MICHIGAN PROBATE & ESTATE PLANNING JOURNAL

Vol. 30 • Summer 2011 • No. 3

TABLE OF CONTENTS

Featured Articles:

STATE BAR OF MICHIGAN PROBATE AND ESTATE PLANNING SECTION

Michigan's RAP Reform Becomes More Instructive for Those Wielding Special Powers of Appointment over Personal Property Held in "Grandfathered" Generation-Skipping Trusts

By James P. Spica*

Introduction

On March 24, 2011, Governor Snyder signed into law a technical amendment to the Personal Property Trust Perpetuities Act of 2008[1] ("2008 Act"). The amending act (enrolled Senate Bill 23 (2011)) and an ancillary set of amendments to Michigan's uniform statutory rule against perpetuities (enrolled Senate Bill 22 (2011)) were assigned 2011 Public Acts Numbers 12 and 11, respectively, with immediate effect. The confluence of these Acts ("Amendment") makes the 2008 Act more instructive for those wielding special powers of appointment over personal property, the transfer tax status of which is still affected by the property's having been held in a trust that was "grandfathered" from federal generation-skipping transfer ("GST") tax under the U.S. Department of the Treasury's effective date regulations.[2]

Such property may enjoy the valuable tax advantage of being exempt from the GST tax, but the effective date regulations subject that advantage to a rule against perpetuities ("RAP") of their own ("Regulatory RAP"), and the Regulatory RAP is expressly liable to be fouled by the exercise of a special power of appointment.[3] The 2008 Act actually did not increase the risk that the exercise of a power of appointment subject to Michigan law might violate the Regulatory RAP, for the Regulatory RAP is entirely independent of local law.[4] But Greenleaf Trust—which proposed the 2008 Act, introduced it to its sponsors, the Michigan Bankers Association and the Council of the Probate and Estate Planning Section of the State Bar, and shepherded the Act through the legislative process[5]—thought that, given the sweeping nature of the Act's perpetuities reforms for personal property held in trust, it might be well if the Act contained some warning of the RAP-related dangers lurking in the Treasury regulations for personal property held in trusts grandfathered from the GST tax.

The upshot is the Amendment, which (in the ways, and for the reasons, discussed below) directs the attention of those interested in "special appointee trusts"[6] to Michigan's uniform statutory rule against perpetuities ("USRAP") and to an improvement (for their purposes) of the USRAP that was effected at the time 2008 Act became law.

The Amendment

Apart from a narrowly drawn anti-Delaware-tax-trap provision, the 2008 Act simply makes the rule against perpetuities ("RAP") and similar rules affecting the duration of trusts inapplicable to interests in personal property held in trusts revocable on, or created after, May 28, 2008.[7] And for the narrow case in which it applies, the Act's anti-Delaware-tax-trap provision extends the ninety-year "wait-and-see period" of Michigan's USRAP to 360 years.[8] The innovation of the Amendment is merely to except "special appointee trusts" from the 2008 Act's application:

> Sec. 4. (1) This act applies only to a nonvested interest in, or power of appointment over, personal property held in a trust that is either revocable on, or created after May 28, 2008, and only to the extent that the trust is not a special appointee trust.
>
> (2) For purposes of this section, a trust is a special appointee trust to the extent it includes assets that were held in a trust that was irrevocable on September 25, 1985, if both of the following apply to the assets:
>
> (a) The assets have continuously been held in trust since September 25, 1985.
>
> (b) The assets have not become subject to

*The author is indebted to Richard C. Mills for comments on a draft of this article.

a general power of appointment since September 25, 1985.[9]

The result is that to the extent a trust created after the 2008 Act's effective date is or becomes a "special appointee trust," nonvested interests in, and powers of appointment over, the assets of the trust remain subject to Michigan's USRAP.[10] *(The RAP-applicability flowchart in the Appendix schematically locates "special appointee trusts" among other circumstances in which Michigan's USRAP applies to property subject to Michigan law after the 2008 Act's effective date.)*

Motivation: The Treasury Regulations

The Treasury's GST tax effective date regulations generally exempt from GST tax any generation-skipping transfer under a trust that was irrevocable on September 25, 1985 to the extent assets are not added to the trust after that date.[11] The regulations contain elaborate rules about what constitutes an "addition" to the assets of a grandfathered trust for this purpose, including a rule that if a nonfiduciary, nongeneral power of appointment is exercised in such a way that the vesting, absolute ownership, or power of alienation of an interest in assets of the grandfathered trust may be postponed or suspended beyond the Regulatory RAP period, the assets subject to the exercise may lose exempt status, thence forward being fully subject to GST tax.[12] And there is a similar rule for the exercise of fiduciary, nongeneral powers.[13]

With respect to both fiduciary and nonfiduciary powers, the Treasury regulations contemplate that the exempt status of assets subject to a trust that was irrevocable on September 25, 1985 may survive the assets' being appointed to a new trust, provided the appointment may not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in the assets beyond the Regulatory RAP period.[14] And in both cases, the Regulatory RAP period is twenty-one years from the death of some life in being at the time the grandfathered trust became irrevocable (plus gestation),[15] though in a nod to the USRAP, the regulations grant that:

> [T]he exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or power of alienation beyond the [regulatory] perpetuates period.[16]

A Trap for the Unwary

It is important to notice that the ninety-year period specified in the Treasury regulations as the Regulatory RAP alternative to the common law testing period is *not* a "wait-and-see" period. Whereas the USRAP sets out two tests for validity, one to be satisfied (if at all) at the time a nonvested interest or power of appointment is created, the other to be satisfied (if necessary) anytime within ninety years thereafter,[17] the Treasury regulations set out two alternative tests *both* of which are to be satisfied *at the time of exercise*: an exercise of a nongeneral power is unoffending under the regulations if either (i) it cannot cause postponement or suspension of vesting, absolute ownership or the power of alienation beyond twenty-one years from the death of some life in being at the time the grandfathered trust became irrevocable (plus gestation); or (ii) it cannot cause postponement or suspension of vesting, absolute ownership, or the power of alienation beyond ninety years from the date of the grandfathered trust's creation.[18]

It follows that the exercise of a nongeneral power of appointment that may postpone or suspend vesting, absolute ownership, or the power of alienation for *the longer of* (i) the common law testing period, or (ii) ninety years satisfies *neither* of the regulatory tests, for as of the time of exercise, it is possible *both* (i) that vesting, absolute ownership or the power of alienation will be postponed or suspended for longer than twenty-one years from the death of some life in being at the time the grandfathered trust became irrevocable (in case all of the measuring lives ter-

minate prematurely), *and* (ii) that postponement or suspension will be longer than ninety years (in case the one of the measuring lives demonstrates real longevity).[19]

Section 2(5) of Michigan's USRAP

Section 1(e) of the USRAP as amended in 1990 by the National Conference of Commissioners on Uniform State Laws was intended to disarm the trap described above by construing all express longer-of-the-two provisions in instruments subject to the USRAP as if they referred only to the common law perpetuities testing period.[20] Michigan, which failed to enact section 1(e) when it originally adopted the USRAP, adopted a version of the provision (tailored for what the Amendment defines as "special appointee trusts") when it adopted the 2008 Act.[21] That version now appears in section 2(5) of Michigan's USRAP.[22]

> (5) If, in measuring a period from the creation of a trust or other property arrangement that was irrevocable on September 25, 1985, language in an instrument governing the effect of an exercise of a power of appointment over property exempt from federal generation skipping transfer tax (a) seeks to disallow the vesting or termination of any interest or trust beyond, (b) seeks to postpone the vesting or termination of any interest or trust until, or (c) seeks to operate in effect in any similar fashion upon, the later of (i) the expiration of a period of time ending with, or not exceeding 21 years after, the death of the survivor of specified lives in being at the creation of the trust or other property arrangement or (ii) the expiration of a period of time that exceeds or might exceed 21 years after the death of the survivor of lives in being at the creation of the trust or other property arrangement, that language is inoperative to the extent it produces a period of time that exceeds 21 years after the death of the survivor of the specified lives.[23]

Now, Michigan has never had a rule against suspension of absolute ownership or the power of alienation with respect to personal property.[24] But with respect to postponement of vesting, the addition of section 2(5) to Michigan's USRAP provided a substantial statutory safeguard against inadvertent loss of GST tax exempt status with respect to powers of appointment over the assets of grandfathered trusts. Given that the maximum period for which exercise of a nongeneral power can postpone vesting is measured from the time the power was *created*,[25] section 2(5) is competent to rescue situations involving exercises of nongeneral powers subject to several common types of perpetuities saving clauses.

Thus, for example, if a special power of appointment over a grandfathered trust is exercised so as to create a new trust subject to a perpetuities saving clause that forces nonvested interests to vest just before the expiration of the common law testing period (measured from the date the grandfathered trust became irrevocable) or ninety years (from that same date), whichever period is *longer*, then (i) section 2(5) will cause the reference to the ninety-year period to be read out of the saving clause, (ii) the exercise will, therefore, not violate the Regulatory RAP, and (iii) the the assets subject to the exercise will, therefore, not lose GST tax exempt status.

It is important to note, however, that section 2(5) does not make Michigan's USRAP foolproof with respect to grandfathered generation-skipping trusts, for the scope of USRAP section 1(e) itself is far from clear.[26] We do not know, for instance, how section 2(5) would be applied if an instrument containing no saving clause at all should exercise a nongeneral power over a grandfathered trust so as clearly to violate the common law RAP—such an arrangement would trigger the USRAP's ninety-year wait-and-see period, which has the effect of a *statutory* longer-of provision.

What the Amendment Achieves

The principal purpose of the Amendment is to warn: by the Amendment, the 2008 Act itself bears the message to those interested in Michigan's perpetuities reform that (thanks to the Treasury regulations) RAP-related concerns associated with assets appointed (directly or indi-

rectly) from trusts of a certain vintage may be entirely different from those associated with other assets held in trusts created after May 28, 2008. An ancillary effect of the Amendment is to make the protection (such as it is) of section 2(5) of Michigan's USRAP available for the exercise of a nongeneral power over assets exempt under the effective date regulations *regardless* whether the power is exercised in favor of a trust that was irrevocable before, or one that became irrevocable after, May 28, 2008.[27]

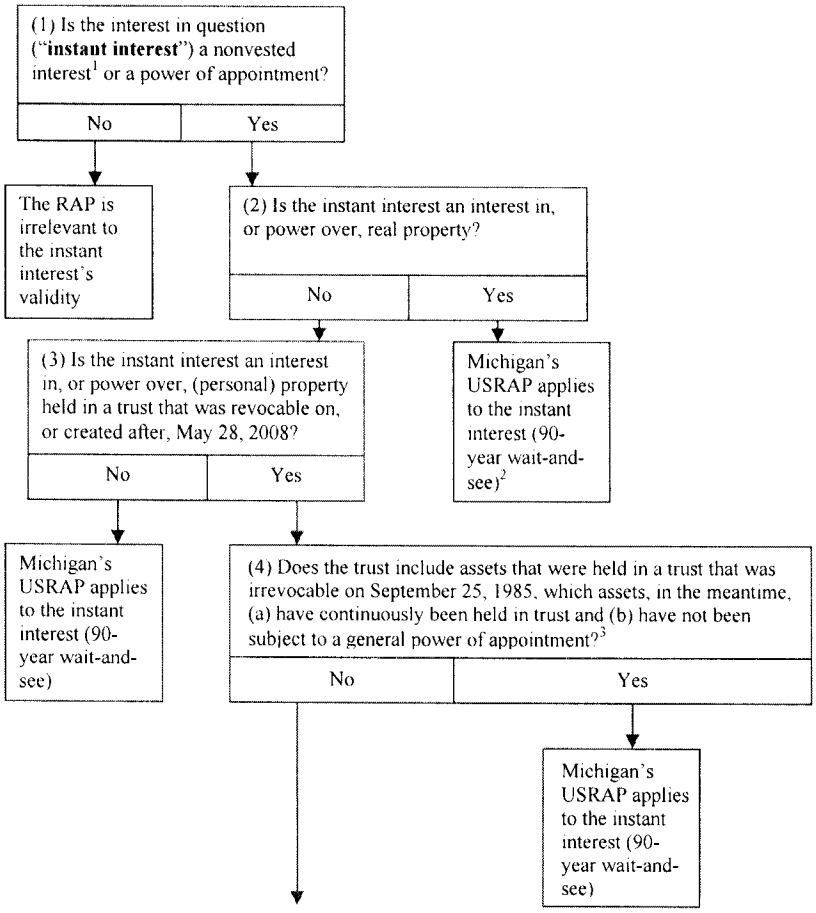
What is more, these benefits are achieved, at least so long as there is a GST tax, at little or no cost to the beneficiaries of "special appointee trusts." For those who contrive to be indifferent to the exemption from that tax, access to perpetuity reform may be purchased simply by subjecting the assets of the trust to a general power of appointment.[28] And in case assets of a "special appointee trust" have lost their GST tax exemption by other means (that is, because of something other than the assets' having been subjected to a general power of appointment[29]), tax planning for the trust will already have focused on the importance of subjecting the assets to a general power—either a presently exercisable power or a testamentary one, depending on whether the greatest tax savings is likely to be produced by the assets' inclusion in the power holder's transfer tax base or that of the appointee.[30]

Conclusion

Anyone who (1) is familiar with the GST tax regulations governing grandfathered trusts, (2) understands the 2008 Act, and (3) is contemplating the exercise of a nongeneral power of appointment over a grandfathered generation-skipping trust subject to Michigan law will immediately sense the danger of extending the period during which vesting of future interests can be postponed beyond what is permitted by the regulations and will disarm that danger by drafting around it. The Amendment is designed to protect those who are *not* familiar with the effective date regulations or with the 2008 Act by making it impossible to appoint assets that may be GST tax exempt under the effective date regulations into the new perpetuities regime and by directing anyone contemplating the exercise of a nongeneral power over such assets to the USRAP, a garbled reference to which he or she will find in the relevant Treasury regulations, and which now incorporates a safeguard against what is, perhaps, the worst of the hidden traps in the regulations.

Appendix

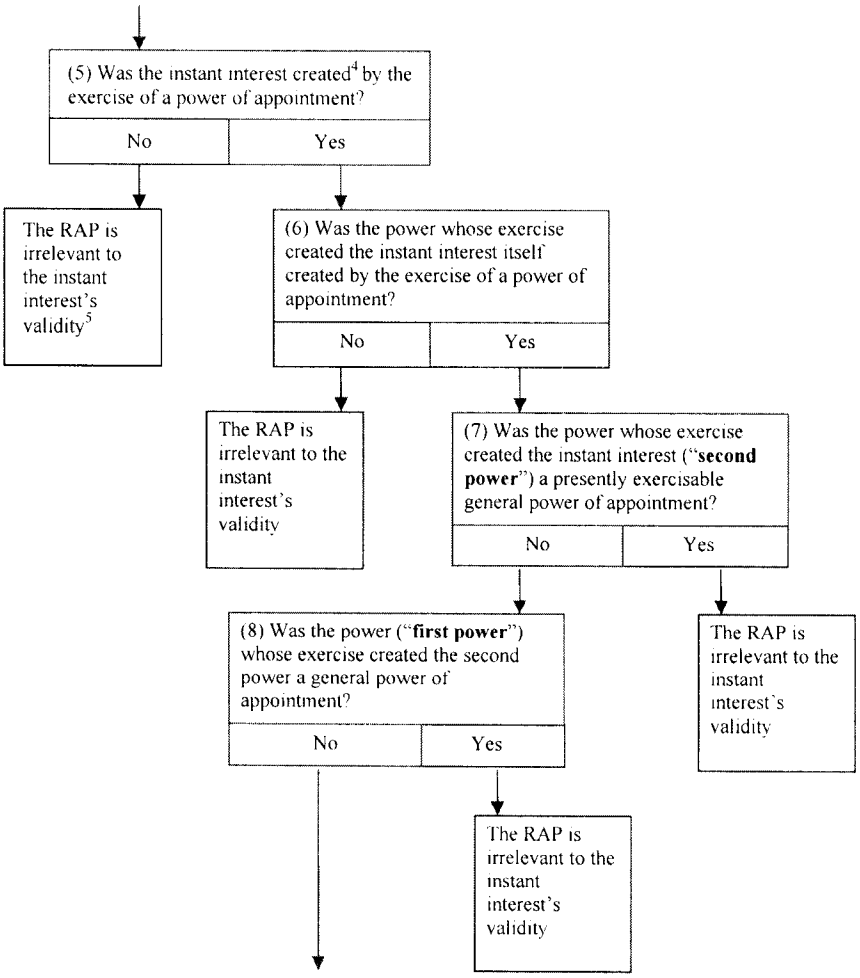
Revised *Post* Perpetuities Reform RAP Applicability Flowchart for Property Subject to Michigan Law



1. I.e., a *contingent* interest created by *transfer*.

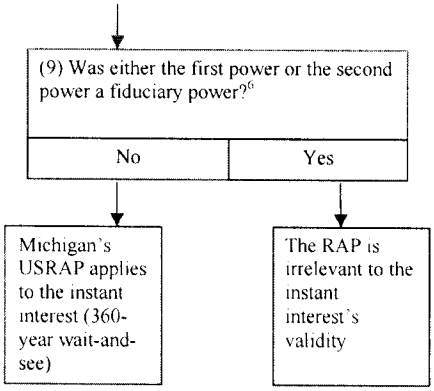
2. The adoption of the uniform statutory rule against perpetuities displaced the common law RAP in Michigan with respect to interests created on or after the USRAP's 1988 effective date. *See* MICH. COMP. LAWS ANN. § 554.53. The common law perpetuities *testing period* is still relevant under the USRAP, for an interest that must vest (if at all) within that period is, *for that reason*, valid under the USRAP. *Id.* § 554.72. But an interest that may vest beyond the common law period cannot be *invalid* under the USRAP before the relevant "wait-and-see" period elapses, a result that flatly contradicts the common law RAP. *See id.* Thus, one should not confuse the continued relevance of the common law *testing period* with continued *application* of the common law RAP itself: the USRAP makes use of the former while displacing the latter.

3. At this point, in order to keep the flowchart binary (i.e., "Yes" or "No," but not both), we have to adopt a sort of separate-share rule: if a trust comprises both (a) assets described in question (4) and (b) other assets, the respective shares are treated as separate trusts for purposes of the flowchart. With respect to the share that comprises assets described in question (4), the answer to question (4) is, "Yes"; with respect to the share that comprises other assets, the answer to question (4) is, "No."



4. For purposes of this flowchart, a preexisting power of appointment *p1* is "created" by another power *p2* to the extent an exercise of *p2* newly subjects assets to *p1*. Thus, for example, if a power holder *H* exercises her power to appoint asset *A* by adding *A* to a preexisting trust *T* over which a beneficiary *B* has a power of appointment, then (for purposes of this flowchart) *B*'s power over *A* is "*created*" by the exercise of *H*'s power.

5. Note that this is *not* to say that such interests cannot be affected by "saving clauses"—provisions in trust or other governing instruments designed to ensure that the RAP is not violated. Saving clauses do not *apply* the RAP to the interests they govern; rather, they prevent the RAP from invalidating those interests by forcing the interests either to vest or terminate within the relevant perpetuities testing period. If a saving clause specifies what is taken (by the drafter) to be the relevant testing period, it may force vesting regardless whether any RAP is actually applicable. A trust provision, for instance, that simply terminates all nonvested interests twenty-one years after the death of the survivor of certain people living at the time of the trust's creation is liable to have that effect *regardless* whether any form of RAP is applicable. Saving clauses vest or terminate interests; they do not *invalidate* them. So, to say that the RAP is irrelevant to a given interest's *validity* says nothing about whether the interest is liable to be convulsed by the effect of a saving clause.



6. I.e., a power of appointment held by a trustee in a fiduciary capacity. *See* MICH. COMP. LAWS ANN. § 554.92(b).

Notes

1. MCL 554.91-.94.

2. Namely Treas. Reg 26.2601-1.

3. *See Id.* 26.2601-1(b)(1)(v)(B); .2601-1(b)(4)(i)(A) (discussed at length *infra* in the text).

4. *See Id.*

5. James P. Spica, *Rule Against Perpetuities Repeal in Michigan*, MICH PROB & EST PLAN J, Summer 2008, at 3.

6. See infra text accompanying note 9.

7. *See* MCL 554.92; Uniform Statutory Rule Against Perpetuities, 2008 PA 149 enacting sec. 1. *See generally* Spica, *supra* note 5, *passim*.

8. MCL 554.93(3); .75(1)(f)-(2). See generally Spica, supra note 5, at 4-9. See also James P. Spica, A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute Is Too Clever by Half (of Infinity), 43 REAL PROP TR & EST L J 673, 678-81 (2009).

9. MCL 554.94 as amended by 2011 PA 12 (with changes effected by amendment indicated typographically).

10. *See Id.* 554.75(1)(f) as amended by 2011 PA 11 (effective March 24, 2011) (making section 2 of Michigan's USRAP inapplicable, except with regard to the ant-Delaware-tax-trap provision, to any interest or power of appointment to which the 2008 Act applies).

11. *See* Treas. Reg 26.2601-1(b)(1)(i).

12. *See id.* 26.2601-1(b)(1)(v)(B). The precise effect of loss of "grandfathered" status is not spelled out in the effective date regulations, and the Internal Revenue Service has taken inconsistent positions in private letter rulings. *See generally* William R. Culp, Jr. & Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP TR & EST LJ 1, 22 (Spring 2010).

13. *See* Treas. Reg 26.2601-1(b)(4)(i)(A).

14. *See id. See also* 26.2601-1(b)(1)(v)(D)(ex. 4) (especially the last sentence).

15. *See Id.* 26.2601-1(b)(1)(v)(B)(2); .2601-1(b)(4)(i)(A)(2).

16. Id. 26.2601-1(b)(1)(v)(B)(2). See also id. § 26.2601-1(b)(4)(i)(A)(2). See generally Jesse Dukeminier, The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities, 185 REAL PROP TR & EST LJ 185, 189-90 (1995).

17. *See* MCL 554.72(1).

18. *See supra* notes 15-16 and accompanying text.

19. *See* Treas. Reg 26.2601-1(b)(1)(v)(D)(ex. 6). *See also* Dukeminier, *supra* note 16, at 195-96.

20. Dukeminier, *supra* note 16, at 187-94.

21. *Compare* Unif. Statutory Rule Against Perpetuities § 1(e) (amended 1990), 8B U.L.A. 237 (2001) *with* MCL 554.72(5) as amended by 2008 PA 149 (effective May 28, 2008). *See* Spica, *supra* note 5, at 10.

22. *See* MCL 554.72(5).

23. *Id.*

24. The common law RAP was partly superseded in Michigan, from 1847 to 1949, by statutory provisions limiting suspension of the power of alienation. *See Lantis v Cook*, 342 Mich 347, 69 NW2d 849 (1955). Those provisions applied only to real property. *Rodey v Stotz*, 280 Mich 90, 273 NW 404 (1937). Later amendments repealed the provisions and restored the applicability of the common law RAP to real property, "thereby making uniform the rule as to perpetuities applicable to real and personal property." Public Act. No. 38, 1948 Mich. Pub. Acts 38 (effective Sept. 23, 1949) (codified as MCL 554.51). And there was no rule against suspension of the power of alienation at common law. *See* JOHN C. GRAY, THE RULE AGAINST PERPETUITIES (4th ed. 1942). Of course, the rule against suspension of the power of alienation has to be distinguished from prohibitions against direct restraints on alienation that may be ineffective *per se*, without regard to their duration. *See, e.g.*, Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 EST PLAN 68, 70 (2001).

25. *See* MCL 556.124.

26. *See* Dukeminier, *supra* note 16, at 199-201.

27. *See* MCL 554.75(1)(f) as amended by 2011 PA 11 (effective March 24, 2011) (making section 2 of Michigan's USRAP inapplicable, except with regard to the ant-Delaware-tax-trap provision, to any interest or power of appointment to which the 2008 Act applies).

28. *See* MCL 554.94(2)(B) (quoted *supra* in the text accompanying note 9).

29. If, for example, a prior exercise of a nongeneral power of appointment has resulted in a "constructive addition" under the Treasury regulations discussed *supra* in the text.

30. Exercise of a nongeneral power so as to create a presently exercisable power causes inclusion in the nongeneral power holder's transfer tax base by means of the Delaware tax trap. *See generally* James P. Spica, *A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, 41 REAL PROP PROB & TR J 165 (2006); Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J TAX'N 242 (1988).

James P. Spica was the principal author of the Personal Property Trust Perpetuities Act, 2008 Michigan Public Acts 148 and 149. He is a member of Dickinson Wright PLLC, specializing in trust banking and estate and tax planning for private clients requiring sophisticated wealth management. He has an LL.M. (in Taxation) from New York University, was a clerk on the U.S. Tax Court, and has held a series of law professorships at the University of Detroit Mercy (tenured 1996) and Wayne State University. He is a member of the Council of the Probate and Estate Planning Section of the State Bar of Michigan and a Consultant to the Trust Counsel Committee of the Michigan Bankers Association. He is also a contributing author to ICLE's *Michigan Estate Planning Handbook, Second Edition.*