TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

REPEAL OF THE RULE AGAINST PERPETUITIES

LEGISLATIVE PROPOSAL (T&E-2011-09)

TO: Saul Bercovitch, Legislative Counsel
State Bar Office of Governmental Affairs

FROM: Philip J. Hayes, Executive Committee, Trusts and Estates Section, State Bar of California, Member, Estate Planning Subcommittee

DATE: July 12, 2010

RE: Repeal of the Rule Against Perpetuities
A proposal to amend Article 2, Chapter 2, Title 2, Part 1, Division 2 (Sections 711 and 722 through 726) of the Civil Code; to repeal Part 2, Division 11 (Sections 21200 et seq.) of the Probate Code; to adopt a new Part 2, Division 11 (Sections 21200-21204) of the Probate Code.

SECTION ACTION AND CONTACTS:

Date of Approval by Section Executive Committee: April 24, 2010
Approval vote: For: 27 Against: 4 Abstain: 0

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SUMMARY OF PROPOSAL:

This is a proposal to repeal the Rule Against Perpetuities and clarify the application of the rule against restraints on the power of a trustee to sell or transfer trust property in California.

ISSUES AND PURPOSE:

I. INTRODUCTION

The common law Rule Against Perpetuities ("the Rule") originated in seventeenth century England at a time when land ownership was the primary source of power and wealth. The Rule prohibits remote vesting of future interests. As classically stated by Professor John Chipman Gray, the common law Rule provides that "no 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 interest." The Rule was developed to curb dead hand control and maintain alienability of property at a time when English lords were attempting to tie up large tracts of land in trust for perpetuity, thus concentrating and restricting access in the hands of the few to the principal source of wealth at the time.

California inherited this common law Rule, which is famous for haunting attorneys and law students for its technical, rigid and sometimes absurd applications, e.g., concepts such as "the fertile octogenarian."[1] Twentieth-century Rule reform efforts sought to make the Rule easier to understand and less draconian in application. The result of this effort was the Uniform Statutory Rule Against Perpetuities (USRAP), which California enacted in 1991 (Probate Code section 21205), and which remains the law in California. Essentially, in California, irrevocable trusts are invalid to the extent they last longer than a life in being at the time of the creation of the interest, plus 21 years. The Rule in California operates to terminate a trust at the end of the perpetuities period regardless of the circumstances existing at that time (e.g., whether the beneficiaries are capable of handling a distribution, whether it is a prudent time to distribute and/or liquidate trust assets, whether the trust continues to serve its intended purpose).

The Executive Committee of the Trusts and Estates Section of the State Bar (TEXCOM) proposes to repeal the Rule because 1) the Rule's original policy no longer applies in a modern society, 2) the Rule terminates a trust arbitrarily, at a time that can be inconvenient or damaging to the beneficiaries (including the breakup of a family business, see below, 3) the Rule has been rendered irrelevant by its widespread repeal throughout the country, 4) the Rule potentially costs the state of California millions of

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[1] The California Supreme Court once excused an attorney's violation of the Rule in a Will he drafted because the Court believed that the Rule was difficult to understand. *Lucas v. Hamm*, 364 P.2d 685, 690 (Cal. 1962).

dollars in trust and legal business, and 5) California residents wishing to establish perpetual trusts may easily do so by establishing situs in neighboring states.

II. THE MODERN MOVEMENT TO ABOLISH THE RULE[2]

A. The Generation Skipping Transfer Tax

For several reasons, the Rule is on its last legs in the United States. The beginning of the end came in 1986, when Congress reformed and revived the generation skipping transfer (GST) tax. Although Congress has levied taxes on gratuitous transfers since the 1800's, prior to 1986 the estate tax on succeeding generations could be avoided by using successive life estates, easily provided by way of perpetual trusts. Because the estate tax only applies upon the passing of a transferable interest - which a life estate is not - these trusts or other successive life estates could continue through many generations with no estate tax due until the termination of the trust. With the passage of the GST tax in the Tax Reform Act of 1986, Congress attempted to close this loophole by imposing a transfer tax upon the transfer of wealth at each generation.

When Congress implemented a transfer tax upon transfers at every generation, it also provided taxpayers with a limited GST tax exemption.[3] The Internal Revenue Code puts no limit on duration of the exemption, and leaves it to state perpetuities laws to determine when the trust or interest must end. Therefore, in a state that has abolished the Rule, a trust funded with the trustor's GST tax exemption amount continuing in perpetuity for successive generations may never be subject to GST tax.[4]

B. States Abandon the Rule

Prior to 1986, only Idaho, South Dakota, and Wisconsin had abolished the Rule. However, with the advent of the GST tax exemption, perpetual trusts became more attractive, and these states gained a relative advantage in attracting new business. This did not go unnoticed. The GST tax exemption is credited with renewing the salience of

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[2] See Robert H. Sitkoff and Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes* (2005) 115 Yale L.J. 356, 373-74 (hereafter Sitkoff).

[3] The exemption, initially $1 million, was $3.5 million last year. IRC §§ 2010 and 2631. Although the GST tax, along with the estate tax, are currently "inapplicable" this year, all interested parties believe that the GST Tax will be reinstated for 2011. If the estate and generation-skipping transfer tax are not reinstated, the issues outlined in this proposal become more acute and pressing.

[4] A typical perpetual GST tax exempt trust created this year might provide discretionary income and principal to the trustor's children for life, then for the benefit of trustor's grandchildren for their lives, and so on for many generations. The trust funded with $7 million today might be worth $28 million in 20 years, and significantly more when the next generation obtains the beneficial interest. In a state with no perpetuities period, the trust could potentially grow and last forever (or least for a very long time), and principal or income distributed, no matter to what generation, would remain free of transfer taxation.

the Rule in estate planning, precipitating the rush to reform perpetuities laws, and touching off, in the broader context of interstate competition for trust funds, a contest between the states for the most attractive trust environment.

The new breed of Rule reform has taken several shapes. Nineteen states and Washington D.C. have either fully abolished the Rule or have abolished it subject to some statutory limitation, such as requiring that the trust contain a power of sale in the trustee, that the trust clearly opt out the Rule, or that the Rule only applies to real property interests.[5] Five states allow very long trusts or perpetuities periods of up to 1,000 years.[6]

A dwindling number of jurisdictions, including California, still follow USRAP.

III. THE COST OF KEEPING THE RULE

Does abolishing the Rule really increase trust business and benefit trust and estate professionals in the reforming states? Law professors Robert H. Sitkoff and Max M. Schanzenbach have completed a detailed econometric study on the domestic competition for trust funds, which asserts a significant increase in trust assets in certain states that abolish the Rule.[7] Rather than detail the differences between actual abolition of the Rule altogether or some variation of reform such as repeal of the Rule provided the trust permits the trustee to sell trust assets, the study considers a state to have abolished the Rule if the state's "perpetuities law in effect permits a perpetual trust."

Based on nearly 20 years of data from four federal agencies charged with banking regulation, the study determines that through *2003*:

- No observable increase in a state's trust assets resulted from abolishing the RAP prior to the introduction of GST tax.
- Since the introduction of the effective GST tax (and the GST tax exemption), roughly $100 billion in trust funds have poured into states that have abolished the Rule.
- Trust assets increased by $6 billion per abolishing state relative to those states that retained the Rule.

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[5] Alaska, Arizona, Colorado, Delaware, District of Columbia, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode .Island, South Dakota, Virginia and Wisconsin.

[6] Florida, Nevada, Utah, Washington and Wyoming.

[7] See Sitkoff and Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes* (2005) 115 Yale L.J. 356, 373-74.

- The increase in trust assets was found only in states that did not levy fiduciary income tax on trust funds attracted from out of state.[8] In such states, the average increase in trust assets was *$14 billion*.

Because of the highly mobile nature of capital, the costs of moving assets to another state to benefit from its friendly income tax environment and perpetuities rules are insignificant. If the Rule has not been abolished in their home state, wealthy persons create perpetual trusts in fiduciary income tax-friendly states that have repealed the Rule. The increase in trust assets impliedly leads to an increase in trust business and revenue for the practitioners and bankers of the abolishing state. Presumably, estate planning attorneys will draft more perpetual trusts, and fiduciaries and banks will see an increase in fees.

The study concludes that there is domestic competition for trust funds, that “trust funds flow to states with more favorable laws and lower taxes,” and “states that do not provide such benefits will lose trust business.”[9] Effectively, “the RAP is dead. Even if some states retain the Rule Against Perpetuities, the Rule will apply, in effect, only to real property in those states. When it matters, people move their financial assets to escape the Rule’s reach.”

In contrast to this empirical evidence, the arguments for retaining the Rule are a desire for social engineering at whatever cost, regardless of true effect: basically, it consists of a gut feeling that trusts should not last longer than 90 years. The social benefits of this policy are purely theoretical and have not been borne out by any studies, to the knowledge of TEXCOM. The conditions that precipitated the formulation of the Rule in the 17th century do not apply in the 21st.

IV. CALIFORNIA SHOULD REPEAL THE RULE

For many California estate planners who have the luxury of choosing situs for a client’s irrevocable trust, California situs is to be avoided if at all possible. The advent of interstate trust companies has facilitated the move of trust situs from California to, say, Nevada, to establish a perpetual trust that avoids state fiduciary income tax.

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[8] Note that the California Franchise Tax Board and a group of interested attorneys have been working together for over a year to reform California’s fiduciary income tax scheme (Rev. & Tax. Sections 17742 et seq.). A probable outcome is that the new scheme will remove income taxation based on the residence of a California fiduciary, which would put California in this category: California could retain trust funds in several circumstances and also attract funds from out of state.

[9] Robert H. Sitkoff and Max M. Schanzenbach, *Perpetuities, Taxes, and Asset Protection: An Empirical Assessment of the Jurisdictional Competition for Trust Funds* (2008) 42 Univ. of Miami Phillip E. Heckerling Institute on Estate Planning, 12-38.

TEXCOM understands the antipathy many planners feel toward repeal of the Rule. To many, the movement is no more than a gimmick: Who needs a 600-year trust anyway? This attitude was held by the author and many other members of TEXCOM who initially opposed repealing the Rule. However, it has become clear over time that retaining the Rule is a quixotic and ultimately self-defeating proposition.

After California Rule reform, estate planners will not be *forced* to extend the length of the trusts they draft beyond the traditional Rule. In fact, with repeal, the duration of the trust would just be another avenue of inquiry to pursue with the client; and who knows, there may be some California residents who desire a 250-year trust, for whatever reason. TEXCOM believes that the choice should be the client's.

V. PROPOSED LEGISLATION

In drafting the proposed statute repealing the Rule in California, the TEXCOM subcommittee studying repeal surveyed the laws of all U.S. jurisdictions that have repealed (or reformed) the Rule to permit trusts that are essentially perpetual. After debating the merits of the various approaches, the committee settled on the approach utilized by several states, most notable New Jersey and Wisconsin. This approach:

- Repeals the Rule Against Perpetuities entirely with respect to the *vesting* of interests in beneficiaries (proposed Probate Code sections 21200 and 21201).

- Removes donative transfers from the ambit of Civil Code section 711, which invalidates restraints on alienation that are repugnant to the interest created, and relocates this restriction on donative transfers to the Probate Code sections pertaining to the Rule Against Perpetuities. The relocated provisions retain and clarify the traditional restrictions on alienation for donative transfers by prohibiting restraints on the power of alienation of assets (whether in trust or otherwise) for a period exceeding the traditional Rule Against Perpetuities (proposed Civil Code subdivision 711(b) and proposed Probate Code sections 21203 and 21204).

The rule against restraints on the power of alienation was reformed and retained for two reasons: 1) mainly, to ensure that California trusts do not violate Internal Revenue Code section 2041(a)(3) (otherwise known as "the Delaware Tax Trap"),[10] and

[10] The Delaware Tax Trap causes the inclusion of trust assets in a beneficiary's estate if the beneficiary exercises a limited power of appointment to extend the period of vesting or alienation. According to the late Prof. Jesse Dukeminier: "Under the orthodox Rule against Perpetuities, exercises of special powers are read back into the original trust instrument creating the trust. The donee of the power is viewed as the agent of the donor. Any interest created by an exercise of a special power must vest or fail within lives-in-being at the creation of the trust, plus twenty-one years, or the interest is invalid. At one time, Delaware had a statute providing that the exercise of a special power began a new perpetuities period, and all interests had to vest or fail within lives-in-being at the time of exercise of the power, not at the creation of the power, plus twenty-one years. Thus it was possible in Delaware to create a perpetual trust through the creation of successive special powers of appointment. Congress responded by enacting *section 2041(a)(3) of the Internal Revenue Code*. The section provides that the donee's gross taxable estate shall include the value of

2) to prevent ownership of a particular asset in trust for perpetuity (satisfying many of the policy considerations behind the Rule).

Although California has had a form of prohibition on restraints on the power of alienation since 1872 in Civil Code section 711,[11] the committee determined that the statute 1) was too ambiguous to satisfy a requirement of a measuring period dating back to the origin of the interest, and 2) has too rarely been applied by California courts in the donative trust context, and thus was not sufficiently reliable to avoid the Delaware Tax Trap. Therefore the committee removed donative transfers from the ambit of Civil Code section 711 (see proposed Civil Code subdivision 711(b)), and added a rule against restraints on the power of alienation pertaining to donative transfers to the Probate Code (see proposed Probate Code sections 21203 and 21204). This rule clarifies that a restraint on the power of alienation over donative property beyond the traditional perpetuities period is void, replacing the rather ambiguous formulation of Civil Code section 711.

Beyond the revisions to proposed Civil Code section 711 and the addition of the rule against restraints on the power of alienation contained in proposed Probate Code sections 21203 and 21204, the proposal also modernizes the language of Civil Code sections 722 through 726, which incorporate outmoded 19th-century language.

HISTORY: Has a similar bill been introduced either this session or during a previous legislative session? No.

IMPACT ON PENDING LITIGATION: Will the proposal have any impact on litigation currently pending? No.

LIKELY SUPPORT & OPPOSITION:

Support	Why?
Trusts and Estates Attorneys	California estate planning attorneys will no longer need to use the law of other states and/or attorneys from other states to carry out the wishes of clients who desire to establish perpetual trusts.

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the appointive assets if the donee exercises a special power '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.' In a jurisdiction that has repealed the common law Rule against Perpetuities and substituted a rule against suspension of the power of alienation, *with a proviso that the power of alienation is not suspended if the trustee has a power of sale, it is impossible for section 2041(a)(3) to apply*."(emphasis added.) Dukeminier and Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. Rev. 1303, at 1332-1333 (August, 2003).

[11] "A condition restraining alienation, when repugnant to the interest created, is void."

Support California Banks and Trust Companies	Why? Would allow establishment of perpetual trusts in California in more trust administration to stay in California.
Oppose Some academics and practitioners, including the American Law Institute	Why? They are opposed in principle to the concept of perpetual trusts.

FISCAL IMPACT: No negative fiscal impact is anticipated. The retention of legal and trust business in California could result in more business for California attorneys, banks, trust companies and professional fiduciaries, potentially expanding the tax base.

GERMANENESS: This proposal requires the special knowledge, training, experience or technical expertise of the members of the Trusts and Estates section because it proposes additions to the trust law which is the special purview of the Committee.

TEXT OF PROPOSAL:

Repeal of the Rule Against Perpetuities:

Civil Code and Probate Code Provisions

CIVIL CODE

SECTION 1. Section 711 of the Civil Code is amended to read:

§ 711. Conditions restraining alienation void

711. *(a)* ~~Conditions~~ *A condition* restraining alienation, when repugnant to the interest created, ~~are~~ *is* void.

(b) Subdivision (a) does not apply to a property interest or power of appointment created by or arising out of any of the following:

(1) A donative transfer,

(2) A premarital or postmarital agreement, domestic partnership agreement, separation or divorce settlement, spouse's election, or similar arrangement arising out of a prospective, existing, or previous marital relationship or domestic partnership between the parties,

(3) A contract to make or not to revoke a will or trust,

(4) A contract to exercise or not to exercise a power of appointment,

(5) A transfer in satisfaction of a duty of support, or

(6) A reciprocal transfer.

(c) Nothing in this section limits the application of Chapter 2 (commencing with Section 21203) of Part 2 of Division 11 of the Probate Code (relating to the permissible period of a condition restraining alienation of property interests described in subdivision (b) of this section).

SEC 2. Section 722 of the Civil Code is amended to read:

§ 722. Dispositions of income

722. ~~Dispositions~~ *A disposition* of the income of property to accrue and to be received at any time ~~subsequent to~~ *after* the execution of the instrument creating ~~such~~ *the* disposition ~~are governed by the~~ *is subject to Chapter 2 (commencing with Section 21203) of Part 2 Division 11 of the Probate Code, relating to the permissible period of a condition restraining the power of alienation, and other applicable* rules relating to future interests.

SEC 3. Section 723 of the Civil Code is amended to read:

§ 723. Accumulations, when void

723. ~~All~~ *A* direction~~s~~ for the accumulation of the income of property, except ~~such~~ as ~~are~~ allowed by this title, ~~are~~ *is* void.

SEC 4. Section 724 of the Civil Code is amended to read:

§ 724. Rights; Limitations

724. (a) ~~An accumulation of the income of property may be directed by any will, trust or transfer in writing sufficient to pass the property or create the trust out of which the fund is to arise, for the benefit of one or more persons, objects or purposes, but may not extend beyond the time permitted for the vesting of future interests~~ *A will, trust or transfer in writing may not direct an accumulation of the income beyond the permissible period of a condition restraining the power of alienation under Chapter 2 (commencing with Section 21203) of Part 2 of Division 11 of the Probate Code.*

(b) Notwithstanding subdivision (a), the income arising from real or personal property held in a trust forming part of a profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries or forming part of a retirement plan formed primarily for the purpose of providing benefits for employees on or after retirement may be permitted to accumulate until the fund is sufficient, in the opinion of the trustee or trustees, to accomplish the purposes of the trust.

SEC 5. Section 725 of the Civil Code is amended to read:

§ 725. Other directions, when void in part

725. ~~If the direction for an accumulation of the income of property is for a longer term than is limited in the last section, the direction only, whether separable or not from the other provisions of the instrument~~ *A provision in an instrument directing the accumulation of income for a term beyond the limit provided in Section 724*, is void ~~as respects the time beyond the limit prescribed in said last section, and no other part of such instrument is affected by the void portion of such direction.~~ *to the extent it directs such accumulation.*

SEC 6. Section 726 of the Civil Code is amended to read:

§ 726. Application of income to support of beneficiaries

726. When ~~one or more~~ *a* person~~s~~ for whose benefit an accumulation of income has been directed ~~is or are destitute of other~~ *does not otherwise have* sufficient means of support or education, the proper court, upon application, may direct a suitable sum ~~to be~~ applied ~~thereto~~ *to the person's support or education* out of the fund directed to be accumulated for the *person's* benefit ~~of such person or persons~~.

SEC. 7. Part 2 (commencing with Section 21200) of Division 11 of the Probate Code is repealed.

SEC. 8. Part 2 (commencing with Section 21200) is added to Division 11 of the Probate Code, to read:

Part 2. Perpetuities and Conditions Restraining the Power of Alienation of Donative Transfers

Chapter 1. Rule Against Perpetuities Repealed

§ 21200. **Rule Against Perpetuities**

21200. No interest in property is void by reason of any rule against perpetuities, whether common law rule or statutory.

§ 21201. Effect of prior laws

21201. (a) This chapter supersedes the common law rule against perpetuities and the California Uniform Statutory Rule Against Perpetuities.

(b) (1) As used in this section:

(A) “Generation-skipping transfer tax” has the meaning provided in Section 20200.

(B) “GST Trust” means an irrevocable trust that provides for a distribution that may be subject to the generation-skipping transfer tax.

(2) This chapter does not apply to any GST Trust that was partly or wholly exempt from generation-skipping transfer tax for any reason as of this chapter’s effective date if applying this chapter would reduce the proportionate share of the GST Trust that is not subject to generation-skipping transfer tax. The Uniform Statutory Rule Against Perpetuities, Part 2 (commencing with Section 21200), in effect immediately before the effective date of this chapter continues to apply to such a GST Trust.

§ 21202. Application of Part 2

21202. (a) Except as provided in subdivision (b), this part applies to a property interest or unexercised power of appointment whenever created.

(b) This part does not apply to a property interest or power of appointment, the validity of which has been determined in a judicial proceeding or by a settlement among interested persons.

Chapter 2. Permissible Period of Restraint on Power of Alienation

§ 21203. Donative Transfers; Permissible period of restraint on power of alienation

21203. (a) A future interest or trust is void to the extent it restrains the power of alienation longer than the permissible period.

(b) The permissible period is 21 years after the death of an individual then alive.

(c) In determining the permissible period,

(1) The possibility that a child will be born to an individual after the individual's death is disregarded;

(2) The lives of individuals selected to determine the permissible period may not be so numerous or so situated that evidence of their deaths is likely to be unreasonably difficult to obtain;

(3) An individual described as the spouse of an individual alive at the beginning of the permissible period is deemed to be an individual alive when the restraint is created, whether or not the individual so described was then alive.

(d) If the settlor of an inter vivos trust has an unlimited power to revoke, the permissible period commences upon the termination of that power.

(e) If a future interest or trust is created by exercise of a power of appointment,

(1) The permissible period is computed from the time the power is exercised in the case of a general power exercisable in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate, whether or not it is exercisable in favor of others, and even if the general power is exercisable only by will;

(2) The permissible period is computed from the time the power is created in the case of powers other than a power described in paragraph (1), but facts at the time the power is exercised are considered in determining whether the power of alienation is suspended beyond the permissible period.

(f) There is no restraint on the power of alienation by a trust or by equitable interests under a trust if the trustee has power to sell, either express or implied, or if a person then alive has an unlimited power to terminate.

(g) If a restraint on the power of alienation exceeds the permissible period, the restraint only, whether severable or not from the other provisions of the instrument that creates the restraint, is void to the extent of the time beyond the permissible period, and no other part of the instrument is affected by the void portion of the restraint.

§ 21204. Interests excluded

21204. Section 21203 does not apply to any of the following:

(a) A property interest or a power of appointment arising out of a nondonative transfer, except a property interest or power of appointment created by or arising out of any of the following:

(1) A premarital or postmarital agreement, domestic partnership agreement, separation or divorce settlement, spouse's election, or similar arrangement arising out of a prospective, existing, or previous marital relationship or domestic partnership between the parties,

(2) A contract to make or not to revoke a will or trust,

(3) A contract to exercise or not to exercise a power of appointment,

(4) A transfer in satisfaction of a duty of support, or

(5) A reciprocal transfer.

(b) A property interest in or a power of appointment with respect to a trust or other property arrangement forming part of a pension, profit-sharing, stock bonus, health, disability, death benefit, income deferral, or other current or deferred benefit plan for one or more employees, independent contractors, or their beneficiaries or spouses, to which contributions are made for the purpose of distributing to or for the benefit of the participants or their beneficiaries or spouses the property, income, or principal in the trust or other property arrangement, except a property interest or a power of appointment that is created by an election of a participant or a beneficiary or spouse.

(c) A property interest, power of appointment, or arrangement for charitable purposes or to a literary or charitable organization, a cemetery corporation, society, or association, or a veterans' memorial organization.

(d) A trust created for the purpose of providing for its beneficiaries under hospital service contracts, group life insurance, group disability insurance, group annuities, or any combination of such insurance, as defined in the Insurance Code.

SEC. 9. This act is operative January 1, 2012. It applies to a condition, direction for the disposition or accumulation of income, interest in property, trust, or power of appointment created before, on, or after the operative date except as otherwise provided in this act.