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BILL ANALYSIS



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House Bill 4602 (Substitute H-2 as reported without amendment)

House Bill 5909 (as reported without amendment)

Sponsor: Representative Tonya Schuitmaker (H.B. 4602)

Representative Andy Meisner (H.B. 5909)

House Committee: Judiciary

Senate Committee: Judiciary

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RATIONALE

Under the common law "rule against perpetuities", a nonvested interest in property is not valid unless it must vest, if at all, within 21 years, plus the period of gestation, after some life or lives in being at the time the interest is created. (A nonvested property interest is an interest to which the transferee is not presently entitled and might never become entitled.) The rule was designed to restrain the power of a landowner to tie up property in long-term or perpetual family trusts. Because the common law rule may invalidate some property transfers that otherwise would be considered reasonable, Michigan enacted the Uniform Statutory Rule Against Perpetuities in 1988. Under this law, an interest that would be valid under the common law continues to be valid, but an interest that would violate the common law rule is invalid only if it does not actually vest or terminate within 90 years after its creation. The statutory rule covers nonvested interests in both real and personal property, as well as powers of appointment (the authority conferred upon a person to create new ownership interests in assets or select the recipient of an interest in property). Although the statutory rule was considered progressive 20 years ago, it now has been suggested that the rule should be eliminated with respect to personal property held in trust, in order to allow people to establish "dynasty trusts" in Michigan.

A dynasty, or perpetual, trust essentially is a technique that allows its creator, the settlor, to pass wealth from generation to

generation without the burden of transfer taxes, including estate and gift taxes and the Federal generation-skipping transfer tax. The trust is irrevocable and its operation is controlled by the terms initially established by the settlor, who cannot control the assets after funding the trust. A central feature of the dynasty trust is its term: The trust is designed to last as long as the settlor has living descendants, and may continue indefinitely. Because the rule against perpetuities limits the duration of trusts, however, dynasty trusts are created in states that have either eliminated the rule or modified it to permit trusts that continue for hundreds of years. Many people believe that Michigan should do the same.

CONTENT

House Bill 4602 (H-2) would amend the Uniform Statutory Rule Against Perpetuities to do the following:

- **Specify that provisions governing the validity of a nonvested property interest or a power of appointment would not apply to an interest in, or a power of appointment over, personal property held in a trust that was revocable or created after the effective date of the Personal Property Trust Perpetuities Act (proposed by House Bill 5909).**
- **Apply the existing provisions if the interest in, or power of appointment over, personal property held in trust were created by the exercise of a**

nonfiduciary second power, but require the use of a 360-year, rather than the current 90-year, period in a determination of whether criteria for validity were satisfied.

-- In the existing provisions, specify that language in a document governing the effect of an exercise of a power of appointment over property exempt from Federal generation-skipping transfer (GST) tax would be inoperative to a certain extent, under particular circumstances.

House Bill 5909 would create the "Personal Property Trust Perpetuities Act" to provide that an interest in, or a power of appointment over, personal property held in trust would not be invalidated by a rule against perpetuities or other specified rules, except as provided regarding a second power.

The bill also would allow the indefinite suspension or postponement of the vesting of a future interest, the satisfaction of a condition precedent to the exercise of a general power of appointment, or the exercise of a nongeneral or testamentary power of appointment, with respect to personal property held in trust, subject to provisions involving a second power.

The bills are tie-barred to each other.

House Bill 4602 (H-2)

Current Provisions

Under Section 2 of the Uniform Statutory Rule Against Perpetuities, a nonvested property interest, a general power of appointment not presently exercisable because of a condition precedent, or a nongeneral power of appointment or a general testamentary power of appointment is invalid unless certain criteria are met. Each set of criteria includes what is commonly called a 90-year wait-and-see period.

Specifically, a nonvested property interest is invalid unless 1) the interest either vests or terminates within 90 years after its creation; and/or 2) when the interest is created, it is certain to vest or terminate within 21 years

after the death of an individual alive at that time.

A general power of appointment not presently exercisable because of a condition precedent is invalid unless 1) the condition precedent either is satisfied or becomes impossible to satisfy within 90 years after its creation; and/or 2) when the power is created, the condition precedent is certain to be satisfied or become impossible to satisfy within 21 years after the death of an individual alive at the time. (A power is "general" if the person may exercise it in favor of himself or herself, or his or her creditors, whether or not it may be exercised in favor or others. A power is "presently exercisable" if its exercise is not required to be by will or otherwise postponed. A "condition precedent" is a condition or event that must happen or be performed before a right may be exercised.)

A nongeneral power of appointment or a general testamentary power of appointment is invalid unless 1) the power is irrevocably exercised or otherwise terminates within 90 years after its creation; and/or 2) when the power is created, it is certain to be irrevocably exercised or otherwise to terminate within 21 years after the death of an individual alive at the time. (A power of appointment is "nongeneral" if the document creating it restricts the person or people who may be appointed to receive the interest. "Testamentary" means pursuant to a will.)

Under the bill, these provisions would apply *except* as provided in Section 5 (described below).

Personal Property Held in Trust

Section 5 lists circumstances under which Section 2 does not apply. Under the bill, Section 2 also would not apply to an interest in, or a power of appointment over, personal property held in a trust that was either revocable on or created after the effective date of the proposed Personal Property Trust Perpetuities Act.

Section 2 would continue to apply, however, to an interest in, or a power of appointment over, personal property held in trust if the interest or power were created, or property were made subject to the interest or power, by the exercise of a second power. In that case, Section 2 would apply only to the

extent of the exercise of the second power and, instead of the 90-year period used to determine validity, a period of 360 years would have to be used.

A 360-year period also would have to be used in a determination of whether to reform a disposition under Section 4. (That section requires a court, upon the petition of an interested person, to reform a disposition in the manner that most closely approximates the transferor's manifested plan of distribution that is within the 90 years allowed by Section 2, if certain conditions are met.)

"Second power" would mean that term as defined in the proposed Personal Property Trust Perpetuities Act.

Property Exempt from GST Tax

The bill would amend Section 2 to provide that 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) sought to allow the vesting or termination of any interest or trust beyond, b) sought to postpone the vesting or termination of any interest or trust until, or c) sought to operate in effect in any similar fashion upon, the later of one of the following:

1. 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
2. the expiration of a period of time that exceeded 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 would be inoperative to the extent it produced a period of time exceeding 21 years after the death of the survivor of the specified lives.

(The GST tax was enacted in 1986 and does not apply to trusts that were irrevocable and in existence on September 25, 1985 (the date on which the 1986 legislation was

introduced in Congress). The tax applies to transfers to grandchildren and others deemed to be two or more generations below that of the person making the transfer. A lifetime exemption, presently \$2.0 million, is available for each individual making a transfer or transfers.)

House Bill 5909

Under the proposed Personal Property Trust Perpetuities Act, an interest in, or a power of appointment over, personal property held in trust would not be invalidated by a rule against any of the following (except as provided below regarding a second power):

- Perpetuities.
- Suspension of absolute ownership.
- Suspension of the power of alienation.
- Accumulations of income.

In addition, all of the following could be indefinitely suspended, postponed, or allowed to go on with respect to personal property held in trust (except as provided below):

- The vesting of a future interest.
- The satisfaction of a condition precedent to the exercise of a general power of appointment.
- The exercise of a nongeneral or testamentary power of appointment.
- Absolute ownership.
- The power of alienation.
- Accumulations of income.

(Generally speaking, the term "future interest" refers to a legal right to receive real or personal property at some time in the future, on a particular date or upon the occurrence of an event. "Power of alienation" refers to power to assign, transfer, or otherwise dispose of property.)

If a first power were exercised so as to subject the property to, or to create, a second power, the period during which the exercise of the second power could postpone the vesting of a future interest in the property, would have to be determined under the Uniform Statutory Rule Against Perpetuities by reference to the time the first power was created. A nonvested, general power of appointment not presently exercisable because of a condition precedent, or a nongeneral or testamentary power of appointment created, or to which

property was subjected, by the exercise of the second power would be invalid, to the extent of the exercise of the second power, unless the interest or power satisfied the Uniform Statutory Rule Against Perpetuities measured from the time the first power was created.

("First power" would mean a nonfiduciary, nongeneral power of appointment over personal property held in trust that is exercised so as to subject the property to, or to create, another power of appointment. "Second power" would mean a nonfiduciary power of appointment over personal property held in trust that is created, or to which property is subjected, by the exercise of a first power and that is not a presently exercisable general power. "Nonfiduciary" would mean, with respect to a power of appointment, that the power of appointment is not held by a trustee in a fiduciary capacity.)

The proposed Act would apply only to a nonvested interest in, or power of appointment over, personal property held in trust that is either revocable on, or created after, the Act's effective date.

MCL 554.72 & 554.75 (H.B. 4602)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

By exempting personal property held in trust from the rule against perpetuities and similar rules, the bills would enable this State's financial institutions to set up dynasty trusts for their clients. Because financial institutions in Michigan cannot offer this type of estate-planning service, they have a disadvantage compared to those in the 21 states that have abolished the rule against perpetuities or extended the "wait and see" period so far out as to make it irrelevant. Currently, if a Michigan resident wishes to establish a dynasty trust, his or her financial institution must refer the client to an out-of-State branch, if there is one, or to a different financial institution in another state. Many people would prefer to work with their local bankers, however, and would feel more comfortable setting up the trust and having it administered in their own

state, if not their hometown. At the same time, the State's financial institutions would prefer to retain the business and earn the fees assessed for administering trusts.

In addition to allowing the growth of Michigan banks, the bills could prevent trust assets from flowing out of the State. An empirical study of the jurisdictional competition for trust funds has shown that, by 2003, approximately \$100 billion in trust assets were moved after 17 states had abolished the rule against perpetuities, according to an article by Harvard Law Professor Robert Sitkoff and Northwestern University School of Law professor Max Schanzenbach. It is reasonable to assume that some of those assets came from Michigan. Although this legislation would not put Michigan into competition with states such as Delaware that offer aggressive tax shelters, the bills would help keep trust assets in this State.

Although it might be desirable to eliminate the rule against perpetuities completely for personal property held in trust, doing so could trigger the so-called "Delaware tax trap". That term refers to a section of the Internal Revenue Code that causes assets subject to a decedent's power of appointment to be included in the gross estate of the decedent, if he or she exercises that power by creating another (second) power that, "under the applicable local law [the rule against perpetuities] can be validly exercised so as to postpone the vesting of any estate or interest in such property...for a period ascertainable without regard to the date of creation of the first power" (26 USC 2041(a)(3)). In Michigan, in the case of a presently exercisable general power, the period for which the exercise of the power may postpone vesting is measured from the time the power is exercised (rather than created), which means that the creation of a second power can restart the perpetuities-testing period. As a result, it is necessary to define how long the holder of the second power can postpone exercising the power. House Bill 5909 would do so by providing for a narrow, residual application of the rule against perpetuities: Interests created by the exercise of the second power would remain subject to the Uniform Statutory Rule Against Perpetuities, but House Bill 4602 (H-2) would substitute a 360-year "wait and see" period for the standard 90-year period.

In addition, House Bill 4602 (H-2) seeks to avert problems related to U.S. Treasury regulations concerning the effective date of the GST tax. The bill would prevent certain exercises of a power of appointment over assets in a grandfathered, GST tax-exempt trust (a trust that was irrevocable on September 25, 1985) from causing the assets to lose their tax-exempt status.

Legislative Analyst: Suzanne Lowe

FISCAL IMPACT

The bills would have an indeterminate fiscal impact on State government. It is unclear whether the bills would have an impact on Michigan tax revenue. Currently, Michigan does not have an estate tax, so there would be no immediate revenue implications relating to it. However, given the scheduled changes to the estate tax at the Federal level, there could be other consequences in the future.

Fiscal Analyst: Stephanie Yu

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.