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HOW FEDERAL TRANSFER TAXES AFFECT THE DEVELOPMENT OF PROPERTY LAW

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My topic, How Federal Transfer Taxes Affect the Development of Property Law, makes the basic assumption that, to some extent, property law exists because of the federal wealth transfer tax system.² As will be seen, this assumption is correct.

Before delving into my topic, however, it is important to understand the basic relationship between property law and federal tax law. In 1940, the Supreme Court captured the essence of this relationship: “State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.”³

Consider how this relationship applies in the context of federal gift taxation. Before a transaction can constitute a taxable event under the federal gift tax system, the applicable state property laws on gifts must be consulted to determine if the “donor” effectively transferred an interest in property to the intended donee. For example, if the putative donor failed to meet the delivery requirement for making the gift under state law,⁴ then the “donor” would still own the interest in the property. Accordingly, since the transfer would be ineffective under state law, the failed transfer would not be subject to gift taxation.⁵

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²Federal wealth transfer taxes include the estate, gift and generation-skipping transfer (GST) tax systems, which are codified under Chapters 11, 12 and 13 of the Internal Revenue Code of 1986, as amended.

³*Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

⁴Under the law of gifts, chattels capable of manual delivery must be physically delivered. See RAY ANDREWS BROWN, *THE LAW OF PERSONAL PROPERTY* § 7.2 (3d ed. 1975). Thus, an attempt to make a gift of a chattel capable of manual delivery by constructive or symbolic delivery will be ineffective to transfer any interest in the chattel to the intended donee. Interestingly, the position taken in a preliminary Restatement draft rejects the manual delivery rule; in fact, the making of a gift by a writing is treated as a separate basis for making a gift rather than as symbolic delivery. See *RESTATEMENT (THIRD) OF PROP.: DONATIVE TRANSFERS* § 6.2(1), cmt. c and § 6.2(2)(Tentative Draft No. 3, 2001).

⁵In *Estate of Kincade v. Commissioner*, 69 T.C. 247 (1977), the Tax Court applied Indiana law and determined that a purported gift of bearer bonds failed for want of delivery. As a result, the bonds were still owned at death by the purported donor and thus were subject to federal estate tax. *Id.*

Estate of Kincade also illustrates the *Bosch* doctrine that applies pervasively in the federal transfer tax area. See *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). See generally Gilbert P. Verbit, *State Court Decisions in Federal Transfer Tax Litigation: Bosch Revisited*, 23 *REAL PROP. PROB. & TR. J.* 407 (1988). Pursuant to the *Bosch* doctrine, a federal court is not conclusively bound by a lower state court’s decision regarding property rights and interests; rather, the federal court must only give proper regard to the decision to determine whether the decision accords with the highest authority in the state. *Estate of Bosch*, 387 U.S.

This gift tax example also illustrates that state property laws on gifts exist independently of the federal gift tax system. And, this will be true for most property laws they develop and exist independently of the federal transfer tax system. Indeed, property laws have existed for centuries whereas the estate tax system, the first of the current federal transfer tax systems, was not enacted until 1916.⁶

In some instances, however, property laws exist because of the federal transfer tax system. I classify such property laws into three categories: the necessary, the appropriate and the unfortunate. In the remainder of this article, I will give examples of federal transfer tax-based property laws in these three categories. By way of illustration, I will primarily rely on statutory laws of Alaska, California and New York, as well as provisions under the Restatement of Property and Trusts and various Uniform Acts.

NECESSARY TAX-BASED PROPERTY LAWS

Examples of necessary tax-based property laws abound in laws that pertain to the apportionment of federal estate taxes.⁷ These are default rules⁸ that provide how the burden of estate taxes is to be borne by various beneficiaries. Indeed, property laws apportioning taxes among beneficiaries are absolutely necessary. It is also necessary to have a default rule that provides how estate taxes allocated to a trust will be apportioned between trust income and principal. The latest version of the Uniform Principal and Income Act provides, as the default rule, that all the apportioned estate taxes allocated to a trust are payable from trust principal.⁹

at 465. In *Kincade*, the Tax Court determined that a judgment entered by a lower court declaring a valid gift did not accord with how the issue would have been decided by the Indiana Supreme Court. *Estate of Kincade*, 69 T.C. at 259-60. See generally Paul L. Caron, *The Federal Courts of Appeals' Use of State Court Decisions in Tax Cases: "Proper Regard" Means "No Regard,"* 46 OKLA. L. REV. 443 (1993).

As one alternative to the perceived problems caused by an overemphasis on state property laws in the federal estate tax marital deduction area, Professor Mitchell Gans has suggested that the *Bosch* case be overruled. Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does The Marital Deduction Strike The Proper Balance?*, 48 EMORY L.J. 871, 931-33 (1999).

⁶See Rev. Act of 1916, ch. 463 §§ 210-212, 39 Stat. 756, 777-80 (1916). The current gift tax system was enacted in 1932. See Rev. Act of 1932, ch. 209 §§ 501-532, 47 Stat. 169, 245-59 (1932). The current GST-tax system was enacted in 1986. See Tax Reform Act of 1986, 99 Pub. L. No. 514, §§ 1431-1433, 100 Stat. 2085, 2717-32 (1986) (codified as amended in scattered sections of I.R.C.).

⁷See, e.g., UNIF. ESTATE TAX APPORTIONMENT ACT (amended 1964), 8A U.L.A. 331 (1993).

⁸Default rules play a major role in the wealth transmission process. Numerous laws provide rules, which, at the option of the transferor or fiduciary, may be countermanded. For example, § 2 of the Revised Uniform Estate Tax Apportionment Act apportions taxes on a prorated basis among persons interested in the estate "unless the will otherwise provides." Consistent with the primacy of federal law, § 2 only applies to estate tax apportionment not otherwise prescribed under the Internal Revenue Code. See I.R.C. §§ 2206-2207B (1994) (prescribing apportionment rules for certain items of property that are subject to federal estate tax).

⁹UNIF. PRINCIPAL & INCOME ACT § 502(a)(6) (amended 1997), 7B U.L.A. 37 (Supp. 2000).

Tax-based property laws also are necessary to take into account the effect of the estate tax marital deduction in order to define properly the intestate rights of a surviving spouse and other distributees. For example, New York law defines the amount distributable by intestacy as the property not disposed of by will reduced by debts, administration expenses and reasonable funeral expenses “but all estate taxes shall be disregarded.”¹⁰ Consider the following example based on New York law: In 2001, husband dies intestate survived by his wife and one child. Husband’s probate estate is valued at \$1,650,000 after deducting debts, administration expenses and reasonable funeral expenses, but before computing federal (and state) estate taxes.¹¹ Under New York law, the wife as surviving spouse is entitled to \$50,000, plus ½ of the remaining net probate estate of \$1,600,000 or \$800,000. In turn, a federal estate tax marital deduction will be allowed for the \$850,000 that passes by intestacy to the wife,¹² so that the husband’s taxable estate will be \$800,000. The combined federal and New York estate tax liability will be \$47,250.¹³ These estate taxes will all be payable from the intestate share of the child.¹⁴

If, instead, estate taxes were deductible to determine the base amount upon which wife’s share was determined, a severe interdependent variable problem would arise. The amount of estate taxes would depend on the value of the marital deduction, but the value of the marital deduction would depend on the value of the distributable base. Although the problem can be solved algebraically,¹⁵ the effect of reducing the base by estate taxes would dramatically decrease the intestate share of the surviving spouse.

Similarly, New York treats estate taxes in the computation of the elective share base under its right of election statute.¹⁶ As with New York’s intestacy statute, the exclusion of estate taxes from New York’s elective share computational base avoids the inappropriate reduction of the surviving spouse’s elective share that could cause an increase in federal and state estate taxes.

¹⁰N.Y. EST. POWERS & TRUSTS LAW § 4-1.1 (McKinney 1998).

¹¹All states have some type of death tax system. The majority of states employ a so-called SOP tax whereby the state death tax equals the amount that is creditable against the federal estate tax by I.R.C. § 2011. *See* IRA MARK BLOOM ET AL., *FEDERAL TAXATION OF ESTATES, TRUSTS & GIFTS* 146-49 (2d ed. 1998) (discussing § 2011).

¹²I.R.C. § 2056(a), (c)(2) (1994).

¹³The federal tax imposed on a taxable estate of \$800,000 is \$267,800, for which a credit of \$220,550 is allowed pursuant to I.R.C. § 2010. New York imposes an estate tax equal to the maximum creditable amount under I.R.C. § 2011, which in the example is \$23,760. *See* N.Y. TAX LAW § 952 (McKinney 1999). The federal estate tax is \$23,490 and the New York estate tax is \$23,760, for a combined total of \$47,250 in estate taxes.

¹⁴Pursuant to New York’s estate tax apportionment statute no tax will be apportioned against the wife’s intestate share because it qualifies for the estate tax marital deduction. *See* N.Y. EST. POWERS & TRUSTS LAW § 2-1.8(c)(2) (McKinney 1998).

¹⁵*See* I.R.S. Pub. No. 904, *Interrelated Computations for Estate and Gift Taxes* (Rev. May 1985).

¹⁶*See* N.Y. EST. POWERS & TRUSTS LAW § 5-1.1A(a)(2) (McKinney 1999). The Uniform Probate Code’s elective share system provides the same methodology. *See* UNIF. PROBATE CODE § 2-204 and cmt., 8 U.L.A. 104 (1998).

APPROPRIATE TAX-BASED PROPERTY LAWS

Many property laws that developed because of federal transfer taxes are appropriate in my judgment. Examples of laws include property laws relating to powers of appointment, trusts, durable powers of attorney and elective share systems, as well as specific property laws on federal transfer taxes.

Powers of Appointment

Because of their incredible flexibility, powers of appointment are important in the drafting of trusts.¹⁷ Indeed, the late Professor Leach described powers of appointment as “the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out.”¹⁸

Under the 1940 Restatement of Property, a general power of appointment was defined as the ability of the donee of the power to appoint property to himself or herself during lifetime or as the donee’s ability to appoint to the donee’s estate if the power was exercisable only by will.¹⁹ A special power was generally defined as the ability to appoint to a class of persons, exclusive of the donee, provided the group was not unreasonably large.²⁰ In between general and special powers was the so-called hybrid power—the ability to appoint to anyone other than the donee or the donee’s estate.²¹

As the use of powers of appointment burgeoned to accomplish tax goals,²² property law definitions were appropriately changed to mirror the tax definitions. The Restatement (Second) of Property, published in 1983, defines a general power of appointment as a power which is “exercisable in favor of any one or more of the following: the donee of the power, the donee’s creditors, the donee’s estate, or the creditors of the donee’s estate.”²³ Not coincidentally, a general power of appointment is defined for estate tax purposes as a power which is “exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. . . .”²⁴

The Restatement (Second) of Property does not completely interface with the estate tax definition for a general power because the estate tax definition makes various exceptions that remove an otherwise general power of appointment from the

¹⁷RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS pt. V, introductory note (1986). See generally RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS §§ 11.1-24.4 (1986).

¹⁸W. Barton Leach, *Powers of Appointment*, 24 A.B.A.J. 807, 807 (1938).

¹⁹RESTATEMENT OF PROP.: FUTURE INTERESTS § 320(1) (1940).

²⁰*Id.* at § 320(2).

²¹See *id.* at § 320(2) cmt. a. The Restatement did not consider it necessary to treat separately hybrid powers because they were “so rare.” See *id.*

²²“Powers of appointment have been extensively employed in various kinds of estate plans in the hope that the power holder will have many of the benefits of ownership of the property subject to the power without the income, gift and estate tax burdens that accompany outright ownership.” RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS, pt. V, introductory cmt., at 5 (1986).

²³*Id.* at § 11.4(1).

²⁴I.R.C. § 2041(b)(1) (1994).

category of general power.²⁵ California, however, has gone this route; it excludes from the category of general powers that are subject to exceptions under the estate tax definition for general power of appointment.²⁶

The Restatement (Second) of Property does not continue the definitions of special and hybrid powers found in the original Restatement; instead it creates a category called non-general powers.²⁷ Under the Restatement (Second) of Property, non-general powers are effectively any powers that are exercisable in favor of anyone other than one of the four persons (the donee, the creditors of the donee, the donee's estate or the creditors of the donee's estate) in whose favor general power of appointment classification would result.²⁸

In effect, the Restatement (Second) of Property adopts the original Restatement's definition for hybrid powers to categorize powers that are not general.²⁹ Overall, a non-general power under the Restatement (Second) of Property is a power that is neither a general power of appointment for property, nor one for federal estate tax purposes.³⁰

Trust Law and Federal Transfer Taxation of Powers of Appointment

The federal taxation of powers of appointment has affected the development of trust law in at least one specific area: the right of a trustee to make discretionary distributions of trust income or corpus to herself. Apart from tax considerations, there is nothing inherently wrong in effectuating the trust creator's intent to allow the sole trustee of a trust to make discretionary trust distributions to herself. Such a power, however, would constitute a general power of appointment for federal estate tax purposes; as a result, the value of the trust principal would be included in the power holder's gross estate under Internal Revenue Code § 2041.

Some states have responded to the estate tax problem caused by discretionary trust powers exercisable in favor of the trustee. Appropriate state measures essentially provide, as a default rule, that the trustee cannot exercise the power if it

²⁵I.R.C. § 2041(b)(1)(A)-(C) (1994).

²⁶CAL. PROB. CODE § 611(b)-(c) (West 1997). California does not, however, specifically except an otherwise general power that is exercisable only with the consent of the creator of the power as does the federal estate tax law. *See* I.R.C. § 2041(b)(1)(C)(i) (1994).

²⁷RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.4(2) (1986).

²⁸*Id.* at § 11.4(1).

²⁹In the process, the Restatement (Second) of Property acknowledges that the use of broad non-general powers had become "fairly common because the donee will not be regarded as the owner of the appointive assets for federal gift and estate tax purposes, even though possessed of broad control over the destination of such assets." *Id.* at § 11.4 cmt. b. In contrast such powers, denominated as hybrid powers, under the 1940 Restatement were considered rare. *See supra* note 21.

³⁰Instead of non-general power terminology, the Restatement might have better mirrored practice by denominating non-general powers as special powers, as California and New York have done. CAL. PROB. CODE § 66(d) (West 1997); N.Y. EST. POWERS & TRUSTS LAW § 10-3.2(a) (McKinney 1992).

would result in estate tax inclusion.³¹ In effect, the property law avoids a trap for the unwary, but allows the trust creator to override the restriction if so desired.³²

Incorporation of Transfer Tax Rules into Elective Share Systems

Another example of appropriate transfer tax-based property laws involves the design of elective share systems. The most difficult problem in constructing an elective share system is to decide which lifetime transfers will be included in the elective share base. Delaware has solved the problem by incorporating the federal estate tax system to define the elective share base.³³

The Uniform Probate Code (UPC) also relies in part on federal estate tax provisions to determine the composition of the augmented estate. For example, UPC § 2-202(1)(i), under the 1969 version of the Uniform Probate Code, includes property in the augmented estate that would be included in a decedent's gross estate under Internal Revenue Code § 2036(a)(1).³⁴

Under New York's elective share system, irrevocable transfers within a year of death are included in the elective share base unless the transfer qualified for the gift tax annual exclusion or the gift tax exclusion for transfers to educational institutions and medical providers.³⁵ Florida's recently revised elective share system adopts New York's approach to transfers within one year of death.³⁶

³¹See, e.g., ALASKA STAT. § 13.36.153 (Michie 1998); FLA. STAT. ANN. § 737.402(4)(a) (West Supp. 2000).

³²On the other hand, New York's trust rule on the issue is not a default rule. See *infra* text and accompanying notes 62-64 (classifying N.Y. EST. POWERS & TRUST LAW § 10-10.1 as an unfortunate rule).

³³See DEL. CODE ANN. tit. 12, § 902 (1999) (defining the base for estate share purposes as follows:

(a) The elective estate means the amount of the decedent's gross estate for federal estate tax purposes, regardless of whether or not a federal estate tax return is filed for the decedent, modified as follows:

(1) Less those deductions allowable under §§ 2053 and 2054 of the Internal Revenue Code of 1986, as amended [26 U.S.C. §§ 2053 and 2054], or the comparable provisions of any later law ("the Code"); and

(2) Without regard to the provisions of § 2040(b) of the Code [26 U.S.C. § 2040(b)] relating to qualified joint interests from which is subtracted the sum of all transfers made by the decedent during the decedent's lifetime which are included for purposes of determining the decedent's federal adjusted gross estate and which were made with the written consent or joinder of the surviving spouse.).

³⁴The 1990 Uniform Probate Code contains similar provisions. See UNIF. PROBATE CODE § 2-205(2)(i)(2) (1990).

³⁵N.Y. EST. POWERS & TRUSTS LAW § 5-1.1A(b)(1)(B) treats most irrevocable transfers made within one year of death as testamentary substitutes for elective share purposes but excepts "any portion of any such transfer that was excludible from taxable gifts pursuant to subsections (b) and (e) of section two thousand five hundred three of the United States Internal Revenue Code, including any amounts excluded as a result of the election by the surviving spouse to treat any such transfer as having been made one half by him or her, shall not be treated as a testamentary substitute." N.Y. EST. POWERS & TRUSTS LAW § 5-1.1A(b)(1)(B) (McKinney 1999).

³⁶FLA. STAT. ANN. § 732.2035(b) (West Supp. 2000) excepts from the elective share base:

Property Laws That Reflect Change in Transfer Tax Laws

In some cases, a change in transfer tax rules may call into question a documentary provision that may have been drafted to take into account a tax provision that has been changed. The change in the marital deduction quantitative rules provides an excellent illustration. Except for very small estates, immediately prior to 1982 the maximum estate marital deduction was generally limited to one-half of the decedent's adjusted gross estate.³⁷ By the Economic Recovery Tax Act of 1981 (ERTA),³⁸ Congress generally removed the quantitative limitation for decedents dying after 1981.³⁹

Based on pre-ERTA law, many wills and trusts were drafted based on formula provisions to take into account the then maximum amount of property that qualified for the estate tax marital deduction. How should such wills and trusts, executed before enactment of ERTA, be treated if the decedent did not change the document and died when the unlimited marital deduction was in effect? Pursuant to ERTA, the default rule is that the unlimited marital deduction amount does not apply to such wills and trusts if a state "does not enact a statute applicable to such estate which construes this type of formula as referring to the marital deduction allowable by federal law as amended by subsection (a), [an unlimited marital deduction] then the amendment [eliminating the quantitative restrictions on the marital deduction amount] shall not apply to the estate of such decedent."⁴⁰

Some states, however, enacted laws that pre-ERTA documents containing maximum marital deduction formula provisions should be construed to refer to the maximum marital deduction at the time of death, that is, an unlimited marital deduction amount.⁴¹ On the other hand, some states enacted legislation confirming that pre-ERTA wills would be based on pre-ERTA law even if death occurred after 1982.⁴²

1. Any transfer of property for medical or educational expenses to the extent it qualifies for exclusion from the United States gift tax under § 2503(e) of the Internal Revenue Code, as amended; and

2. After the application of subparagraph (b)1, the first \$10,000 of property transferred to or for the benefit of each donee during the 1-year period, but only to the extent the transfer qualifies for exclusion from the United States gift tax under § 2503(b) or (c) of the Internal Revenue Code, as amended.

³⁷See Treas. Reg. § 20.2056(a)-1(c)(2) (as amended in 1994).

³⁸Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 305 (1981) (codified as amended in scattered sections of I.R.C.).

³⁹I.R.C. § 2056(a) (1994). See Treas. Reg. § 20.2056(a)-1(c)(3) (as amended in 1994).

⁴⁰Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(e)(3), 95 Stat. 305 (1981).

⁴¹See, e.g., ALASKA STAT. § 13.11.277 (Michie 1998); UTAH CODE ANN. §§ 75-2-613, 75-7-501 (1993).

⁴²See, e.g., CAL. PROB. CODE §§ 1034, 1138.14 (West 1997); VA. CODE ANN. §§ 64.1-62.1 (Michie 1995).

If federal transfer taxes are ever repealed⁴³ important constructional rules will be necessary to deal with estate plans that were drafted to minimize estate, gift generation-skipping transfer and (GST) transfer taxes.

Property Laws to Secure Federal Transfer Tax Benefits

Property Laws to Secure the Marital Deduction

States have enacted numerous property laws that are designed for one reason: To facilitate the allowance of the federal estate or gift tax marital deduction. California, for example, has a chapter in its Probate Code, entitled “Marital Deduction Gifts,” which contains seven complex property law sections that are designed to carry out a transferor’s intention to obtain a marital deduction for federal transfer tax purposes.⁴⁴

New York has two interesting marital deduction provisions. One is designed to avoid loss of the marital deduction by an unwitting violation of the marital deduction rules on funding.⁴⁵ The other provides that any property qualifying for the estate tax marital deduction abates last in New York’s abatement scheme.⁴⁶

Property Laws to Secure the Charitable Deduction

States have also enacted numerous property laws that are designed for another reason: To facilitate the allowance of the federal estate or gift tax charitable deduction. As in the marital deduction area, California has specific statutes that are designed to shore up a charitable deduction for split-interest trusts, that is, charitable remainder and charitable lead trusts.⁴⁷

Many states have statutes that are designed to ensure that a trust qualifies as a private foundation so that transfer and income tax deductions can be secured.⁴⁸ These statutes generally bar a trust from engaging in activities prohibited under the Internal Revenue Code that disqualify private foundation status.⁴⁹

States may also except charitable dispositions from trust rules. For example, in New York a court may order the invasion of trust principal for the benefit of an

⁴³Tax legislation in 2001 repeals the federal estate and GST transfer tax systems in 2010, *see* Economic Growth and Tax Reconciliation Act of 2001, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69 (2001) (to be codified at I.R.C. §§ 2210(a) and 2664), but reinstates these systems in 2011. *See id.* § 901, 115 Stat. at 150. The gift tax system was not repealed by the 2001 legislation.

⁴⁴CAL. PROB. CODE §§ 21520-21526 (West 1997).

⁴⁵N.Y. EST. POWERS & TRUSTS LAW § 2-1.9 (McKinney 1998). This provision is designed to avoid violation of Rev. Proc. 64-19, 1964-1 C.B. 682. *See* Estate of de St. Aubin v. Commissioner, 76 T.C.M. (CCH) 409 (1998).

⁴⁶N.Y. EST. POWERS & TRUSTS LAW § 13-1.3(c)(5) (McKinney 2001).

⁴⁷CAL. PROB. CODE §§ 21540-21541 (West 1997).

⁴⁸At least twenty states have adopted such provisions. *See* RESTATEMENT (THIRD) OF PROP.: DONATIVE TRANSFERS § 12.2 statutory note, at 170 (Tentative Draft No. 1, 1995).

⁴⁹*See, e.g.*, CAL. PROB. CODE § 16102 (West 1997); N.Y. EST. POWERS & TRUSTS LAW § 8-1.8 (McKinney 1992). *See also* N.Y. NOT-FOR-PROFIT CORP. LAW § 406 (McKinney 1997) (barring certain corporations from engaging in activities that would preclude private foundation status).

income beneficiary but may not do so if application “would reduce or eliminate a charitable deduction otherwise available to any person or entity under the income tax, gift tax or estate tax provisions of the internal revenue code, the provisions of this section shall not apply to such trust.”⁵⁰

Uniform Principal and Income Act Provisions

Approved in 1997, the Uniform Principal and Income Act generally authorizes a trustee to make adjustments between principal and income at the trustee’s discretion.⁵¹ However, the Act specifically bars the making of an adjustment if the adjustment would have a negative impact on receiving transfer and income tax benefits, including the loss of a marital or charitable deduction.⁵² Another provision mandates an adjustment to principal to ensure that the maximum marital or charitable deduction is obtained.⁵³

Uniform Trust Code

Approved in 2000, the Uniform Trust Code, following the lead of the Restatement of Property⁵⁴ sanctions judicial modification to achieve tax objectives of the trust creator. Uniform Trust Code § 514 provides as follows: “To achieve the settlor’s tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor’s probable intention. The court may provide that a modification has a retroactive effect.”⁵⁵ The Uniform Trust Code also sanctions the combination and division of trusts by trustees.⁵⁶ As explained in the Comment, the

⁵⁰N.Y. EST. POWERS & TRUSTS LAW § 7-1.6(d) (McKinney 1998).

⁵¹UNIF. PRINCIPAL & INCOME ACT § 104 (amended 1997), 7B U.L.A. 9 (Supp. 2000).

⁵²*See id.* at §§ 104(c)(1),(3),(4) and comment on the limitations on the power to adjust.

⁵³UNIF. PRINCIPAL AND INCOME ACT § 506(b) (amended 1997), 7B U.L.A. 40 (Supp. 2000) provides as follows:

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income. *See also* UNIF. PRINCIPAL AND INCOME ACT § 413(a) (amended 1997), 7B U.L.A. 33 (Supp. 2000) (specific rule regarding unproductive property to obtain marital deduction).

⁵⁴*See* RESTATEMENT (THIRD) OF PROP.: DONATIVE TRANSFERS § 12.2 (Tentative Draft No. 1, 1995).

⁵⁵In August 2000, New York enacted legislation that permits a trustee, without the need for court intervention, to modify trusts to obtain the benefits of marital and charitable tax deductions. *See* N.Y. EST. POWERS & TRUSTS LAW §11-1.11 (McKinney 2001).

⁵⁶UNIF. TRUST CODE § 515 cmt. (2000).

provision is designed to facilitate and maximize transfer tax benefits in the estate tax marital deduction and GST-tax areas.⁵⁷

Property Laws to Utilize the Gift Tax Annual Exclusion

The gift tax annual exclusion is one of the premier estate planning minimization devices.⁵⁸ Properly utilized, an annual exclusion gift can eliminate gift, estate, and even GST taxes. The making of annual exclusion gifts is particularly useful when an individual is close to death, for example, when the individual is terminally ill. Yet, such individual may not then have the mental capacity to make the gifts, for example, the individual has Alzheimer's disease.

Over time, the use of durable powers of attorney for property has expanded and states have enacted statutory short form durable powers to facilitate the creation of durable powers.⁵⁹ Unfortunately, most short form durable powers do not specifically authorize the agent to make gifts on behalf of the principal. As a result, the Internal Revenue Service has been quite successful in its contention that an annual exclusion gift by the agent exceeded his or her authority thereby causing the gifted property to be subject to estate taxation.⁶⁰

Although the principal could specifically authorize the making of gifts (as well as the creation and alteration of trusts) in the underlying short form durable power of attorney, oftentimes the principal or the principal's attorney does not know that gift making power must be specifically authorized. New York has recognized the problem as a trap for the unwary and has modified its short form durable power to include gift making power to obtain a gift tax annual exclusion of \$10,000.⁶¹

UNFORTUNATE TRANSFER TAX- BASED PROPERTY LAWS

Finally, there are some property laws that are enacted to secure federal transfer tax benefits which, in my judgment, are unfortunate for varying reasons. These include: the absolute prohibition on certain discretionary distributions by trustees; Alaska's community property trusts for non-residents; elimination of creditors' rights in self-settled trusts and the repeal of the Rule Against Perpetuities as applied to certain trusts.

⁵⁷*Id.*

⁵⁸See Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, 48 CLEV. ST. L. REV. 749 (2000).

⁵⁹See UNIF. DURABLE POWER OF ATTORNEY ACT, 8A U.L.A. 77 (Supp. 2000) (enacted in over thirty states).

⁶⁰See, e.g., *Estate of Swanson v. United States*, 46 Fed. Cl. 388 (2000), *aff'd* 2001 U.S. App. LEXIS 11537 (Fed. Cir. 2001); *Estate of Casey v. United States*, 948 F.2d 895 (4th Cir. 1991), *rev'g* T.C. Memo 1989-511 (1989).

⁶¹The following power is a default power in New York's statutory short form durable power: "(M) making gifts to my spouse, children and more remote descendants, and parents, not to exceed in the aggregate \$10,000 to each of such persons in any year." N.Y. GEN. OBLIG. LAW § 5-1501(a) (McKinney 2001).

Barring trustee from making certain discretionary distributions

In my judgment, states have enacted unfortunate property laws because of the federal transfer tax system. Consider New York's trust law fiat (as distinct from a default rule) that bars a trustee from making discretionary trust distributions to himself.⁶²

In force since 1945, this law is designed to prevent adverse estate and gift tax consequences to the power holder.⁶³ Because the legislation is not a default rule that can be overridden by a trust creator, it frustrates the intention of a trust creator who desires a trustee to make distributions to himself or herself even though the power may be subject to federal estate taxation. Indeed, if the trustee's wealth would not be sufficient to trigger federal estate tax,⁶⁴ New York's trust law produces unjustified non-tax results.

Alaska: Winning property law's race to the bottom⁶⁵

In my view, Alaska has been the leading recent culprit in enacting unfortunate property laws based in whole or in part on federal transfer tax laws. Three recent Alaska laws were motivated in part by transfer tax considerations and were enacted solely for the purpose of enhancing Alaska's economy by attracting business from non-residents.

Alaska's Opt-In Community Property System

Consider Alaska's opt-in community property system for non-residents.⁶⁶ Enacted in 1998, Alaska allows couples who are not residents of Alaska to create an Alaska community property trust provided at least one of the trustees is an Alaska

⁶²N.Y. EST. POWERS & TRUSTS LAW § 10-10.1 (McKinney 1992) provides in part as follows:

Except in the case of a trust which is revocable by such person during lifetime, a power conferred upon a person in his or her capacity as trustee of an express trust to make discretionary distribution of either principal or income to himself or herself or to make discretionary allocations in his or her own favor of receipts or expenses as between principal and income, cannot be exercised by him or her.

⁶³N.Y. EST. POWERS & TRUSTS LAW § 10-10.1 cmt. (McKinney 1992).

⁶⁴Less than 2% of decedents' estate are subject to federal estate taxation. See James R. Repetti, *The Case for the Estate and Gift Tax*, 87 TAX NOTES 1493, 1494 (2000). Because the 2001 Tax Act increases the exemption level, even fewer decedents' estate will be subject to federal estate taxation during this decade.

⁶⁵Paraphrasing the "race-to-the bottom" description in the environmental law area, see Richard L. Revesz, *Article: Rehabilitating Interstate Competition: Rethinking the "Race-to-the-bottom" Rationale For Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992), property law's "race-to-the-bottom" may be viewed as a race by states away from rationale property laws that states would pursue if they did not face competition for business to the increasingly undesirable property laws that they enact because of such competition. See Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, CORNELL L. REV. 1035, 1037-38 (2000) (discussing trust laws enacted by entrepreneurial states).

⁶⁶ALASKA STAT. § 34.77.060(b) (Michie 1998).

domiciliary or Alaska bank or trust.⁶⁷ As recently explained, the law's objective is to give "non-residents who establish community property trusts the ability to take advantage of the double basis step-up available to community property under Internal Revenue Code . . . section 1014(b)(6)."⁶⁸

The tax objective sought under an Alaska community property trust involves the interplay between the federal estate and income tax law. A quirk in the income tax law provides that the basis in both halves of the community property on the death of the first spouse will be determined by reference to the federal estate tax value of the community property.⁶⁹ In effect, the basis of the surviving spouse's one-half interest in community property will be stepped up (or stepped down) from its pre-death basis by using the estate tax value for the community property. If the basis is stepped-up in value, then unrealized capital gains will be forever exempt from income tax.

Alaska's opt-in community property system for non-residents is a brazen attempt to entice non-residents to create community trusts to obtain income tax benefits which are derived from the estate tax system. The fly in the ointment is the uncertainty over section 1014(b)(6). Will the Internal Revenue Service recognize Alaska's opt-in community property laws under 1014(b)(6)?⁷⁰ Indeed, will section 1014(b)(6) be repealed?⁷¹ Of course, if the tax advantages of section 1014(b)(6) were not available, one would assume that non-residents would cease creating community property trusts.

Alaska Law on Self-Settled Trusts and Creditors

Another recent Alaska law involves self-settled trusts. Defying established trust law principles,⁷² Alaska bars creditors from reaching property in an Alaska trust, that is, one having an Alaska trustee, even if the trustee can make discretionary distributions of trust property to the trust creator.⁷³ A few states have recently joined Alaska's race to the bottom in this area.⁷⁴ Although the primary reason for the

⁶⁷*Id.* at § 34.77.100. Although only one spouse may transfer property into the community property trust, both spouses must sign the trust agreement. *Id.*

⁶⁸Jonathan G. Blattmachr et. al., *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & TR. J. 615, 617 (1999).

⁶⁹I.R.C. § 1014(b)(6) (1994).

⁷⁰*See* Blattmachr, *supra* note 68, at 622-34 (discussing the risks involved if Alaska's definition of community property does not qualify under I.R.C. § 1014(b)(6)).

⁷¹President Clinton's 2001 Budget Proposal included the repeal of § 1014(b)(6). *See* Joint Commission on Taxation Description of Tax Provisions in President's FY 2001 Budget at 682-84.

⁷²*See* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (Tentative Draft No. 2, 1998).

⁷³ALASKA STAT. § 34.40.110(a)-(b) (Michie 1998). *See generally* Jeremy M. Veit, Note, *Self-Settled Spendthrift Trusts and the Alaska Trust Act: Has Alaska Moved Offshore?*, 16 ALASKA L. REV. 269 (1999).

⁷⁴*See, e.g.*, DEL. CODE ANN. tit. 12, § 3571 (1998); NEV. REV. STAT. § 166.040 (1999). It turns out Colorado and Missouri already had such laws. *See* COLO. REV. STAT. § 38-10-111 (1997); MO. REV. STAT. § 456.080 (1992) (providing protection for self-settled spendthrift trusts against future creditors). *See generally* Karen E. Boxx, *Gray's Ghost—A Conversation*

Alaska law was to compete with off-shore trust havens,⁷⁵ the law also was intended to provide a significant transfer tax benefit for non-residents who create self-settled trusts.⁷⁶ If creditors cannot reach trust property, then the automatic reason for inclusion of the trust property in the trust creator's gross estate would be removed.⁷⁷ At this time, however, is not clear whether Alaska's law will bar creditors from reaching assets in an Alaska trust created by a non-resident⁷⁸ and even if it did, whether the trust property might still be included in the trust creator's gross estate.⁷⁹

Alaska's Repeal of the Rule Against Perpetuities

The very recent perpetuities repeal movement is the best example of how federal transfer tax laws affect the development of property law in the worst of ways.⁸⁰ Since Alaska attempted to repeal its perpetuities law with respect to trusts in 1997,⁸¹ several other states have followed suit⁸² and other states are considering whether to

About The Onshore Trust, 85 IOWA LAW REV. 1195 (2000); Sterk, *supra* note 65; Randall J. Gingiss, *Putting A Stop To "Asset Protection" Trusts*, 51 BAYLOR L. REV. 987 (1999).

⁷⁵Consider the summary of the sponsor's testimony: "[T]here is a huge market for trusts—very large assets where people are looking for ways of preserving these assets for future generations and more than just one or two generations . . . [C]urrently this market is largely going to foreign countries such as Asia, Caribbean, Cayman Islands and Cook Islands. Those countries have strong trust laws. . . . [T]he Caymen Islands has 30 major banks as they are administering funds, including the trusts." *Hearings on H.B. 101 Before the Subcomm. on Labor and Commerce*, 20th Leg. (Ala. 1997) (statement of Representative Vezey).

⁷⁶See RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (Tentative Draft No. 2, 1998); Johnathan G. Blattmachr et al., *New Alaska Act Provides Many Estate Planning Opportunities*, 24 ESTATE PLANNING 347 (1997).

⁷⁷See *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986) (inclusion under I.R.C. § 2036(a)(1) and Rev. Rul. 76-103, 1976-1 C.B. 293) (inclusion under I.R.C. § 2038). See generally John K. Eason, *Home From the Islands: Domestic Asset Protection Trust Alternatives Impact Traditional Estate and Gift Tax Planning Considerations*, 52 FLA. L. REV. 41, 73-84 (2000).

⁷⁸See Sterk, *supra* note 65.

⁷⁹See Eason, *supra* note 77, at 73-84.

⁸⁰Prior to 1997, three states had repealed their rules against perpetuities either wholly or in part. See IDAHO CODE § 55-111 (Michie Supp. 2000) (effective Feb. 1, 1957) (repealing dead hand control rules over personal property); WIS. STAT. § 700.16 (1999) (effective 1969) (repealing the rule against perpetuities but maintaining a rule against the undue suspension of the power of alienation in both real and personal property); S.D. CODIFIED LAWS § 43-5-8 (Michie 2000) (effective 1983) (adopting Wisconsin's approach).

⁸¹Although Alaska was the first state to enact recent perpetuities repeal legislation, the legislation did not effectively repeal the rule as intended. Legislation in the Spring of 2000 finally succeeded. See ALASKA STAT. §§ 34.27.075, 34.27.100 (Michie 1998). Alaska's Spring 2000 legislation also added a 1000 year vesting period for powers of appointment, see ALASKA STAT. § 34.27.051 (Michie 1998), ostensibly to avoid the so-called Delaware trap under §§ 2041(a)(3) and 2514(d) of the Internal Revenue Code of 1986, as amended.

⁸²See ARIZ. REV. STAT. § 14-2901(a)(3) (1995); DEL. CODE ANN. tit. 25, § 503(a) (Michie Supp. 2000); 765 ILL. COMP. STATE. ANN. 305 /4 (West 2001); ME. REV. STAT. ANN. tit. 33,

fall in line.⁸³ Did Alaska and these other states suddenly uncover some fatal problem with a rule that has acknowledged societal benefits?⁸⁴ Or, has the Rule Against Perpetuities (Rule) been repealed to allow for the exploitation of the federal GST-Tax exemption? Unfortunately, it is the latter.

By repealing the Rule, the GST exemption amount⁸⁵ can be enjoyed in perpetuity under a properly crafted GST exempt-trust, also referred to as dynasty trusts.⁸⁶ Recognizing the interrelationship between perpetuities and the GST exemption, Alaska crassly repealed the Rule to encourage non-residents to create Alaska trusts.⁸⁷ Soon other states joined in the quest for more trust business and to ensure that their wealthy residents did not need to leave their home to create a trust that would be perpetually exempt for GST tax purposes.⁸⁸

My concern with perpetuities repeal is that important social goals that the Rule fostered will not be realized. Consider Lewis Simes's articulation of the important societal goals that the Rule facilitates-curbing dead hand control of property and allowing its control by living members:

It is socially desirable that the wealth of the world be controlled by its living members and not by the dead. I know of no better statement of that doctrine than the language of Thomas Jefferson, contained in a letter to James Madison, when he said: "The earth belongs always to the living

§ 101-A (1999); MD. CODE ANN., EST. & TRUSTS § 11-102(e) (Michie 2000); N.J. STAT. ANN. §§ 46:2F9 - 2F11 (1989); OHIO REV. CODE ANN. § 2131.09(B) (West 1994); R.I. GEN. LAWS § 34-11-38 (Supp. 2000); VA. CODE ANN. § 55-13.3F (Michie 2000).

⁸³See H.B. 566, S.B. 2060, 78th Leg., 2d Sess. (Iowa 2000); S.J. Res. 4, 70th Leg. (Nev. 1999); S.B. 5957, 1999 Leg., 222nd Sess. (N.Y. 1999); Tenn. Perpetual Trust Act, H.B. 912, S.B. 565, 101st Leg. (Tenn. 1999).

⁸⁴See *infra* text accompanying note 87.

⁸⁵The original GST exemption amount of \$1,000,000 is indexed for inflation until 2004. See I.R.C. § 2631(c). In 2001, the GST exemption amount was \$1,060,000. See Rev. Proc. 2001-13, § 3.18. From 2004-2009, the GST exemption amount will equal the estate tax exemption amount in the applicable year. See I.R.C. § 2631(c) (as effective in 2004). Thus, the GST exemption amount will be \$1,500,000 in 2004 and \$3,500,000 in 2009.

⁸⁶See generally Ira Mark Bloom, *The GST Tax Tail is Killing the Rule Against Perpetuities*, 87 TAX NOTES 569 (2000).

⁸⁷The testimony of Representative Vezey, the sponsor of the Alaska perpetuities repeal legislation, revealed that perpetuities repeal was the result of his efforts to look at what could be done to stimulate economic development in the state of Alaska and to look at why it is that Alaska couldn't be more of a financial center for the economy of Alaska, America and the whole world. . . . [H]e looked to see if there was an opportunity to change [Alaska's] laws that would encourage financial markets to headquarter in Alaska. With the help of a number of individuals who were also looking for a home for this type of an entity, they came up with some changes that could be made in Alaska to [Alaska's] trust laws that would make Alaska an attractive place to administer large trusts. *Hearings on H.B. 101 Before the Subcomm. on Labor and Commerce*, 20th Leg. (Ala. 1997) (statement of Representative Vezey).

⁸⁸See *supra* note 81.

generation. They may manage it then, and what proceeds from it, as they please during their usufruct.”⁸⁹

In a recent article, I tried to predict some of the problems in a world which not only does not curb dead hand control, but encourages infinite dead hand control.⁹⁰ I first tried, perhaps oxymoronically, to quantify perpetuity. Looking to the world of astrophysicists, it turns out human life on earth is reliably predicted to end in about one billion years from now.⁹¹ Consider some of the problems with long-lasting, perhaps even perpetual trusts. The wealth that can be amassed from a one million dollar trust after relatively short periods of time, based on an after-tax return of 6%, is startling.⁹² Imagine the wealth and power the lucky dynastic family members might enjoy from GST-exempt trusts.⁹³ Such trusts will likely name as fiduciaries already powerful corporate trustees whose wealth and power will grow as trustees over dynasty trusts.

In a dynasty trust, the trustees will likely be given discretionary powers over trust property for the trust creator’s lineal descendants. Consider why Professor Lawrence W. Waggoner, Director of Research of the Joint Editorial Board for the Uniform Probate Code, predicts that such discretionary trusts will become an administrative nightmare:

Overtime, the administration of such trusts is likely to become unwieldy and very costly. Government statistics indicate that the average married couple has 2.1 children. Under this assumption, the average settlor will have more than 100 descendants (who are beneficiaries of the trust) 150 years after the trust is created, around 2,500 beneficiaries 250 years after the trust is created, and 45,000 beneficiaries 350 years after the trust is created. Five hundred years after the trust is created, the number of living beneficiaries could rise to an astounding 3.4 million.⁹⁴

⁸⁹LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND, 58-59 (1955). See RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS, part I (1983); Jesse Dukeminier, *Perpetuities: The Measuring Lives*, 85 COLUM. L. REV. 1648, 1710 (1985); Lawrence W. Waggoner, *Perpetuities: A Perspective on Wait-and-See*, 85 COLUM. L. REV. 1714 (1985).

⁹⁰See Bloom, *supra* note 86.

⁹¹See I-Juliana Sackmann et al., *Our Sun. III. Present and Future*, 418 THE ASTROPHYSICAL J. 457 (1993), available at http://adsbit.harvard.edu/cgi-bin/nph-article_query?1993ApJ...418..457S.

⁹²The value after 100 years would be \$369 million; after 200 years it would be \$136.43 billion; after 300 years, the value would be \$50.395 trillion. See Ira Mark Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 ALB. L. REV. 260, 301 n.219 (1981).

⁹³See generally James R. Repetti, *Democracy, Taxes and Wealth*, 76 N.Y.U.L. REV. 825 (2001).

⁹⁴Letter from Lawrence W. Waggoner, Lewis M. Simes Professor of Law, to Ira Mark Bloom, Professor of Law (Oct. 26, 2001) (on file with the *Cleveland State Law Review*).

In my judgment, the repeal of the Rule Against Perpetuities, without enactment of some other control over the dead hand, will be a disaster.⁹⁵ By its repeal, our generation irresponsibly jeopardizes the well-being of successive generations.

One positive benefit of estate, gift, and GST-tax repeal would be that perpetual trusts would not be necessary to accomplish tax goals. Perhaps then, states can focus attention on the problem of dead hand control, hopefully by way of placing some limitation on the duration of trusts.⁹⁶

CONCLUSION

For good and for bad, the federal transfer tax system has affected the development of property law and will likely continue to do so unless the federal transfer tax system is permanently repealed.⁹⁷ If the federal transfer tax system is ultimately repealed, many existing transfer tax based property laws will become obsolete. Still others, particularly laws repealing control over the dead hand, may have a rebirth.

⁹⁵See VERNER F. CHAFFIN, *GEORGIA'S PROPOSED DYNASTY* (2000); See generally Joel C. Dobris, *The Death of the Rule Against Perpetuities, or the RAP Has No Friends – An Essay*, 35 REAL PROP., ROB. & TR. J. 601 (2000).

⁹⁶In the Spring of 2000, Florida amended its USRAP provisions to allow for a 360 year wait-and-see period. FLA. STAT. ANN. § 689.225(2)(f) (West Supp. 2000). This change extends dead hand control-unwisely in my judgment. The Florida legislation also addresses the problem of excessive dead hand control in two ways. First, courts may modify or terminate trusts in various circumstances, including when it is in the best interests of the trust beneficiaries. FLA. STAT. ANN. § 737.4031 (West Supp. 2000). Second, trusts may be modified or terminated with consent of all of the beneficiaries and trustees. FLA. STAT. ANN. § 737.4032 (West Supp. 2000). In both instances, termination and modification may be postponed by the trust creator, but only for the first 90 years of the trust's existence.

⁹⁷See *supra* note 43.