decedent's youngest child attained the age of 35. /6/ At that time, the trust corpus and accumulated income were to be distributed to the decedent's children or lineal issue. In addition, the decedent's will further provided that:

Notwithstanding the other provisions of [the MMM Family Trust], if my husband, JOHN, survives me he shall have a testamentary power to appoint the corpus and any accumulated income as he may see fit among our lineal issue, the wives or widows of my sons, and the husband of my daughter; but such class shall not include my estate or my creditors or my husband's estate or his creditors.

On October 27, 1972, approximately 5 1/2 months after the decedent's death, John formally renounced the power of appointment over the MMM Family Trust granted him by decedent's will.

Respondent, in a notice of deficiency mailed to petitioner on February 5, 1976, determined that the value of the property in the Harris Trust, with respect to which the decedent exercised her power of appointment, was includable in her estate under section 2041(a)(3).

As a general rule, property with respect to which a decedent dies possessing a general power of appointment, /7/ is includable in his gross estate under section 2041(a). Conversely, where a

PAGE 673

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PAGE 674

decedent is the donee of a nongeneral or special power of appointment, /8/ the value of his gross estate does not include the value of the property over which such power extends at the time of his death. An exception to this latter rule is found in section 2041(a)(3).

Because the rule against perpetuities (hereinafter sometimes referred to as the Rule) is so inextricably a part of section 2041(a)(3), before discussing that section and its requirements, and the question of whether they are here satisfied, it will be helpful to review briefly the purpose and operation of the Rule.

The principal purpose of the rule against perpetuities is to promote the free alienability of property by ensuring that its ownership is not suspended for an inordinate length of time. /9/ Future interests which make uncertain, for more than the permissible period, the ultimate takers of property violate this objective by seriously impeding the power of alienation. /10/ Hence, the rule against perpetuities evolved at common law to eliminate these impediments or so-called "fetterings of property."

At common law, the rule against perpetuities was a rule against the suspension of the power of alienation and against the remoteness of vesting. /11/ A suspension of the power

of alienation exists when there are no persons in being who can collectively transfer complete ownership of property. /12/ If a future interest causes such a suspension for longer than the permissible period, the future interest is invalidated by the rule against perpetuities. Likewise, the rule against perpetuities voids future interests which may not vest within the permissible period. /13/ In most instances where a future interest is invalidated under the Rule because the interest suspends the power of alienation for too long a period, such interest would also be rendered ineffective for remoteness of vesting and vice versa. /14/

PAGE 674

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PAGE 675

It is important to note that not all "fetterings of property" which suspend its ownership come within the Rule. It is only those fetterings which may last longer than the permissible period that are invalid. /15/ The most common period during which fetterings are permissible is measured by some life or lives in being at the time such interest is created plus 21 years. /16/ In the case of an interest in property appointed under a special power of appointment, the permissible period is computed from the date of the *creation* of the power. /17/ For example, assume A dies and leaves property to B for life with the remainder to whomever B appoints by will; provided, however, that B may not appoint to his estate, his creditors, or the creditors of his estate; i.e., his power is a special power. Assume further that B dies and appoints the property to the children of C. To determine if the appointment by B is valid under the rule against perpetuities, it is construed as if A had died and left the property to B for life with the remainder to the children of C. /18/

Over the years some States have modified the permissible period by statute. In Delaware, for instance, the period of perpetuities for an interest appointed under a special power of appointment is computed from the date of the *exercise* of the special power rather than from its creation. /19/ Thus, in Delaware it is possible for the absolute ownership of property to be indefinitely suspended through the successive exercises of such special powers. To illustrate this point, assume A died and left property to B for life with the remainder to whomever B appoints by will; provided, however, that B's power is only a

PAGE 675

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PAGE 676

special power. Assume further that B dies and exercises his power by appointing the property to C for life with the remainder to whomever C appoints by will under a special power; then C exercises the power in the same way and so on. Under the common law rule, the contingent interests which did not vest within the period of the Rule would be void; however, because Delaware law computes the perpetuities period from the date of

the exercise of the special power, the Rule will not be violated. Absent section 2041(a)(3), the effect of the Delaware statute would be to permit the continual transfer of property from generation to generation without the occurrence of an estate tax. /20/ Specifically, the donees each are given a life estate in the property which expires at their deaths and is therefore not included in their respective gross estates. Moreover, the remainder interest is not includable in their estates because under local law they do not own it and also because property subject to a special power of appointment is not taxed as part of the gross estate. To prevent this from happening, Congress enacted as part of the Powers of Appointment Act of 1951, section 811(f)(4) of the Internal Revenue Code of 1939, the predecessor of section 2041(a)(3). /21/

Section 2041(a)(3) /22/ generally requires the inclusion in the

PAGE 676

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PAGE 677

gross estate of the value of any property with respect to which the decedent by his will has exercised a post-1942 power by creating a second power. A further requisite to inclusion is that the second power, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the appointed property, or to suspend the absolute ownership or power of alienation of such property, for a period ascertainable without reference to the date of creation of the first power.

In the instant case, Ross Harris, the decedent's father, under the terms of his will, transferred certain property into the newly created Harris Trust for the benefit of his wife, the decedent, and the decedent's sister. In addition to a one-third income interest in the Harris Trust, the decedent's father gave decedent a testamentary power to appoint her portion of the income and corpus of the trust to anyone other than her estate, her creditors, or the creditors of her estate. Upon her death, the decedent, through her will, appointed the property subject to her special power to the MMM Family Trust. The decedent's will also granted to her husband, John, a testamentary power to appoint the corpus of her newly created MMM Family Trust to the children of the decedent or the spouses of those children. However, John could not appoint this interest to his estate, his creditors, or the creditors of his estate. Under the facts it is clear that the decedent by will exercised a power of appointment by creating a second power in her husband. /23/ The issue presented is whether decedent's exercise of her power comes within the purview of section 2041(a)(3).

Petitioner's position is that section 2041(a)(3) was drafted to catch the successive exercises of powers which, under the local rule against perpetuities, could be validly exercised without regard to the date the first power was created. He argues that because Wisconsin expresses its rule against perpetuities in terms of a prohibition on the suspension of the power of alienation, and because the perpetuities period is measured from the date the first power is created, section 2041(a)(3) is not violated.

PAGE 677

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PAGE 678

Respondent's position and reasoning are as follows: In Wisconsin the statutory rule against perpetuities is concerned with the suspension of the power of alienation. Wis. Stat. Ann. sec. 700.16. Under this statute, an interest is void only if it suspends the power of alienation for a period longer than a life or lives in being, plus 30 years. Wis. Stat. Ann. sec. 700.16(1)(a). However, the statute also states that there is no suspension of the power of alienation when the property interest is held in a trust where the trustee has the power to sell the assets of the trust. Wis. Stat. Ann. sec. 700.16(2) and (3). In addition, remoteness of vesting is not prohibited in Wisconsin so long as there is no suspension of the power of alienation. *In re Walker's Will*, 258 Wis. 65, 45 N.W.2d 94 (1950). In the present case, the decedent exercised a power by creating in her husband another power which he, in turn, could validly exercise by placing the property subject to the power in a perpetual trust for the benefit of, for example, his children and their descendants. By giving the trustee of the newly created trust a power of sale over the corpus, the Wisconsin rule against perpetuities is not violated despite the fact that ownership of the property may never vest in anyone. From this, respondent concludes, section 2041(a)(3) applies to tax decedent's exercise of her power. He argues that Congress intended section 2041(a)(3) to function independently of State law. He maintains that the statute unequivocally indicates that if a power violates any one of three conditions of title, viz, (1) postponement of vesting, (2) suspension of the powers of alienation, or (3) suspension of absolute ownership, then the property subject to the power must be included in the gross estate. Therefore, he concludes, because the decedent exercised her power by creating in her husband another power which could be validly exercised to indefinitely postpone the vesting of any interest in such property, section 2041(a)(3) is applicable to include the appointed property in her gross estate.

While respondent's position may comport with a literal reading of the statute, apart from that it is without support in the legislative history, the regulations, and in the roots underlying the Rule at the time the predecessor of section 2041(a)(3) was enacted. We therefore agree with petitioner.

As previously noted, the common law rule against perpetuities was a rule against the suspension of the power of alienation and against remoteness of vesting. Also previously noted was the

PAGE 678

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PAGE 679

fact that in most instances a future interest invalidated because the interest suspends the power of alienation for too long a period, would also be rendered ineffective for

remoteness of vesting. At an early stage in American history, a number of States passed statutes modifying or abrogating the common law rule against perpetuities and substituting therefore a statutory rule against perpetuities. /24/ The most significant of these statutory enactments occurred in New York in 1830. At that time, the New York legislature adopted legislation prohibiting the suspension of the power of alienation of real property and suspension of the absolute ownership of personal property. /25/ This statute, which remained substantially unmodified until 1958, served as a model perpetuity statute for several other States. /26/ Over the years, certain other States passed statutes expressing the rule against perpetuities in terms of remoteness of vesting rather than suspension of the power of alienation or of absolute ownership. /27/ Still other States preserved, unmodified, the common law rule. /28/ In 1951, when the predecessor of section 2041(a)(3) was adopted, there was anything but a uniform rule against perpetuities. A transfer valid under one State's rule might be invalid under another State's rule. Despite the lack of uniformity among the States, there were, nevertheless, two prevalent formulations of the rule which existed. On the one hand, there were those States which modeled their perpetuity statutes after New York's in terms of suspension of the power of alienation or absolute ownership; on the other hand, there were those States whose rule was expressed in concepts concerning remoteness of vesting. With this background in perspective, the purpose and choice of words used by Congress in section 2041(a)(3) becomes clear.

Section 2041(a)(3) taxes a power which is exercised by creating a second power which "under the applicable local law can be validly exercised so as to *postpone the vesting of any estate or interest in property, or suspend the absolute ownership or power of alienation of such property,*" for an impermissible period of time. (Emphasis added.)

PAGE 679

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PAGE 680

The language of the statute regarding postponement of vesting, suspension of absolute ownership, and suspension of the power of alienation, does not, as respondent maintains, provide for alternative conditions applicable in all cases. Rather, each condition of title is simply shorthand terminology for the local rule against perpetuities. Thus, section 2041(a)(3) taxes the exercise of any power of appointment if the donee exercises the power by creating a second power which, under the applicable local rule against perpetuities, can be validly exercised to effect the appropriate condition of title for longer than the permissible period. Accordingly, if the local rule against perpetuities is expressed in terms of remoteness of vesting, under section 2041(a)(3) we must determine if vesting of appointed property may be postponed for a period ascertainable without regard to the date of the creation of the first power. Similarly, if the local rule is expressed in terms of suspension of the power of alienation or absolute ownership, a determination must be made as to whether the prohibited condition may exist for longer than the permissible period.

Our interpretation of the statute is further supported by respondent's own regulations which provide in pertinent part:

(ii) If the power is exercised by creating another power of appointment which, under the terms of the instruments creating and exercising the first power and under applicable local law, can be validly exercised so as to (a) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (b) *(if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than of vesting)* suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power. [Sec. 20.2041-3(e)(1)(ii), Estate Tax Regs.; emphasis added.]

Thus, under section 2041(a)(3), the exercise of any power of appointment will be taxable if the donee exercises the power by creating a second power which can be validly exercised so as to postpone the vesting of any interest in property, or "(if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than vesting)" suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power. Hence, the question is whether the Wisconsin law of perpetuities, the applicable local law in this case, measures the period of

PAGE 680

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PAGE 681

perpetuities from the time a general or special power is exercised or from the time it was created.

As previously noted, Wisconsin has by statute eliminated the common law rule against perpetuities and has substituted in its stead a rule against suspension of the power of alienation modeled after New York's statute. Wis. Stat. Ann. sec. 700.16(5); *In re Walker's Will*, 258 Wisc. 65, 45 N.W.2d 94 (1950). In pertinent part the relevant Wisconsin statute provides:

Sec. 700.16 *Perpetuities and suspension of power of alienation.* (1)(a) A future interest or trust is void if it suspends the power of alienation for longer than the permissible period. The permissible period is a life or lives in being plus a period of 30 years. * * * *

(c) If a future interest or trust is created by exercise of a power of appointment, the permissible period is computed from the time the power is exercised if the power is a general power as defined in s. 702.01(4) even if the power is exercisable only by will; in the case of other powers the permissible period is computed from the time the power is *created* but facts at the time the power is exercised are considered in determining whether the power of alienation is suspended beyond a life or lives in being at the time of creation

of the power plus 30 years. [Emphasis added.]

In the instant case, decedent's power was not a general power of appointment as defined in sec. 702.01(4), Wisconsin Statutes, /29/ and is therefore governed by the second clause of subsection (c) of the Wisconsin statute set out above. Under this clause the perpetuities period is measured from the date the first power is created. Since a requisite of section 2041(a)(3) is that under the applicable local law the perpetuities period on the second power is computed from a date ascertainable without regard to the date of the creation of the first power, the statute has no application in this case. See A. Casner, Estate Planning, pp. 675, 710-711 (3d ed. 1961).

To hold otherwise would have the undesirable effect of indirectly imposing upon one State the rule against perpetuities of another State. In other words, the conditions of title which appear in section 2041(a)(3) are not defined in the Internal Revenue Code. They are, as stated above, various State law formulations of the rule against perpetuities, and therefore, we

PAGE 681

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must look to State law for their meaning. Because of the many statutory variations of the Rule, a transfer by appointment may comply with one State's rule on suspension of the power of alienation and yet violate another State's rule against remoteness of vesting. In this instance, a literal reading of section 2041(a)(3) would tax the exercise of the power of appointment. As a result, draftsmen would be held to a standard requiring them to avoid creation of conditions of title considered objectionable in States other than their own. /30/ This interpretation of section 2041(a)(3) would ignore the evolution of the Rule throughout the various States and extend its reach well beyond that intended by Congress. Indeed, the Senate Report /31/ accompanying the predecessor of section 2041(a)(3) in referring to a situation in "at least one state" indicates to us that Congress did not intend the application of the statute to be so broad in its scope. /32/

Respondent asserts that acceptance of petitioner's position would leave open to individual States the ability to circumvent section 2041(a)(3) by enacting laws similar to those in Wisconsin. Aside from the fact that we think it unlikely that States would take such steps to upset established local property law, any potential for abuse in this area would better be curbed by Congress. Indeed, without deciding the question at this time, through passage of the generation-skipping transfer provisions in 1976, /33/ it would appear that Congress has already acted, albeit indirectly, to close the loophole perceived by respondent in this case.

Accordingly,

Decision will be entered for the petitioner.

Footnotes

/1/ Unless otherwise indicated, all section references are to the Internal Revenue Code

each appointed by her will. However, Josephine or the decedent could not appoint their of 1954, as in effect at the time of the decedent's death.

/2/ The record does not contain the date of Ross' death but it occurred sometime around 1958.

/3/ In the event that either Josephine or the decedent died prior to the termination of the Harris Trust, their respective income interests were thereafter payable to whomever each appointed by her will. However, Josephine or the decedent could not appoint their income interests to their respective estate, creditors, or creditors of the estate.

/4/ Specifically, John was to receive one-half of the decedent's income interest in the Harris Trust for his life. If he died before the termination of the Harris Trust, his income interest was thereafter payable to the MMM Family Trust.

/5/ The decedent's will also gave the trustee of the MMM Family Trust the power to sell any property not specifically devised or bequeathed.

/6/ The number of decedent's children and their respective ages are not in the record.

/7/ With certain exceptions, sec. 2041(b) defines a "general power of appointment" to mean a power which is exercisable in favor of the decedent, his estate, or the creditors of either.

/8/ A "special power of appointment" is one which is not a general power as defined in sec. 2041(b). See n. 7 *supra*.

/9/ 5 R. Powell, Real Property 537, et seq. (1977). /10/ 5 R. Powell, *supra* at 553.

/11/ 4 Restatement, Property, sec. 370 (1944). /12/ 4 Restatement, *supra*, Comment i. /13/ 4 Restatement, *supra*, Comment j.

/14/ The most common example of an interest which causes no suspension of the power of alienation but which may not vest within the perpetuities period is one where A conveys land to B church to be held so long as the property is used for a parsonage, and thereafter to C and his heirs. There is no suspension of the power of alienation because B and C could unite and convey complete ownership of the property; however, C's interest may vest beyond the perpetuities period and is therefore voided under the Rule. See 5 R. Powell, *supra* at 588-590.

/15/ 4 Restatement, *supra*, Comments b and c. /16/ 5 R. Powell, *supra* at 574.

/17/ W. Leach, "Perpetuities in a Nutshell," 51 Harv. L. Rev. 638, 653 (1938).

/18/ Further, when testing the appointment under the Rule, circumstances existing at the time the appointment is made are taken into account. W. Leach, *supra* at 654.

/19/ The relevant Delaware statute provides:

Sec. 501. Powers of appointment; effect of rule against perpetuities.

Every estate or interest in property, real or personal, created through the exercise, by

will, deed or other instrument, of a power of appointment, irrespective of: (1) Whether such power is limited or unlimited as to appointees; (2) The manner in which such power was created or may be exercised;

(3) Whether such power was created before or after the passage of this section, shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment. No such estate or interest shall be void on account of any such rule unless the estate or interest would have been void had it been created at the date of the exercise of such power of appointment otherwise than through the exercise of a power of appointment. [Del. Code Ann. tit. 25, sec. 501 (1974).] /20/ W. Leach, *supra* at n. 37.

/21/ The Senate Report accompanying the Powers of Appointment Act of 1951 stated in pertinent part:

"The new section 811(f)(4) deals with successive powers of appointment. In at least one State a succession of powers of appointment, general or limited, may be created and exercised over an indefinite period without violating the rule against perpetuities. In the absence of some special provision in the statute, property could be handed down from generation to generation without ever being subject to estate tax.

"Under section 811(f)(4) the exercise of any power of appointment created after October 21, 1942, will be taxable if it is exercised by creating another power of appointment which under local law can in turn be exercised so as to postpone the vesting of the property for a period which is ascertainable without regard to the date of the creation of the first power. This is true whether or not the first power is exercisable in favor of the holder of the power or his estate. [S. Rept. 382, to accompany H.R. 2084 (Pub. L. 82-58), 82d Cong., 1st Sess. (1951).]"

/22/ Sec. 2041(a)(3) provides as follows:

(a) In General. -- The value of the gross estate shall include the value of all property --
* * * *

(3) Creation of another power in certain cases. -- To the extent of any property with respect to which the decedent -- (A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037,

exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

/23/ Her husband's renunciation of this second power does not alter the fact that the decedent exercised her power by creating a second power. See sec. 20.2041-1(d), Estate Tax Regs.

/24/ L. Simes, *Future Interests* 263, et seq. (2d ed. 1966). /25/ L. Simes, *supra* at 298, et seq. /26/ L. Simes, *supra* at 312. /27/ S R. Powell, *supra* at 549-552. /28/ See n. 27 *supra*.

/29/ Wis. Stat. sec. 702.01(4) provides in part:

(4) "General power" means a power exercisable in favor of the donee, his estate, his creditors or the creditors of his estate, whether or not it is exercisable in favor of others. *
* *

/30/ It might be argued that Congress intended to use the common law rule against perpetuities as a touchstone in sec. 2041(a)(3). However, while it appears that Congress, through sec. 2041(a)(3), sought to encourage compliance with that aspect of the common law rule which measures the perpetuities period from the date of a special power's creation, it is far from clear that Congress intended to also force compliance with all aspects of that rule. Indeed, assuming we could define a universal common law rule, acceptance of this approach would likewise have the ill effect of imposing the common law rule and all its mysteries in the many States which have statutorily modified the common law rule to alleviate some of its more arcane aspects. We think Congress did not intend such a result. /31/ See n. 21 *supra*.

/32/ That is not to say that the statute has application in only one State; rather, we are merely stating that we do not think Congress intended it to operate as extensively as respondent argues here.

/33/ See secs. 2601, et seq., I.R.C. 1954, as amended.

Statement of Legislative Intent

By Stephen E. Greer

This bill follows the intent of originally proposed SB 162 which would abolish the Rule Against Perpetuities but does so in a manner which avoids a potential tax trap, discovered after SB 162 was introduced last year. The following discussion is as close as the law comes towards approaching rocket science. Nonetheless even though complicated, the proposed legislative fix encompassed by this bill is extremely important to: individuals who have established dynasty trusts in our state; the lawyers who drafted them; and our reputation as the premier state in which to establish a trust. This legislation is strictly remedial in nature and attempts to fix a later discovered tax problem attendant with the manner in which the Rule Against Perpetuities was abolished in April of 1997.

I. Who is behind this bill and why?

A group of estate planning attorneys in Alaska meet informally on a continual basis to discuss the very complex and continually changing aspects of the estate planning profession. These attorneys are dedicated to the improvement of Alaska's laws to keep us in the forefront of the trust industry. Alaska has been on the cutting edge of this industry on a nationwide basis in recent years. This reputation is the result of our state enacting creative and innovative trust laws, which not coincidentally is being replicated by an increasing number of other states. Nonetheless if we in Alaska are to remain in the forefront, our laws must be kept current. Being a leader has its disadvantages. The strength and weakness of any new law can not be fully assessed at the outset. Only after some time passes can this assessment be made. The burden of constantly improving existing law and the willingness to address change is the one which any leader must bear, whatever the profession. Make no mistake about it, we in Alaska are nationally respected as a leader in the trust industry. Unfortunately compounding our responsibility of remaining a leader in trust law is its inextricable link with federal tax law. As we all know, federal tax law constantly changes. Our laws must both anticipate and keep current with these changes. If we fail in this effort, all previous efforts to establish a trust industry in this state will go for naught.

This bill addresses and answers that challenge. There are other bills concerning trust and probate law which have been or will be introduced in this legislature which address the challenge of remaining a leader in the field of trusts. No attorney who has expressed a desire to participate in the formulation of these laws has been excluded, on the contrary all those who have been willing to contribute have been invited to participate. It can also be said none of these bills represents the exclusive position of the drafter but more often than not are a product of compromise and painstaking review.

II. History of our state law concerning the Rule Against Perpetuities and its importance to trusts.

The common law rule against perpetuities ("RAP") as it relates to trusts states every beneficial interest and the property subject to those beneficial interests, must vest within a period of time measured from the time the trust was originally created. The period of time is the lifetimes of all beneficiaries alive at the time the trust was created, plus 21 years. If it is determined at the time the trust was created that there exists a possibility an interest of a beneficiary might not vest within this period of time, then this interest is void. The Alaska legislature enacted the Uniform Statutory Rule Against Perpetuities ("USRAP") effective January 1, 1996. This Uniform Rule ameliorates the harshness of the common law rule and adopts a "wait and see" approach to determine whether a beneficial interest might vest and establishes a term of 90 years as an alternative within which time a beneficial interest can vest.

In April of 1997, our legislature amended AS 34.27.050(a) by including (3) which states the RAP is inapplicable to those trusts where a trustee has the ability to make a distribution to a person who is living at the time the trust is created. Because in almost every case a trustee can make the above described distribution, it was generally accepted we had abolished the RAP, if not explicitly, at least implicitly. Abolishing the RAP is a significant reason for the growth of our state's trust business since 1997. By rendering the RAP ineffective as applied to trusts, it became possible to create a trust which could continue forever. These trusts are frequently referred to as

“perpetual trusts ” or “dynasty trusts” and the terms are used interchangeably here. By making a trust “perpetual” it is also possible to avoid the diminishing effect of estate tax as the trust property passes from one generation to the next. As a result trust assets can grow dramatically, resulting in Alaska becoming a very attractive place to create a trust. When we enacted this legislation in 1997, we were not the first state to abolish the RAP, although we were one of the few states to have done so. Unfortunately an increasing number of other states have seen the benefit of abolishing the RAP. Illinois, Idaho, South Dakota, Maryland, Wisconsin and Ohio are just a few of those states which have joined the parade. Many other states have legislation either pending or under consideration.

III. Why was it decided to abolish the RAP with the introduction of SB 162?

The manner in which we abolished the RAP left some uncertainty in the minds of outside practitioners whether or not we had in fact done so. As a result it was felt it would be better for us to just come out and say so by statute. This would have the practical effect of making our trust laws more understandable to outside observers and would naturally increase the marketing potential of our state. In addition it would also cure a technical glitch which was discovered after the 1997 law was passed, where it unclear whether a charitable lead dynasty trust could be created in our state or whether a trust funded exclusively with Crummey withdrawal rights would be considered perpetual. That was the frame of mind which existed when SB 162 was originally introduced.

IV. What was wrong with SB 162?

The intent of SB 162 was commendable. However after SB 162 was introduced it was discovered the manner in which we abolished the RAP in April of 1997 created a potential tax consequence. Passage of SB 162 would only perpetuate this problem. The tax problem is very difficult to understand but it exists with any perpetual trust in which a beneficiary is given a special power of appointment. This bill follows the intent of SB 162 in abolishing the RAP

except in the one limited circumstance where property is subject to the exercise of a special power of appointment which is exercised to create a successive power of appointment. Even then the perpetuity term is being extended for all practical purposes into perpetuity. This bill is distinguishable from SB 162 because this bill provides a legislative fix for perpetual trusts drafted after April 1, 1997 and also avoids the "Delaware Tax Trap" for perpetual trusts created after the date of enactment. As will be discussed, giving future beneficiaries special powers of appointment are an indispensable tool in the formulation of a perpetual trust. By giving beneficiaries the special power to appoint trust assets, it is possible to make this otherwise irrevocable trust, flexible so future events can be addressed.

V. Typical Perpetual Trust with Special Powers of Appointment.

In a trust it is quite common to give beneficiaries special powers of appointment. A beneficiary who has a special power of appointment can decide who can benefit from the trust property either at their death or during their life depending on whether the power is a testamentary or inter vivos special power of appointment. If a special power of appointment is not exercised then the trust document invariably provides for a disposition in some alternative manner.

Example 1. A creates a trust for B and gives B a special power to appoint the trust property at B's death to any individual other than to B's estate or creditors of B's estate. The trust document further states if B fails to exercise the special power of appointment, the property will be distributed outright to B's 2 children, C and D. C turns into a drug addict and D is an anesthesiologist with a high exposure to liability. B could exercise the special power of appointment and appoint the trust property away from C and give it to D in trust for the benefit of D. The trust for D could be drafted to prevent the attachment of the trust assets by D's creditors. Furthermore D could be given a special power of appointment to further appoint the trust assets to those beneficiaries which D might choose and in the manner in which D might choose, whether as an outright distribution or in trust for those beneficiaries.

VI. Detailed explanation of tax problem.

The Internal Revenue Code ("Code") imposes estate tax on property owned by a person at the moment of death. Property subject to the exercise of a special power of appointment will not be included in the estate of a person who holds this special power of appointment. This is because the ownership rights attendant to a special power of appointment do rise to a level where the property subject to this power of appointment would be included in a person's estate for estate tax purposes. On the other hand property subject to a general power of appointment will be included in the holder's estate.

In 1951 virtually every state in the country had adopted the RAP. The federal government was satisfied with this rule because this rule states all trusts must eventually terminate. When trusts terminate and the assets are distributed to the beneficiaries, the property will be exposed to estate tax when the beneficiaries die. The RAP states whenever the holder of a special power of appointment exercises it to create other trusts which in turn give beneficiaries of those trusts the further ability to exercise special power of appointments, the time period within which these powers may be exercised and the time period in which the property interests subject to these successive special powers of appointment must vest, is measured by calculating the perpetuities period from the date of creation of the trust instrument granting the first special power of appointment. Sounds complicated but really not.

Example 2. A creates a trust for B and gives B a special power of appointment. B exercises the special power of appointment to create trusts for C and D, and gives both C and D special powers of appointment. C and D can validly exercise their special power of appointments only if those special powers can be exercised within the applicable perpetuities period. This period is measured from the date of the instrument creating the first special power of appointment. Moreover the property subject to this power also must vest within this same time period.

Delaware modified its RAP to provide whenever a holder of a special power of appointment exercises a special power of appointment to create another trust which in turn gives the beneficiaries of those trusts the ability to exercise special power of appointments, a new beginning date for measuring the perpetuities period arises at the moment a special power of appointment is exercised to create a successive special power of appointment. Thus it was possible in Delaware to create a trust which gave holders of special powers of appointment the ability to exercise them to create successive special powers of appointment and these trusts could last forever. Furthermore if a beneficiary was given a special power of appointment as opposed to a general power of appointment, the trust property would not be included in the beneficiary's estate and would escape estate tax. The ability to have trusts go on forever and avoid the imposition of estate tax naturally promoted the trust industry in Delaware.

The federal government attempted to fix the Delaware problem by enacting the predecessor to now Internal Revenue Code section IRC 2041(a)(3) and its gift tax counterpart 2512(d). These sections provide property subject to special power of appointment will be included in the estate of the holder of a special power of appointment if the holder exercises the special power of appointment in a manner which creates successive special powers of appointment, but only if on the date in which the successive power of appointment was created, the determination of the perpetuity period did not relate back to the date of the instrument creating the first special power of appointment. As indicated in the example 2, above, in every other state, except Delaware, the date for determining the validity of the exercise of a special power of appointment and the determination of the vesting period of property subject to its exercise relates back to the date of the instrument creating the first special power of appointment. In Delaware successive special power of appointments did not relate back, instead a whole new perpetuities period is commenced when successive special power of appointments are exercised. Eventually Internal Revenue Code sections 2041(3) and 2512(d) became known as the "Delaware Tax Trap" because a Delaware practitioner could inadvertently "fall into the trap" and subject the trust property to either gift or estate tax if they created a trust which gave beneficiaries the ability to exercise special powers of appointment to create a successive special powers of appointment.

VII. How have other states avoided the Delaware Tax Trap when they abolished the RAP?

As previously indicated, other states have seen it in their interest to abolish the RAP. However in at least a few of those states, they have done so in a way which does not run afoul of the Delaware Tax Trap by coming under the holding of a Tax Court case, known as the Estate of Murphy v. Commissioner, 71 T.C. 671 (1979). These jurisdictions do not state their RAP as a time in which property interests must vest but rather as a time in which the power of alienation can not be suspended. A rule against the power of alienation states by implication that it is permissible to create a trust which prevents the trust property from being sold. At common law this would be considered a restraint on alienation and this direction would be considered void as against the public policy of promoting the free transferability of property. In those states which have stated their RAP as a time in which the power of alienation can not be suspended, they place a time period on the inalienability of property after which time the property must be capable of being sold. This period of time is invariably stated as a variation of the same time period found in the RAP pertaining to vesting of property interests.

Treasury regulations under 2041(a)(3) provide whether a state articulates its RAP as a rule against the remote vesting of property or as a rule against the suspension of the power of alienation, if a power of appointment is exercised to the create another power of appointment then the period of time in which the vesting of property is delayed (if local law states the rule as one against the remote vesting of property) or in which the power of alienation is suspended (if local law states the rule as one against the power of alienation) must be ascertainable by referring back to the date the first power of appointment was created. When one thinks about it this makes little sense. Even though a local law might state its rule as one against the suspension of power of alienation, having the power of alienation does not address the concern which Congress had in mind when it passed the predecessor of sections 2041(a)(3) and 2512(d). If a trust is created in a jurisdiction where a trust can continue forever but the only condition is the property of the trust must be capable of being sold at either the direction of the trustee or the beneficiaries, then it is still possible to have property continue in trust forever without the imposition of estate tax.

The only requirement is the property of the trust must be capable of being exchanged for other property within a stated period of time. The Tax Court in Estate of Murphy v. Commissioner, held 2041(a)(3) is to be read in the alternative, so, if Wisconsin had no RAP pertaining to the vesting of property, but instead had a rule limiting the time in which the power of alienation can be suspended, and furthermore provided that all special powers of appointment relate back, then 2041(a)(3) is not violated. Even though this interpretation does nothing to prevent the use of perpetual trusts to avoid estate tax, the Court found itself bound by Treasury's own regulations. Furthermore Treasury acquiesced in the Tax Court's decision which means the IRS will be bound by the Tax Court's interpretation in future cases. As a result some states which permit perpetual trusts simply provide that although the RAP is otherwise abolished they do have a rule against the suspension of the power of alienation. Furthermore they go on to state any exercise of a special power of appointment must relate back to the date the first special power of appointment was created. These states have a distinct competitive edge over Alaska because in these states a beneficiary can exercise a special power of appointment and exercise it to create successive special powers of appointment, without fear of IRC sections 2041(a)(3) and 2512(d) being violated. Although the vesting of property interests might be delayed, the power of alienation will not be suspended beyond the permissible period, provided the trustee or beneficiaries are given the ability to direct the sale or exchange of trust property for other property.

VIII. How does the Murphy case affect Alaska?

In our state the RAP has always been stated as a rule against the remote vesting of property and not as a rule against the suspension of the power of alienation. When we changed AS 34.27.050 in 1997 we continued to state the RAP as a rule against the remote vesting of property. As a result, any perpetual trust created after April 1, 1997 which gave a beneficiary a special power of appointment which could be exercised to create successive powers of appointment, has the potential for running afoul of Internal Revenue Code sections 2041(a)(3) and 2512 (d). This is because under present Alaska law when a special power of appointment is exercised to create a successive power of appointment, the property subject to these powers will have its vesting

delayed for a period of time that can not be ascertained by referring back to the date of the instrument creating the first power of appointment. In Alaska for trusts created after April 1, 1997, there is no stated period of time in which property interests must vest. As a result, the maximum length of time in which vesting can be delayed can not be determined by referring back to the date of the instrument creating the first power of appointment. Thus, all trust property subject to the exercise of a special power of appointment, which was exercised to create a further trust giving those beneficiaries special powers of appointment, renders that property subject to estate tax or gift tax. This creates a potential problem because it defeats the expectations of those individuals who created these trusts.

IX. Legislative Fix.

We in Alaska could fix this problem by abolishing the RAP and enacting a rule against the suspension of the power of alienation. In so doing we would fall squarely within the Murphy decision. This is what many other states have seen fit to do and this would protect all perpetual trusts drafted after the date of enactment of this bill. However this would do nothing to protect perpetual trusts created after April, 1997 which contain special power of appointments.

This legislation is meant to fix the potential tax problem in both scenarios. For all trusts created after the effective date, the RAP would be abolished except in those instances in which property interests are subject to a special power of appointment which in turn is exercised to create a successive special power of appointment. In this one limited circumstance, the period of time within which these property interests must vest will relate back to the date the first special power of appointment was created, thus avoiding 2041(a)(3). The period of time in which property interests must vest which are subject to a special power of appointment exercised to create a successive special power of appointment would be extended to 1000 years. Although this trust might not be perpetual, a 1000 year term is nonetheless a very large period of time for a trust to last. The 1000 year term is not unique to Alaska. In fact the idea of a 1000 year term was taken directly from legislation now pending in Florida.

Alaska's legislation further provides contingent special power of appointments are valid if exercised within a 1000 years from the date the trust was first created. This corrects an oversight in the 1997 legislation which left in tact a USRAP provision that contingent special power of appointments were valid only if exercised within a 90 year period from the date the trust was created. This oversight dramatically reduces the effectiveness of using special power of appointments in perpetual trusts created under our present law and thus makes Alaska uncompetitive with other states which permit perpetual trusts.

The ability to make the provisions of this bill retroactive to April of 1997 is possible by the clear wording of the second sentence of AS 34.27.070(a) as it now exists in our law. This provision provides the law in effect at the time a power of appointment is exercised to create a successive power of appointment controls, even though for purposes of determining the vesting period the date of exercise relates back to the date of the instrument creating the first power of appointment, which of course predates the date of enactment of this bill. This provision would be removed from 34.27.070(a) and restated and added as a new subsection (d).

Example 3. A created an inter-vivos trust for B on May 1, 1997 and gave B a special power of appointment which B exercised on January 1, 2001 (or any date after April 1, 1997) to create trusts for C and D, giving both C and D special powers of appointment. A's exercise of the special power of appointment on January 1, 2001 would take into account the law in effect on January 1, 2001. If this bill becomes law, it would provide the determination of the period of time in which the vesting of all property interests which are subject to the power of appointment exercised on January 1, 2001 relate back to May 1, 1997 (the date of the instrument creating the first special power of appointment). The period of time in which the property must vest is 1000 years computed from May 1, 1997. Because the period of time in which this property must vest can not be ascertained without regard to the date of the first power, there is no violation of IRC sections 2041(a)(3) or 2512(d).

FISCAL NOTE No. 1

Bill Version: CSSB 162 (JUD)

(S) Publish Date: 1-13-00

STATE OF ALASKA
2000 LEGISLATIVE SESSION

Revision Date/Time (Note if correction) 1/12/00, 5:14 PM Dept. Affected Law
 Title "... relating to the rule against perpetuities, non-vested property interests, and powers of appointment ..." BRU Civil Division
 Component Commercial
 Sponsor Senate Judiciary Committee by Request
 Requester Senate Rules Committee Component No. 2211

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2000) cost: _____

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

CSSB 162 (JUD) permits certain situations where the Rule Against Perpetuities will be superceded, thereby permitting nonvested property interests and certain powers of appointment to be perpetual and never terminating unless otherwise provided for in the governing instrument creating the interest or power of appointment. Under current law, these interests are generally invalid unless, when created, they are to vest or become exercisable within 21 years after the death of an individual then alive or within 90 years of creation.

Passage of CSSB 162 (JUD) would have no fiscal impact on the Department of Law.

Prepared by: Joan M. Kasson *Joan M. Kasson* Phone 465-5370
 Division Attorney General's Office Date/Time 1/12/00, 5:14 PM
 Approved by Commissioner *Bruce M. Botelho* Bruce M. Botelho, Attorney General Date 1/12/00
 Agency Department of Law

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Sponsor Statement

SB 162

In April of 1997, our legislature amended AS 34.27.050(a) by including (3) which states the RAP is inapplicable to those trusts where a trustee has the ability to make a distribution to a person who is living at the time the trust is created. Because in almost every case a trustee can make the above-described distribution, it was generally accepted we had abolished the RAP, if not explicitly, at least implicitly. Abolishing the RAP is a significant reason for the growth of our state's trust business since 1997. By rendering the RAP ineffective as applied to trusts, it is possible to create a trust, which can continue forever. These trusts are frequently referred to as "perpetual trusts" or "dynasty trusts." With careful drafting and the proper allocation of generation skipping tax exemption "perpetual trusts" can avoid all federal estate tax and continue to grow and made available for the use of successive generations. As a result many states have seen it in their interest to abolish the Rule Against Perpetuities. Arizona, Delaware, Idaho, Illinois, Maine, Maryland, Ohio, Rhode Island, South Dakota, and Wisconsin have seen it in the interest to abolish the Rule Against Perpetuities. Colorado, Florida, Iowa, New Jersey, Nevada all have pending legislation to abolish the Rule Against Perpetuities.

However, after we "abolished" the RAP in April of 1997 it was discovered we had also inadvertently stumbled into a potential estate or gift tax problem under sections 2041(a)(3) or 2512(d) of the Internal Revenue Code, also known as the "Delaware Tax Trap." The tax problem is very difficult to understand but it exists with any perpetual trust in which a beneficiary is given a special power of appointment. Anyone who creates a perpetual trust usually wants to give the trust beneficiaries a power to direct the disposition of the trust assets at their deaths as a means of making the trust flexible and adaptable so the needs of future generations can be adequately served. This power to direct the disposition of trust assets at death is referred to as a special, limited or non-general power of appointment. Under our present law if a beneficiary exercises a special power of appointment by directing that the trust assets be continued in trust for the benefit of an individual and that individual is also given a special power of appointment then the trust assets will be subjected to either estate or gift tax liability. A large number of perpetual trusts created in Alaska since 1997 are vulnerable to this problem. It should

be noted that many other states that have abolished the Rule Against Perpetuities also stumbled into the Delaware Tax Trap. The technical nature of the problem makes it truly a trap.

Fortunately a relatively simple solution is at hand. The mechanics of the Delaware Tax Trap can be avoided by requiring that in the limited circumstance where a special power of appointment is exercised to create a successive power of appointment the trust property must eventually vest. This Bill states that in the limited circumstance described above, the date in which trust property must eventually vest is 1000 years from the date of creation of the original trust instrument. A trust, which can last 1000 years, is practically speaking akin to being perpetual. For all other purposes the Rule Against Perpetuities can be abolished and this Bill does exactly that.

Passage of this Bill is necessary if Alaska is to remain a suitable place for all individuals, resident and non-resident alike, who have or would want to create a perpetual trust. On the other hand, failure to pass this Bill not only puts existing perpetual trusts at risk but would eliminate Alaska as a suitable place to create perpetual trusts. This would prove harmful to not only our own citizens but also this legislature's effort to build a viable trust industry in this state. Lastly failure to pass this Bill could also have the unintended consequence of drawing Alaskan capital away from this state, as many wealthy Alaska citizens desiring to create perpetual trusts would invariably seek out other states where they are not exposed to the dangers of the Delaware Tax Trap.