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Revitalizing the Generation-Skipping Transfer Tax

Daniel Hemel* and Robert Lord**
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SUMMARY

Congress first enacted the generation-skipping transfer (GST) tax in 1976 to protect the estate and gift tax base and to ensure that extraordinary fortunes would bear their fair share of the transfer tax burden. Nearly a half-century into the life of the GST tax, those goals remain unrealized. In recent decades, high-net-worth individuals have succeeded in shifting hundreds of billions of dollars to "dynasty trusts" that—under current law—are poised to escape federal wealth transfer taxation indefinitely. The rise of dynasty trusts reduces the revenue-raising potential of the estate and gift taxes and allows a privileged class to exert vast economic and political power based solely on an accident of birth.

This white paper presents a legislative reform agenda designed to reinvigorate the GST tax, stem the rise of dynasty trusts, and bring hundreds of billions of dollars back within the federal transfer tax base. We highlight three flaws in current law that account for the GST tax's failure: (1) very high exemption amounts; (2) loopholes that allow high-net-worth taxpayers to stuff GST-exempt trusts with assets worth many multiples of the exemption amount; and (3) the lack of any durational limit on dynasty trusts in states that have abolished the rule against perpetuities. Our three-part reform agenda addresses each of these flaws. First, we propose a reduction in the GST exemption from the current level ($11.7 million) to the 2009 level ($3.5 million). A $3.5 million GST exemption still would be higher, in inflation-adjusted terms, than the exemption amount advocated by the Reagan administration. Second, we propose a set of common-sense loophole closers that would prevent high-net-worth taxpayers from stuffing GST-exempt trusts with assets worth far more than the exemption amount. Third, we propose to limit the maximum duration of a trust's GST exemption to two generations, with an exception that would allow tax-free distributions to beneficiaries who were alive at the time of the trust's inception. Our plan would shore up the estate and gift tax base and stem the rise of dynasty trusts while allowing more than 99 percent of American families to pass wealth across multiple generations tax-free.

I. BACKGROUND

A. The Problem of Generation-Skipping Transfers

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A "generation-skipping transfer" (GST) is a gift or bequest to a beneficiary who is two or more generations below the transferor (e.g., a transfer from a grandparent to grandchild or from a great-aunt to a great-nephew). Before 1976, the federal wealth transfer tax laws did not specifically address generation-skipping transfers. Taking advantage of that gap in the law, very high-net-worth individuals often shifted assets to trusts that benefitted multiple generations. For example, an individual might seek to reduce cumulative estate and gift tax liabilities by transferring assets to a trust for the benefit of her lineal descendants. The initial transfer to the trust might be subject to estate or gift tax, but assets in the trust would escape further rounds of transfer taxation when the transferor's children and potentially the transferor's grandchildren died. The term "dynastic trust" (or "dynasty trust") emerged in the legal literature in the 1950s and 1960s to describe trusts that were designed to keep wealth outside the estate and gift tax base for multiple generations.[1]

Practitioners, scholars, and policymakers have long recognized that generation-skipping transfers pose a threat to the estate and gift tax system. As early as 1935, the Treasury Department identified generation-skipping transfers as a problem and proposed a specific tax on such transfers as a solution.[2] President Truman told Congress in 1950 that under then-current law, "vast accumulations of wealth may completely escape tax over several generations."[3] A 1969 report by the Treasury Department—prepared under President Johnson and transmitted to Congress by President Nixon's first Treasury Secretary—observed that "[t]he ability to skip generations causes an inequitable distribution of the transfer tax" because "some families are required to pay a transfer tax at each generation" while families with larger fortunes are able to "avail themselves of the opportunity to skip a tax."[4]

B. The Rule Against Perpetuities

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[1] See Charles Looker, The Impact of Estate and Gift Taxes on Property Disposition, 38 Cal. L. Rev. 44, 66-67 (1950) (defining "dynastic trust" as a trust designed to "run as long as the law will allow" while remaining outside the federal estate and gift tax base); Lawrence M. Friedman, The Dynastic Trust, 73 Yale L.J. 547, 547 (1963) (defining "dynastic trust" as "a trust set up primarily to perpetuate the trust estate for as long a period as possible"). Professor Friedman noted that "extreme forms" of the dynasty trust were "rare" at the time. See id. A study of 1957 and 1959 estate tax returns also found few trusts skipping more than two generations. See American Law Institute, Federal Estate and Gift Tax Project: Study on Generation-Skipping Transfers Under the Federal Estate Tax: Discussion Draft No. 1, at 119-20 (Mar. 28, 1984), reprinted in Generation-Skipping Transfer Tax: Hearing Before the House Committee on Ways & Means, 98th Cong. 49, 179-80 (1984).

[2] As early as 1935, the Treasury Department proposed a specific tax on generation-skipping transfers. General Tax Reform: Hearing Before the House Committee on Ways & Means, 93rd Cong., 1st Sess. 1502 (1973) (statement of James B. Lewis).

[3] Special Message to the Congress on Tax Policy, Jan. 23, 1950, in Public Papers of the Presidents of the United States: Harry S. Truman—1950, at 120, 125 (Government Printing Off. 1965).

[4] U.S. Treasury Department, Tax Reform Studies and Proposals pt. 3, at 389 (Comm. Print 1969), https://www.finance.senate.gov/imo/media/doc/PrtTaxReform3.pdf.

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Until the enactment of the first GST tax, the only backstop that prevented dynasty trusts from keeping assets out of the estate and gift tax base permanently was the common-law rule against perpetuities. As of 1976, every state except Idaho and Wisconsin followed the common-law rule.[5] Under that rule, an interest in trust is void unless it is certain to vest, if at all, no later than 21 years after the end of a "measuring life" (i.e., an identifiable person who is alive at the time the interest is created).[6]

Even within the confines of the common-law rule, individuals can establish trusts that last for over a century and make distributions to descendants six or more generations below the transferor.[7] For example, an individual might establish and transfer assets to a trust for her descendants with a clause providing that the trust will terminate—and all of its assets will be distributed to beneficiaries—21 years after the death of the last-to-die descendant who was alive at the time of the trust's inception. Such a trust would comply with the common-law rule because all interests would be certain to vest within 21 years of the end of a measuring life. If the transferor has a great-grandchild alive at the time of the trust's inception, that great-grandchild would be a measuring life. If the great-grandchild's own great-grandchildren are born within 21 years of her death, the trust would ultimately make distributions upon termination to the transferor's great-great-great-great-grandchild (i.e., six generations below the transferor). Still, the common-law rule meant that even before the GST tax's enactment, virtually all assets in trust were subject to some outer limit on the length of time that they could remain outside the estate and gift tax base.

C. Legislative Response

Not content to rely on the common-law rule against perpetuities as the only check on dynasty trusts, Congress enacted the first GST tax in 1976 as part of a larger tax reform bill with broad bipartisan support.[8] Ten years later, as part of the Tax Reform Act of 1986, Congress largely adopted the Reagan administration's proposal for a revised GST tax. The framers of the 1976 and 1986 GST taxes—the House Ways and Means Committee in the first case, the Reagan Treasury Department in the second—emphasized three policy objectives:

1. **Base protection:** The framers of the 1976 and 1986 GST taxes recognized that generation-skipping transfers significantly reduced the revenue-raising potential of the existing estate and gift taxes by transforming a once-every-generation tax into a once-every-two-

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[5] Robert H. Sitkoff and Max M. Schazenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356, 430-33 tbl.5 (2005).

[6] A beneficiary's interest "vests" when the beneficiary has met all the conditions necessary for the interest to take effect. An unborn beneficiary's interest is always unvested, because the unborn beneficiary hasn't met one of the necessary conditions (namely, being born).

[7] See Lucy A. Marsh, The Demise of Dynasty Trusts: Returning the Wealth to the Family, 5 Estate Planning & Community Prop. L.J. 23, 30-31 (2012) (providing examples of long-lasting trusts that comply with the common-law rule).

[8] See Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1879.

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generations or once-every-three-generations tax. One objective of the GST tax was to protect the transfer tax base from further erosion.[9]

2. **Equity:** The framers of the 1976 and 1986 GST taxes observed that the individuals and families with the largest fortunes were also the ones with the greatest flexibility to make generation-skipping transfers.[10] A second objective of the GST tax was to ensure that very high-net-worth individuals and families bore their fair share of the tax burden.

3. **Neutrality:** Before the GST tax, individuals faced strong tax incentives to transfer assets to multigenerational trusts rather than directly to their children. The framers of the 1976 and 1986 GST taxes believed that the tax laws should be "neutral" between trusts and other methods of transferring wealth (e.g., outright gifts and bequests) and should not distort choices about which family members receive gifts and bequests.[11]

The 1976 GST tax was, in some respects, quite narrow. Most significantly, it applied only to transfers to multigenerational trusts.[12] Thus, for example, an outright gift or bequest to the transferor's grandchild would not have been subject to the tax (because it was not a transfer in trust). A gift or bequest to a trust that benefited only the transferor's grandchildren also would not have been subject to the tax (because all of the beneficiaries were members of the same generation). Notwithstanding its narrowness, though, the 1976 tax was extraordinarily complex.[13] Starting in the early 1980s, the Reagan administration Treasury Department sought to design a revised GST tax that would be both simpler and more comprehensive than its predecessor.

The Reagan administration presented its proposal to Congress in April 1983. The Reagan administration proposal extended the GST tax to include outright gifts as well as transfers to single-generation trusts where the beneficiaries were two or more generations below the transferor. At the same time, the Reagan administration proposal introduced an upfront

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[9] See H.R. Rep. 94-1380, 94th Cong., 1st. Sess. 47 (1976); Generation-Skipping Transfer Tax, Hearing Before the House Committee on Ways & Means, 98th Cong., 2d Sess. 12 (1984) (statement of Ronald A. Pearlman, Acting Assistant Secretary of the Treasury for Tax Policy).
[10] H.R. Rep. 94-1380, supra note 9, at 47; Generation-Skipping Transfer Tax, supra note 9, at 13 (statement of Ronald A. Pearlman).
[11] H.R. Rep. 94-1380, supra note 9, at 47; Generation-Skipping Transfer Tax, supra note 9, at 13 (statement of Ronald A. Pearlman). Proponents of the 1986 tax did not rest their case on the premise that once-per-generation taxation is "an independent objective of transfer taxation." See, e.g., id. at 39 (statement of Harry L. Gutman). For example, Ronald Pearlman, the top tax official in the Reagan administration Treasury Department at the time, told the House Ways and Means Committee that "the notion that a transfer tax should be imposed once per generation was not the starting point for Treasury's analysis" but reflected "the conclusion we reached by applying general principles to the particular problems involved in generation-skipping transfers." Id. at 5 (statement of Ronald A. Pearlman).
[12] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006, 90 Stat. 1520, 1882.
[13] See A. MacDonough Plant & Lynn Wintriss, Generation Skipping Transfer Tax, 17 Balt. L. Rev. 271, 271-72 (1988).

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exemption that did not depend on whether the beneficiary was the transferor's grandchild.[14] Congress largely adopted the Reagan administration's proposal as part of the bipartisan Tax Reform Act of 1986. The 1986 GST tax remains in effect, largely unmodified, today.

II. CURRENT LAW

Under current law, the GST tax applies to gifts and bequests to transferees who are two or more generations younger than the transferor. These younger transferees are known in GST tax parlance as "skip persons."[15] A family-member transferee is a "skip person" if she or he is—by blood, marriage, or adoption—the transferor's grandchild, grandniece/grandnephew, or first cousin twice removed (or great-grandchild, great-grandniece/great-grandnephew, first cousin thrice removed, and so on).[16]

Outside the family, generations are defined by the span of time between the transferor's and transferee's birth. An individual born within 12½ years of the transferor is treated as part of the same generation; an individual born more than 12½ years but not more than 37½ years after the transferor is assigned to the next generation; and a person born more than 37½ years but not more than 62½ years after the transferor is assigned to a generation two below.[17] A non-family member who is more than 37½ years younger than the transferor will thus be a skip person.

The GST tax can be triggered by a "taxable distribution," a "taxable termination," or a "direct skip."[18] A taxable distribution is a distribution from a trust to a skip person. A taxable termination occurs when the only remaining beneficiaries of a trust are skip persons. For example, if an individual establishes a trust for her descendants, the death of her last surviving child would be a taxable termination because the only remaining beneficiaries would be grandchildren or more remote "skip persons." A direct skip is a gift or bequest to a skip person or to a trust or other entity whose only beneficiaries are skip persons.

The GST tax rate is the same as the maximum estate tax rate (currently, 40 percent).[19] The GST tax laws are designed to prevent duplicative taxation of the same generational skip. To illustrate: Consider an individual who establishes a trust for her descendants. A taxable termination will occur when the transferor's last surviving child dies. Subsequent distributions to the transferor's grandchildren won't be subject to GST tax (on the theory that the skip over the transferor's children's generation was already taxed once when the taxable termination

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[14] Generation-Skipping Transfer Tax, supra note 9, at 13-14 (statement of Ronald A. Pearlman) (describing Treasury's 1983 proposal).
[15] I.R.C. § 2613 (defining "skip person").
[16] To mitigate potential unfairness in the event of a premature death, a special provision allows a grandparent to make a transfer to a grandchild free of GST tax if the grandparent's child/grandchild's parent is no longer alive at the time of the transfer. See I.R.C. § 2651(e).
[17] I.R.C. § 2651(d).
[18] I.R.C. § 2611; see also § 2612 (defining "taxable distribution," "taxable termination," and "direct skip").
[19] I.R.C. § 2641(a)(1).

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occurred). However, distributions to the transferor's great-grandchildren *will* be subject to GST tax unless another taxable termination occurs in the interim.[20]

A final—and especially consequential—feature of the GST tax is the GST exemption. Every individual is allowed a GST exemption, which she or he can allocate to lifetime gifts and/or to bequests. To take a straightforward example: If an individual transfers $100,000 to a trust and allocates $100,000 of GST exemption to the trust on a timely filed gift tax return, the trust will be entirely exempt from GST tax for its duration: the termination of an interest in the trust will not give rise to a taxable termination, and distributions from the trust will not be taxable distributions. If an individual transfers $100,000 to a trust but allocates only $90,000 of GST exemption, then the trust will have an "inclusion ratio" of 0.1.[21] The applicable rate on taxable terminations and taxable distributions for that trust will be 0.1 times the maximum estate tax rate (i.e., 4 percent if the maximum estate tax rate is 40 percent).[22] Moreover, any trust that was irrevocable as of September 25, 1985 is categorically exempt from GST tax except insofar as it receives gifts or bequests after that date.[23]

III. REASONS FOR CHANGE

A. The Failure of the GST Tax

Forty-five years after Congress first enacted the GST tax, and 35 years after Congress reenacted the GST tax in its current form, it seems safe to say that the tax has lived up to none of the framers' objectives:

1. Base protection: Estate and gift tax revenues as a percentage of GDP, which topped 0.3 percent of GDP at the time of the first GST tax's enactment, fell below 0.1 percent of GDP in fiscal year 2019 and are projected to remain below that threshold through fiscal year 2026 (see Figure 1). Generation-skipping transfers are only one factor contributing to the decline of estate and gift tax revenues, but clearly the GST tax alone has not proven sufficient to protect the estate and gift tax base from continued erosion.

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[20] I.R.C. § 2653(a).
[21] See I.R.C. § 2642.
[22] I.R.C. § 2641(a)(1)—(2).
[23] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2), 100 Stat. 2085, 2731.

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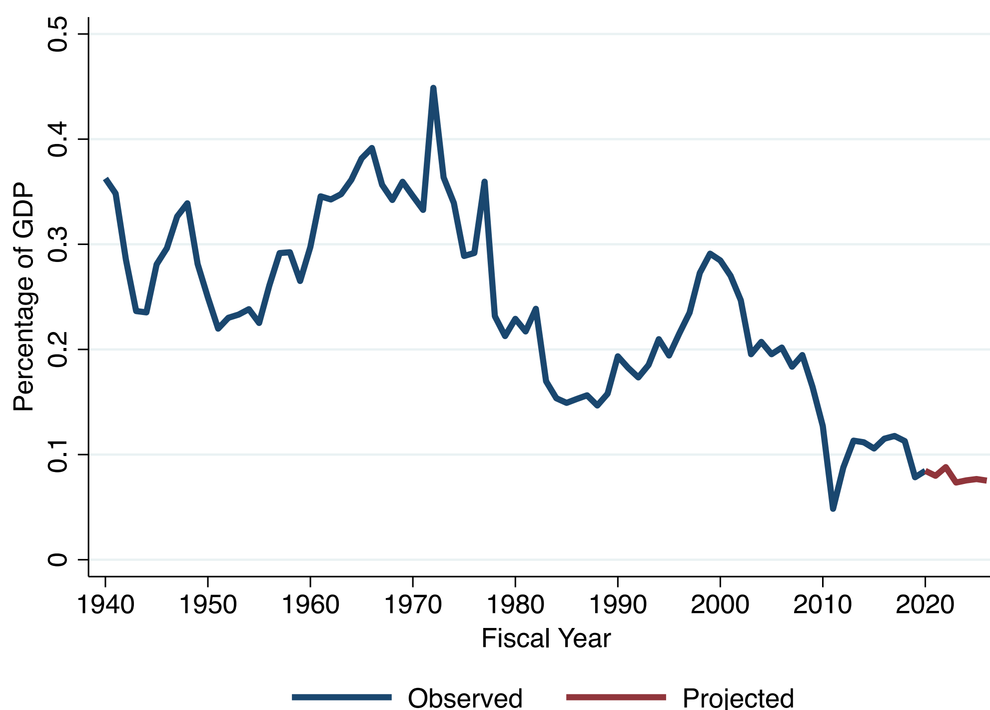
Figure 1. Estate and Gift Tax Revenues as a Percentage of Gross Domestic Product



Source: White House Office of Management & Budget, Historical Tables, https://www.whitehouse.gov/omb/historical-tables (tables 2.2, 2.3, 2.5); authors' calculations

2. Equity: Less than 0.1 percent of estates pay any tax under current law,[24] and within that rarefied group, the largest fortunes do not necessarily pay the most in taxes.[25] As explained below, sophisticated estate planning strategies allow high-net-worth individuals and families to transfer hundreds of millions—potentially billions—of dollars to dynasty trusts that will remain free of estate, gift, and generation-skipping transfer taxes into eternity. Clearly, the GST tax has not succeeded in ensuring that the wealthiest individuals and families shoulder their fair share of the transfer tax burden.

3. Neutrality: Federal transfer tax laws continue to distort the giving and estate-planning decisions of high-net-worth individuals. Certainly, the tax incentive to use trusts rather than other mechanisms of wealth transmission remains strong.[26] And in particular, the current structure of the GST tax incentivizes individuals and families to use complex and costly vehicles so that they

[24] See Tax Policy Center Briefing Book 410 (2020), https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax.

[25] See, e.g., Zachary R. Mider, How Wal-Mart's Waltons Maintain Their Billionaire Fortune: Taxes, Bloomberg (Sept. 12, 2013), https://www.bloomberg.com/news/articles/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes.

[26] Nearly half (49 percent) of all gifts reported to the IRS for calendar years 2010 through 2016 were made to trusts. See Jessica Holland, 2010-2016 Gifts, Statistics of Income Bulletin, Summer 2019, at 1 tbl.1, https://www.irs.gov/pub/irs-soi/soi-a-ingf-1906.pdf.

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can stuff GST-exempt trusts with as much value as possible. To be sure, any transfer tax will affect estate planning decisions, and the distortions and inefficiencies generated by the current GST tax are less problematic than the revenue and equity implications. Still, the lack of a durational limit on the GST exemption supersizes the incentive for taxpayers to pursue aggressive and distortive planning strategies.

B. Causes of Failure

Why has the GST tax fallen so far short of its framers' goals? Three factors, in particular, account for the GST tax's failure:

1. Large exemption: During the leadup to the Tax Reform Act of 1986, the Reagan administration Treasury Department proposed a GST exemption of $1 million per person. With an exemption at that level, a top administration official observed that the "vast majority of taxpayers" would be "completely shielded from the impact of the GST tax system."[27] The Reagan administration "strongly urge[d] Congress "not to deviate significantly from the $1,000,000 exemption level."[28] Congress heeded the Reagan administration's advice and kept the GST exemption level at $1 million for another dozen years.

The legislative lifting of the GST exemption amount began in 1997, when Congress took the relatively innocuous step of adjusting the exemption for inflation.[29] A more dramatic change came with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the first of the two major Bush tax cuts.[30] EGTRRA elevated the GST exemption from $1.06 million for 2001 to $3.5 million for 2009 and then repealed the GST tax entirely for 2010.[31] Because EGTRRA was passed under budget reconciliation rules that prohibited any deficit increases beyond a 10-year period, the GST exemption would have returned to its pre-EGTRRA level absent further legislative action. Instead, Congress and the Obama-Biden administration agreed at the end of 2010 to a $5 million GST exemption going forward (plus annual cost-of-living adjustments).[32] The Tax Cuts and Jobs Act of 2017 temporarily doubled the exemption for 2018 to 2025. The exemption now stands at $11.7 million per person ($23.4 million per couple) in 2021[33] and is scheduled to fall by half in 2026.

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[27] See Generation-Skipping Transfer Tax, supra note 9, at 19-20 (statement of Ronald Pearlman).
[28] Id. at 20.
[29] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(d), 111 Stat. 787, 846. The inflation-indexing provision took effect in 1999.
[30] Pub. L. No. 107-16, § 521(c), 115 Stat. 37, 72.
[31] Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 521(c), 115 Stat. 37, 72 (2001).
[32] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 302, 124 Stat. 3296, 3301-02. The 2010 law also retroactively restored the GST tax for 2010. Taxable distributions, taxable terminations, and direct skips in 2010 remained GST tax-free. However, trusts that received transfers that year will be subject to GST tax upon a subsequent taxable distribution or termination. Taxpayers can retroactively apply part of all of their GST exemption to 2010 transfers.
[33] Rev. Proc. 20-45.

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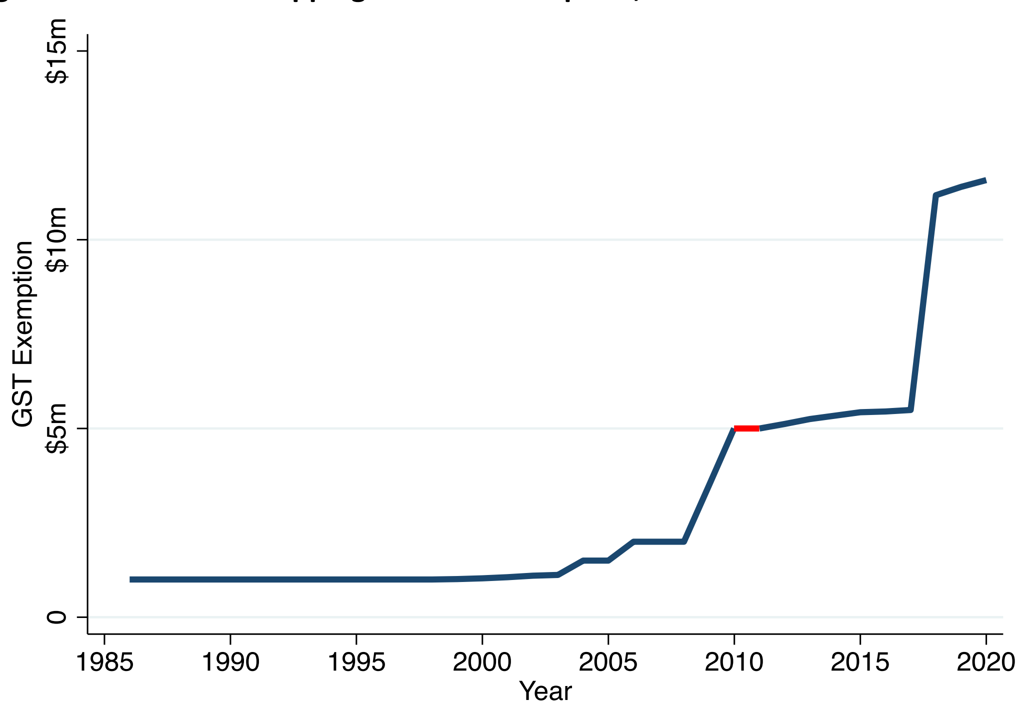
Figure 2. Generation-Skipping Transfer Exemption, 1986-2021



Note: The red region corresponds to calendar year 2010, when the GST tax was temporarily repealed. Taxpayers who made transfers to trusts that year had the option of allocating GST exemption (up to $5 million, less previous allocations) to those trusts in order to reduce subsequent GST tax on taxable distributions and taxable terminations.

The very large GST exemption means that a high-net-worth couple can transfer $23.4 million to GST-exempt trusts in 2021 and let that money grow outside the estate and gift tax base indefinitely. With the magic of compound annual growth, $23.4 million can easily become a trust of several hundreds of millions of dollars within two generations.[34] The GST exemption is, in this respect, an exemption that nearly swallows the rule.

2. Leveraging the exemption: An even larger hole in the transfer-tax base results from sophisticated avoidance strategies that allow high-net-worth taxpayers to leverage the GST exemption in order to move many multiples of $23.4 million into GST-exempt trusts. In a separate white paper, we address loopholes affecting the estate and gift taxes.[35] One of these loopholes—

[34] For example, at an after-tax real rate of return of 3 percent, $23.4 million will grow over 75 years to $215 billion (in 2021 dollars). The real rate of return from 1870 to 2015 (before taxes) was 8.46 percent on U.S. equity and 2.85 percent on U.S. bonds. See Òscar Jordà, Katharina Knoll, Dmitry Kuvshinov, Moritz Schularick & Alan M. Taylor, The Rate of Return on Everything, 1870–2015, 134 Q.J. Econ. 1225, 1278 tbl.IX, 1282 tbl.X (2019).

[35] See Daniel Hemel & Robert Lord, Closing Loopholes in the Estate and Gift Tax Base (Aug. 13, 2021), http://ssrn.com/abstract=3904454.

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involving valuation discounts for interests in family-controlled entities—has particularly significant consequences for the GST tax.

To see how taxpayers can stuff GST-exempt trusts with assets worth far more than $23.4 million per couple, consider the following example. First, a high-net-worth couple will establish one or more irrevocable trusts, transfer $23.4 million to the trusts, and allocate all of both spouses' GST exemptions to the trusts. The trusts will therefore have inclusion ratios of zero—and will be exempt from the GST tax forever as long as they do not receive any more gifts or bequests—because the amount of GST exemption allocated to the trusts equals the amount of assets transferred.[36] The trusts will typically be set up as intentionally defective grantor trusts (IDGTs)—trusts that are treated as separate from the grantor for transfer tax purposes but not for income tax purposes—such that transactions between the grantors and the trusts won't have income tax consequences.[37]

Next, the couple will contribute a large amount of securities or other assets to a family limited partnership or family limited liability company (LLC). For example, the couple might follow the model in *Grieve v. Commissioner*,[38] in which the taxpayer established a limited liability company with two classes of LLC units. The Class A units in *Grieve* represented an 0.2 percent ownership interest but had 100 percent of the voting power; the Class B nonvoting units represented the remaining 99.8 percent ownership interest. The couple might place assets with a fair market value of $360.72 million into the LLC so that the undiscounted value of the Class B units is $360 million (99.8 percent of $360.72 million). Like the taxpayer in *Grieve*, the couple might claim that the true value of the Class B units—after accounting for lack of control and lack of marketability—should be discounted by 35 percent (in this case, to $234 million). Note that the Tax Court in *Grieve* sustained a 35 percent discount for lack of control and lack of marketability even though the assets in the LLC were shares of stock in a company that is publicly traded on the New York Stock Exchange.

Finally, the couple will "sell" the Class B LLC units to the trusts in exchange for $234 million in installment notes. The significance of the $234 million figure is that it is 10 times the amount of "seed money" in the trusts. A 10-to-1 ratio between purchase price and seed money follows a common "rule of thumb" among estate planners seeking to ensure that the transaction is treated as a bona fide sale with economic substance rather than an additional gift.[39]

The GST-exempt trusts will then have net assets with an undiscounted value of $149.4 million (i.e., the initial $23.4 million transfer plus LLC units with an undiscounted value of $360 million, minus the $234 million in installment notes). This sum—which is more than six times the

[36] See I.R.C. § 2642.
[37] See Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-7 I.R.B. 28.
[38] See Grieve v. Comm'r, T.C. Memo 2020-28.
[39] The 10 percent rule of thumb is the "predominant customary approach," though "[n]owhere in any case law, published ruling, or administrative pronouncement is the 10% funding required." See Richard A. Oshins & Jerome M. Hesch, Economic Substance and the 10% Funding "Myth" for Trusts, 44 Estate Planning 17, 17-18 (2017).

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couple's combined GST exemption—can grow for many more generations without being subject to transfer tax. Moreover, the couple can use the equity in the trusts as seed money for further installment purchases, with even larger amounts going into a new LLC and ultimately being transferred to the GST-exempt trusts.

Installment sales of discounted assets to GST-exempt trusts are an especially dramatic example of GST tax avoidance, but high-net-worth individuals and families can use additional tools to reduce cumulative transfer-tax liabilities across generations:

- **Payment of income tax by deemed owner of GST-exempt grantor trust:** Under Revenue Ruling 2004-64, the deemed owner of a grantor trust can pay tax on income generated by the trust without those payments being subject to gift or GST tax.[40] In effect, the deemed owner (typically the grantor[41]) can confer an additional economic benefit on a GST-exempt trust—total relief from income tax during the deemed owner's lifetime—without the additional benefit being considered a taxable gift. The GST-exempt trust thereby enjoys years—potentially decades—of income-tax-free growth on top of a perpetual exemption from transfer tax.
- **Tax-exclusive base for direct skips:** In the rare case that a high-net-worth individual pays any GST tax, she can reduce her effective tax rate substantially by making an inter vivos gift to a skip person or to a trust whose only beneficiaries are skip persons. The GST tax for direct skips—like the gift tax, but unlike the estate tax or the GST tax for taxable distributions and terminations—is calculated on a tax-exclusive basis.[42] Thus, for example, a high-net-worth individual who has exhausted all of her exemptions and wishes to set aside an additional $1.8 million for her grandchildren could make a gift of $1 million to a trust for her grandchildren and their lineal descendants. She would owe $400,000 of gift tax and $400,000 of GST tax, for a cumulative (tax-inclusive) tax rate of 44.4 percent.[43] By contrast, if she had made a taxable bequest of $1.8 million to a trust and the trust then distributed the remaining amount to the taxpayer's grandchildren, the cumulative tax rate would be 64 percent.[44] Put differently, a taxable gift to beneficiaries two generations below the transferor faces roughly the same cumulative estate, gift, and GST tax liability as a taxable bequest to beneficiaries one generation below the transferor (44.4 percent versus 40 percent).
- **Annual gift and GST tax exclusions:** Each year, an individual can transfer an amount up to the annual gift tax exclusion ($15,000 in 2021) to a trust for a skip person (e.g., a

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[40] See Rev. Rul. 2004-64, 2004-2 C.B. 7.

[41] Under some circumstances, the deemed owner may be the beneficiary. See, e.g., Jerome M. Hesch, A Gift From Above: Estate Planning on a Higher Plane, 150 Trusts & Estates no. 11 (Nov. 2011) (describing beneficiary defective inheritor's trust (BDIT)).

[42] See I.R.C. § 2603(a)(3).

[43] $800,000/$1.8 million ≈ 44.4%.

[44] The estate tax liability (40% x $1.8 million = $720,000) would leave $1.08 million to be distributed to trust beneficiaries. A 40 percent GST tax would then apply to the $1.08 million distribution (40% x $1.08 million = $432,000). The cumulative tax liability would be $720,000 + $432,000 = $1.152 million, or 64 percent of $1.8 million.

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grandchild) without paying gift or GST tax or using up any of her $11.7 million exemption.[45] To achieve this result, the trust must give its beneficiary a so-called *Crummey* power—a right to withdraw the contribution from the trust for a limited time after the trust receives the contribution.[46] The trust also must have only one beneficiary, and the trust must either (1) dissolve before the beneficiary's death or (2) be structured such that the trust's assets will be included in the beneficiary's gross estate.[47] As a result, the trusts that receive GST tax-free annual gifts cannot be perpetual trusts. However, tax-free annual gifts indirectly support the growth of GST-exempt perpetual trusts because they allow high-net-worth individuals to create sizeable GST-exempt trusts for each of their grandchildren (or other skip-person beneficiaries). Those grandchildren or other beneficiaries can withdraw from these separate trusts without depleting the assets of the GST-exempt perpetual trust. Note that the annual exclusion is applied on a per-donor and per-donee basis. Thus, a married couple with four grandchildren could make a total of $120,000 in tax-free gifts to those grandchildren's trusts each year (2 donors multiplied by 4 donees multiplied by $15,000) without consuming any of the couple's combined $23.4 million GST exemption.

- **Health and education exclusion trusts (HEETs):** In recent years, some advisers to high-net-worth clients have begun to recommend the use of "health and education exclusion trusts" (HEETs) to avoid GST tax. As the name suggests, a HEET provides for the health and education expenses of its beneficiaries (e.g., the grantor's lineal descendants). Under one (rather doubtful) interpretation of the GST tax laws, HEETs can be used to pay health and education expenses (e.g., private-school tuition) for generations of beneficiaries without ever facing transfer tax.[48]

3. Abolition of the rule against perpetuities: Nearly two dozen states and the District of Columbia have now either abolished the rule against perpetuities or allowed trusts to opt out of the rule's application. As a result, GST-exempt trusts in those states can keep assets outside the estate and gift tax base indefinitely.[49] The total value of assets in these trusts is unknown, but it is clearly large. For example, Robert Sitkoff and Max Schazenbach estimate that between 1997 and 2003 alone, approximately $102 billion in trust funds flowed into states that had either

[45] I.R.C. § 2642(c)(3)(A).
[46] See Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968)
[47] I.R.C. § 2642(c)(2).
[48] Under I.R.C. § 2611(b), a distribution from a trust will not be considered a generation-skipping transfer if it is paid to a tax-exempt educational organization for tuition or to a medical provider for medical care. HEETs always have at least one charitable beneficiary in an attempt to ensure (a) that a transfer to a HEET won't be considered a direct skip if all the non-charitable beneficiaries are skip persons and (b) that the death of the last non-skip person beneficiary won't give rise to a taxable termination if the non-charitable beneficiaries include non-skip persons.
[49] See Howard M. Zaritsky, The Rule Against Perpetuities: A Survey of State (and D.C.) Law (2020), https://www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf; Robert H. Sitkoff and Max M. Schazenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356, 430-33 tbl.5 (2005). Three states—Idaho, South Dakota, and Wisconsin—had abolished the rule against perpetuities before 1986.

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abolished the rule against perpetuities or allowed trusts to opt out.[50] More recent FDIC data—from the first quarter of 2021—indicates that $823 billion of personal fiduciary assets are held by banks in states that have abolished the rule against perpetuities or allow opt-out.[51] Public and private trust companies in South Dakota—which are typically not FDIC-insured and therefore not included in the FDIC data—held more than $350 billion as of 2019.[52] FDIC and state-level data do not distinguish between GST-exempt and non-exempt trusts, but the amount in GST-exempt trusts that are not subject to the rule against perpetuities is almost certainly in the hundreds of billions of dollars and potentially in the trillions of dollars.[53]

C. The Case for Acting Now

The rise of dynasty trusts presents a crisis for the federal wealth transfer tax system. Absent a change in law, assets in GST-exempt trusts will remain outside the federal estate and gift tax base until those assets are distributed to beneficiaries, and dynasty trusts can be structured so that they never are required to distribute assets. The problem that President Truman warned Congress about in 1950 remains nearly three-quarters of a century later—and with the widespread abolition of the rule against perpetuities, the problem has grown even more severe.

Although the problem is not a new one, it demands immediate legislative action—for three reasons:

1. Growth of extraordinary fortunes: According to data from Forbes, U.S. billionaire wealth has grown by more than 1,800 percent in inflation-adjusted terms since 1990 and by more than 50 percent from March 2020 to July 2021 (see Figure 3). Failure to address flaws in the GST tax now will allow much of this wealth to be moved to GST-exempt dynasty trusts (e.g., through installment sales of discounted interests in family-controlled entities). Congress has an opportunity now to plug the hole, rather than leaving future lawmakers with the more difficult task of bringing assets already in dynasty trusts back within the estate and gift tax base.

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[50] Robert H. Sitkoff and Max M. Schazenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356, 404 (2005).
[51] Authors' analysis based on Federal Deposit Insurance Corp., SDI Data, https://www7.fdic.gov/sdi/download_large_list_outside.asp (last visited Aug. 13, 2021). The list of states that have abolished the rule against perpetuities or allowed trusts to opt out is taken from Zaritsky, supra note 49.
[52] South Dakota Department of Labor & Regulation, Division of Banking, Industry Overview 19 (Aug. 2020), https://boardsandcommissions.sd.gov/bcuploads/agenda_082720_ppt_industry_overview.pdf. The South Dakota Trust Company advertises the fact that its clients include 100 billionaires and 300 centimillionaires. South Dakota Trust Company LLC, Private Trust Companies, https://www.sdtrustco.com/pftc-regulated-and-unregulated (last visited Sept. 8, 2021).
[53] The figures here do not include trusts in states that still have some version of the rule against perpetuities but impose no meaningful limit on duration (e.g., Arizona, which limits the duration of trusts to 500 years, or Colorado and Utah, which set the limit at 1,000 years). See Zaritsky, supra note 49, at 7.

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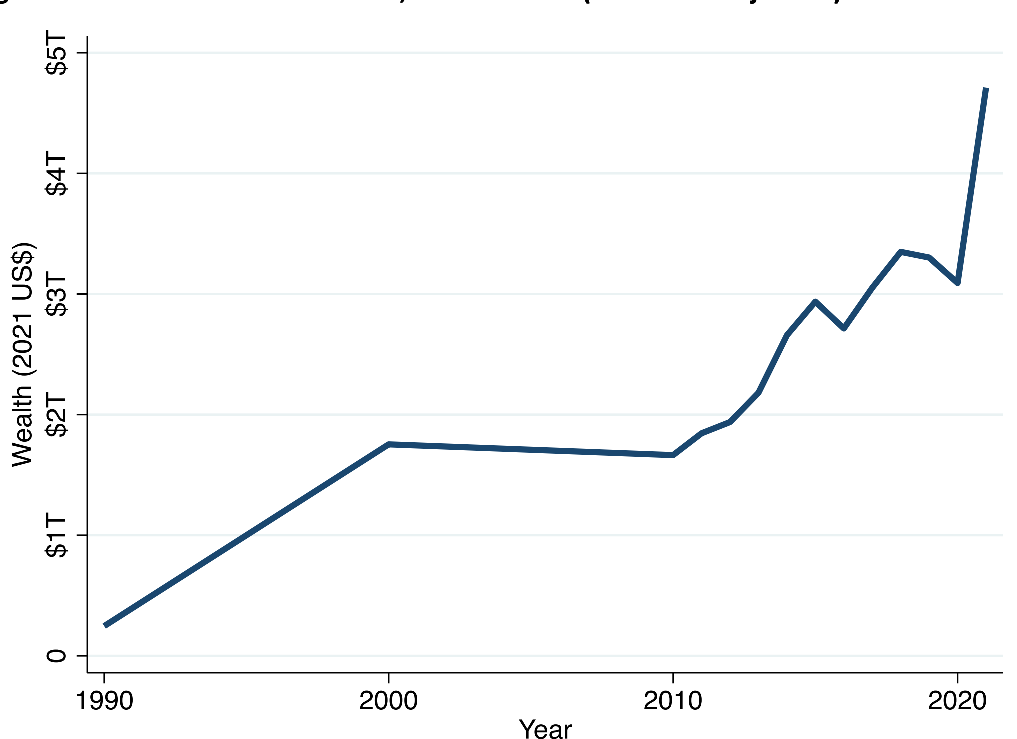
Figure 3. U.S. Billionaire Wealth, 1990—2021 (Inflation-Adjusted)



Source: Forbes 400 Billionaire Lists (collated by Americans for Tax Fairness and the Institute for Policy Studies). **Note:** Figures are in current U.S. dollars (based on the Consumer Price Index for the second quarter of 2021). 2021 data is through July 9, 2021.

2. Racial justice: Evidence of a widening racial wealth gap in the United States strengthens the case for GST tax reform.[54] While progressive transfer-tax reforms generally have the effect of reducing the wealth gap between white and African-American families, this is particularly true for GST tax reforms, which affect the very largest and oldest fortunes in the United States.

3. Democratic distortions: Especially in the wake of Supreme Court and lower-court decisions dismantling campaign finance regulations, the accumulation of extraordinary wealth inside GST-exempt dynasty trusts raises the risk that individuals and families with effective control of these trusts will be able to purchase a degree of political influence that is inconsistent with a well-functioning democracy. The role of trusts in campaigns is usually indirect (e.g., an individual whose wealth comes from a family trust will make large contributions or self-finance a campaign for office), but trusts also contribute directly to candidates, parties, and political action committees.[55] For example, trusts associated with the Koch family contributed $13 million to an Arlington, Virginia-based political group between 2014 and 2017, while a trust associated with the Wendt family of San Francisco contributed $1.35 million to Ohio Governor John Kasich's

[54] See Dorothy A. Brown, The Whiteness of Wealth: How the Tax System Impoverishes Black Americans—and How We Can Fix It 19 (2021).
[55] See, e.g., Federal Election Commission Advisory Opinion 2004-02 (NCEC), http://saos.fec.gov/aodocs/2004-02.pdf (holding that political action committee may accept contribution from testamentary trust).

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political action committee in the 2015-2016 election cycle.[56] A particular concern about some trust contributions is that the individuals behind the trust are not always determinable from FEC disclosures, giving rise to a new type of "dark money" in politics. And whereas section 501(c)(4) organizations that receive "dark money" contributions are subject to limits on political campaign activities,[57] trust contributions to political action committees can be used for campaign activities without limit.

IV. AGENDA FOR REFORM

Our agenda for a revitalized GST tax addresses each of the three flaws identified above: (1) the very high exemption amount; (2) loopholes that allow high-net-worth taxpayers to transfer assets worth many multiples of the GST exemption amount to dynasty trusts without paying any transfer tax; and (3) an exemption that, because of the demise of the rule against perpetuities, now lacks any durational limit. To address these three flaws, we propose (1) a return to the 2009 estate, gift, and GST tax parameters (including exemption amounts), (2) a series of loophole-closing measures that will make it much harder for high-net-worth individuals to stuff GST-exempt trusts, and (3) a durational limit on the GST exemption. These three proposals are not inextricable: for example, we would strongly urge Congress to adopt the second and the third even if a return to 2009 parameters proves politically infeasible. Combined, though, the three proposals would help to transform the GST tax from an easily avoidable obstacle into a meaningful check on the accumulation of dynastic wealth.

A. Lowering the Exemption Amount

Throughout its two terms, the Obama-Biden administration called on Congress to make the 2009 transfer tax parameters permanent.[58] From a historical perspective, the 2009

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[56] See Federal Election Commission, Individual Contributions, https://www.fec.gov/data/receipts/individual-contributions (last visited Aug. 20, 2021) (searches for "Charles G. Koch 1997 Trust," "David H. Koch 2003 Trust," and "Wendt Family Trust").

[57] Specifically, a section 501(c)(4) organization must be "primarily engaged in promoting in some way the common good and general welfare of the people of the community." Treas. Reg. § 1.501(c)(4)-1(a)(2)(i). The promotion of social welfare "does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office." Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii). These regulatory provisions are often interpreted by practitioners to mean that campaign activities cannot equal or exceed 50 percent of a section 501(c)(4) organization's total activities. See Erika K. Lunder & L. Paige Whitaker, Congressional Research Service, 501(c)(4)s and Campaign Activity: Analysis Under Tax and Campaign Finance Laws 4 (May 17, 2013).

[58] U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals 125 (May 2009), https://home.treasury.gov/system/files/131/General-Explanations-FY2010.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals 147 (Feb. 2010), https://home.treasury.gov/system/files/131/General-Explanations-FY2011.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals i n.1 (Feb. 2011), https://home.treasury.gov/system/files/131/General-Explanations-FY2012.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals 75-76 (Feb. 2012), https://home.treasury.gov/system/files/131/General-Explanations-FY2013.pdf;

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exemption levels—$3.5 million for the estate and GST taxes, $1 million for the gift tax—were remarkably favorable to high-net-worth taxpayers. Recall that the Reagan administration in April 1983 proposed a $1 million GST exemption in 1983 and urged Congress not to deviate significantly in either direction.[59] Adjusted for inflation (which the Reagan proposal was not), a $1 million exemption in April 1983 is equivalent to approximately $2.77 million in July 2021.[60] Put differently, the Obama-Biden administration proposal is more "conservative"—in the sense of being more favorable to high-net-worth taxpayers—than the inflation-adjusted equivalent of the Reagan administration's GST starting point.

We think that a return to the 2009 parameters would be eminently reasonable. Only 5,668 estates of individuals who died in 2009 reported any estate tax—approximately 0.2 percent of all individuals who died that year.[61] The figure would be somewhat higher today in light of modest inflation and a dozen years of strong stock-market growth, but the number of taxable returns still would be well below 1 percent of all deaths.[62] The other 99 percent of decedents

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U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals 138-40 (Apr. 2013), https://home.treasury.gov/system/files/131/General-Explanations-FY2014.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals 158-59 (Mar. 2014), https://home.treasury.gov/system/files/131/General-Explanations-FY2015.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals 193-94 (Feb. 2015), https://home.treasury.gov/system/files/131/General-Explanations-FY2016.pdf; U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals 177-78 (Feb. 2016), https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf.

[59] See supra notes 27-28 and accompanying text.

[60] The adjustment is based on the (unchained) Consumer Price Index for All Urban Consumers (CPI-U). U.S. Bureau of Labor Statistics, CPI Inflation Calculator, https://www.bls.gov/data/inflation_calculator.htm (last visited Aug. 31, 2021). For calendar years 2017 and later, cost-of-living adjustments in the Internal Revenue Code are based on a different index, the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). Chained CPI generally increases at a slower pace than unchained CPI. See Daniel Hemel, Indexing Unchained, 83 Law & Contemp. Probs. 83 (2020).

[61] Internal Revenue Service, Statistics of Income Division, Table 2—Estate Tax Returns Filed for 2009 Decedents, Values for Tax Purposes, by Tax Status and Size of Gross Estate (Aug. 2013), https://www.irs.gov/pub/irs-soi/09es02yd.xls. In total, 12,940 estate tax returns were filed for individuals who died that year (including nontaxable returns). An estate must file a return if it elects to transfer any deceased spousal unused exclusion (DSUE) amount to a surviving spouse—thus, some nontaxable returns may correspond to the death of the shorter-lived spouse in a couple that will ultimately face estate tax liability upon the longer-lived spouse's death. In 2009, a total of 2,437,163 deaths were reported in the United States. See Kenneth D. Kochanek, Jiaquan Xu, Sherry L. Murphy, Arialdi M. Miniño & Hsiang-Ching Kung, Deaths: Final Data for 2009, 60 Nat'l Vital Stat. Rep. no. 3, at 1 (Dec. 29, 2011).

[62] The Tax Policy Center estimates that with a $3.5 million exemption, the number of taxable returns would be approximately 0.5 percent of all deaths in 2021 and 0.6 percent in 2022. See Urban-Brookings Tax Policy Center, T18-0144 - Estate Tax Returns and Liability Under Current Law and Certain Prior Laws, 2019-2028 (Sept. 27, 2018), https://www.taxpolicycenter.org/model-estimates/baseline-estate-tax-tables-sep-2018/t18-0144-estate-tax-returns-and-liability-under. The Penn Wharton Budget Model estimates that with a $3.5 million exemption, the number of taxable returns would be 0.45 percent of all deaths in 2022. See Victoria Osorio, Senator Bernie Sanders' Estate Tax: Budgetary Effects, Penn Wharton Budget Model (Jan. 23, 2020), https://budgetmodel.wharton.upenn.edu/issues/2020/1/23/sanders-estate-tax.

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would be able to leave the entirety of their wealth to the living beneficiaries of their choosing—children, grandchildren, great-grandchildren, and non-descendants of any age—without paying any estate or GST tax.

B. Closing Gaps in the Transfer Tax Base

Lowering the exemption amount is a necessary step toward a revitalized GST tax, but it is far from sufficient. Unless Congress acts to close transfer tax loopholes, high-net-worth taxpayers will continue to stuff GST-exempt trusts with assets worth many multiples of the exemption amount. Comprehensive GST tax reform requires complementary base-protecting measures. In an accompanying white paper on estate and gift tax reforms,[63] we suggest six such measures:

- Repealing section 2702(b)(1), the provision that enables high-net-worth individuals to achieve extraordinary transfer tax savings via grantor-retained annuity trusts (GRATs);
- Treating all irrevocable trusts as nongrantor trusts for income tax purposes;
- Limiting valuation discounts for interests in family-controlled entities (specifically, prohibiting all lack-of-control discounts with respect to interests in family-controlled entities and prohibiting lack-of-marketability discounts with respect to non-business assets);
- Shifting to a tax-inclusive base for gift taxes;
- Limiting the gift tax annual exclusion to outright gifts (i.e., abrogating *Crummey v. Commissioner*); and
- Extending valuation consistency requirements—which, under current law, require taxpayers to use consistent valuations for income and estate tax purposes—to the gift tax.[64]

All of these proposals with the exception of the first (GRATs) apply in the GST context too:

- Treating irrevocable trusts as nongrantor trusts for income tax purposes would prevent living donors of GST-exempt trusts from providing those trusts with an additional transfer-tax-free economic benefit (i.e., income tax relief).
- Limiting lack-of-control and lack-of-marketability discounts for interests in family-controlled entities would make it harder for high-net-worth individuals and families to claim implausibly low valuations on transfers to GST-exempt trusts. Valuation disputes would not go away entirely, but high-net-worth individuals and families could no longer claim cover from cases like *Grieve* for discounts that are entirely disconnected from economic reality.
- Shifting to a tax-inclusive base for both gift and GST taxes would prevent high-net-worth individuals who have exhausted their exemption from avoiding nearly an entire

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[63] See Hemel & Lord, supra note 35.

[64] We also suggest extending valuation consistency requirements to property that qualifies for the estate tax marital deduction. See id. at 11.

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generation's worth of transfer taxes by taking advantage of the tax-exclusive base for gift taxes and direct skips.

- Limiting the GST tax annual exclusion to outright gifts would align the law with Congress's original purpose for enacting an annual exclusion: to obviate the need for keeping records and filing returns with respect to "wedding and Christmas gifts and occasional gifts of relatively small amounts."[65] The annual exclusion was never meant to give high-net-worth individuals a way to top up their lifetime exemptions.
- Extending valuation consistency requirements to the gift tax would mean that taxpayers could not claim an improbably low valuation on property transferred by gift and then claim a higher basis for income tax purposes when the property is ultimately sold. Since GST tax valuations for lifetime transfers are tied to gift tax valuations,[66] our valuation consistency proposal would apply similarly to both taxes.

Grantor-retained annuity trusts play a less direct role in GST tax avoidance because GRATs generally cannot be used to stuff GST-exempt trusts. (We relegate the technical explanation to the margin.[67]) Even so, revitalizing the GST tax will require Congress to close gift tax loopholes such as GRATs because without an effective gift tax, the GST tax is largely irrelevant: high-net-worth families can avoid transfer taxes perpetually by making tax-free lifetime gifts from one generation to the next.

A final challenge for lawmakers relates to HEETs. As noted above, some advisers are telling high-net-worth clients with no remaining GST exemption that they still can create perpetual trusts that will never face GST tax by establishing HEETs. The Obama-Biden administration, starting in 2013, called on Congress to "clarify" that the GST tax exclusion for health and education expenses applies only to payments by living donors. The Obama-Biden proposal would apply only to trusts created after the introduction of legislation and to transfers made after that date to pre-existing trusts.[68]

One concern regarding the Obama-Biden proposal is that it might be read to legitimize the claim that HEETs established and funded before the introduction of reform legislation can avoid GST tax. HEETs, though, never "worked" under the GST tax laws—which is to say, based on a fair reading of the relevant statutes and regulations, HEETs never achieved the favorable tax

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[65] H.R. Rep. 708, 72nd Cong., 1st Sess., at 29 (1932); S. Rep. 708, 72nd Cong., 1st Sess., at 41 (1932). It bears mention that the GST tax annual exclusion, as applied to transfers in trust, is significantly less objectionable than the gift tax annual exclusion because the GST tax annual exclusion is limited to transfers to single-beneficiary trusts where the assets of the trust will be included in the beneficiary's gross estate. See Bridget J. Crawford, Reform the Gift Tax Annual Exclusion to Raise Revenue, Tax Notes, July 25, 2011, at 443, 444.

[66] Treas. Reg. § 26.2642-2(a)(1).

[67] Under I.R.C. § 2642(f)(1), a taxpayer cannot allocate GST exemption to a gift until after the "estate tax inclusion period." The estate tax inclusion period for a GRAT does not end until the last annuity payment. See I.R.C. § 2036(a). Although the grantor can allocate GST exemption to the GRAT remainder at that point, there is no advantage of allocating GST exemption to a GRAT remainder rather than making an outright gift of the remainder amount.

[68] FY 2013 Greenbook, supra note 58, at 148.

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results that promoters advertise. HEET promoters suggest that the initial transfer to a HEET isn't a direct skip—and the lapse of an interest in a HEET won't ever give rise to a taxable termination—because of the presence of a charitable interest. However, under a statutory anti-abuse rule, an interest must be disregarded for GST tax purposes if it is used "primarily to postpone or avoid" GST tax.[69] HEET promoters are explicit about the fact that the inclusion of a charitable interest is intended to avoid GST tax.[70] Some advisers to high-net-worth clients have suggested that a sufficiently large charitable interest might allow HEETs to escape the anti-abuse rule.[71] But as attorney Julie Kwon emphasizes, the statutory anti-abuse rule "bases its criterion purely on the intention motivating inclusion of the interest and does not indicate that the magnitude of the interest is relevant."[72] Indeed, taxpayers who increase the charitable beneficiary's interest in order to avoid GST tax are running afoul of the same rule they seek to circumvent. One would have to bury one's head in the sand to think that taxpayers creating HEETs are including charitable beneficiaries for non-tax reasons, rather than to avoid GST tax.[73]

Nonetheless, the current anti-abuse statute's emphasis on taxpayers' subjective motivations creates challenges for the IRS, for courts, and for tax advisers who are trying to help their clients comply with the laws. No one other than the taxpayer really knows the taxpayer's "primary" purpose for adding a charitable beneficiary to a trust. A taxpayer with mixed motives (e.g., wanting to avoid GST tax but also wanting to support a favorite charity) might not even be sure herself which of her two motives predominates.

A bright-line quantitative rule would make the GST tax laws easier for the IRS to enforce and easier for courts to adjudicate, as well as offering certainty to well-intentioned taxpayers. We would suggest a 50 percent threshold: a charitable interest should be disregarded for GST tax purposes at any time that the charitable interest (aggregated with other charitable interests in

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[69] See I.R.C. § 2652(c)(2); see also Treas. Reg. § 26.2612-1(e)(2)(ii) ("An interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax.").

[70] See, e.g., Michael N. Delgass & Deborah S. Gordon, HEET Wave, 144 Trusts & Estates no. 3, at 20, 21 (Mar. 2005) (stating that GST tax avoidance "is accomplished by providing that the HEET always has a charitable beneficiary (whose perpetual life allows the HEET to avoid a taxable termination for GST purposes)").

[71] See, e.g., Colleen DeBaise, Tool for Grandparents to Help Out With Tuition, Wall St. J. (Oct. 20, 2005), https://www.wsj.com/articles/SB112975681151873562 (quoting Mel Warshaw, a wealth adviser for J.P. Morgan Private Bank in Boston, as recommending a 20 percent income interest for the charitable beneficiary).

[72] Julie K. Kwon, Advanced Generation-Skipping Transfer Tax Issues, ALI-ABA Estate Planning in Depth, 43rd Annual Advanced Summer Program (June 2007).

[73] The Obama-Biden Greenbooks raised a different objection to HEETs: that "[t]he intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person's tuition." FY 2017 Greenbook, supra note 58, at 186. This interpretation of legislative intent is difficult to square with the text of I.R.C. § 2611(b)(1), which applies to "any transfer, which, <u>if made inter vivos by an individual</u>, would not be treated as a taxable gift by reason of section 2503(e) (relating to exclusion of certain transfers for educational or medical expenses)." The "if made inter vivos" language suggests that Congress was contemplating transfers that would <u>not</u> be made inter vivos.

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the same trust) represents less than 50 percent of the net fair market value of the property transferred. Thus, a gift to a trust whose only beneficiaries are skip persons and charities would be a direct skip unless the charities' interests represented 50 percent or more of the fair market value of the trust. Likewise, the termination of an interest in a trust whose only remaining beneficiaries are skip persons and charities would be a taxable termination unless the charities' interests represented 50 percent or more of the fair market value of the trust at the time of the termination. Congress could clarify, either in statutory text or legislative history, that the new 50 percent threshold does not preclude the IRS from issuing deficiency notices to HEETs that failed to pay GST tax on direct skips and taxable terminations within the statute of limitations period.

C. Limiting the Duration of the GST Exemption

By lowering the exemption amount and closing loopholes in the transfer tax base, Congress can significantly strengthen the GST tax. But unless Congress limits the duration of the GST exemption, the hundreds of billions (if not trillions) of dollars already in GST-exempt dynasty trusts will remain outside the transfer tax base indefinitely. Moreover, even at a $3.5 million exemption level, new GST-exempt dynasty trusts of massive size will continue to arise. For example, a trust that acquired $3.5 million of Tesla stock at that company's IPO in 2010 would be worth more than $660 million as of this writing.[74] A return to the $3.5 million exemption level will not prevent early-stage investors in the Teslas, Facebooks, and Amazons of the future from creating new dynasty trusts of extraordinary value and indefinite duration.

The Obama-Biden Proposal. The starting point for any discussion of a durational limit on the GST exemption is the Obama-Biden administration's thoughtful proposal for a 90-year limit on any GST exemption allocated to a trust. The Obama-Biden administration's 90-year rule—which the administration presented to Congress every year from 2012 onwards[75] —would have been the most significant progressive change to federal wealth transfer tax law in a generation. If the proposal were in effect today, a GST-exempt trust established in 2021 could continue to make tax-free distributions to skip persons only until 2111. After that date, GST tax would be imposed when the trust distributed assets to a skip person or when a death, disclaimer, or other event resulted in all the remaining beneficiaries of the trust being skip persons.

While the 90-year limit would mark a meaningful improvement over the dynasty trust status quo, it still leaves two important gaps:

- *First*, the proposal would not apply to trusts created before the date of enactment unless they received post-enactment transfers. While the grandfathering provision for existing trusts reflected an understandable regard for settled expectations, events since 2017

[74] See Tesla Inc, Google Finance, https://www.google.com/finance/quote/TSLA:NASDAQ (last visited Sept. 2, 2021).
[75] See FY 2012 Greenbook, supra note 58, at 129-130; FY 2013 Greenbook, supra note 58, at 81-82; FY 2014 Greenbook, supra note 58, at 143-44, FY 2015 Greenbook, supra note 58, at 164-65; FY 2016 Greenbook, supra note 58, at 200-01; FY 2017 Greenbook, supra note 58, at 183-84.

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substantially alter the transfer tax landscape and make a grandfathering provision untenable. Most significantly, the December 2017 tax law doubled the estate, gift, and GST tax exemptions for the 2018-2025 period. Then in November 2019, the Trump administration finalized a Treasury regulation that effectively allowed taxpayers to lock in the benefit of the higher exemption amount by making transfers to trusts while the higher exemption remained in effect.[76] In light of these changes—and in anticipation of the possibility that an incoming Biden-Harris administration would tighten the federal wealth transfer tax rules—high-net-worth taxpayers raced to utilize their lifetime gift and GST exemptions by making large transfers to GST-exempt trusts in late 2020 and early 2021. As a result, hundreds of billions of dollars flowed into irrevocable trusts after the 2020 election.[77] If preexisting trusts are grandfathered, then these assets can continue to grow indefinitely without ever being subject to federal wealth transfer taxes.[78]

- *Second*, even for post-enactment trusts, the 90-year proposal would allow extraordinary fortunes to remain outside the federal wealth transfer tax base for very long periods. For example, imagine a taxpayer born in 1950 whose child is born in 1980 and whose grandchild is born in 2010. The taxpayer could establish a trust for the benefit of her descendants in a state with no rule against perpetuities in 2022, transfer assets to the trust, and allocate GST exemption to the transfer. Under the Obama-Biden proposal, the trust's GST tax exclusion would terminate in 2112. To avoid GST tax, the trust could make an exempt distribution to the taxpayer's descendant or descendants in 2111. If each generation of the taxpayer's family is spaced 30 years apart, the taxpayer's great-great-great-grandchild will be 11 years old at that time.[79] The great-great-great-grandchild would not need to pay federal wealth transfer taxes until her death, which—if she lives to be 90—would occur in 2190 (by which point the initial transferor's great-great-great-great-great-great-grandchildren would potentially be alive).

Thus, while the Obama-Biden proposal would prevent taxpayers from establishing new dynasty trusts that escape federal wealth transfer taxation *forever*, it still would allow assets to

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[76] Treas. Dec. 9884, 84 Fed. Reg. 64,995 (Nov. 26, 2019).

[77] See Robert Frank, Here's Why Rich Kids Could Get Hundreds of Billions from Their Parents If Biden Wins, CNBC (Oct. 14, 2020), https://www.cnbc.com/2020/10/14/rich-kids-could-get-hundreds-of-billions-from-their-parents-if-biden-wins-.html.

[78] A similar surge occurred in 2012 amid concerns that Congress would allow the estate and gift tax exemption to fall from $5 million to $1 million. Approximately $234 billion in transfers to trusts were reported on gift tax returns that year. See Jessica Holland, 2010-2016 Gifts, Statistics of Income Bulletin, Summer 2019, at 1 tbl.1. Only $4.3 billion of total gift tax was paid with respect to 2012 returns. See id. at 6 fig.I. Given a 35 percent gift tax rate in effect in 2012, these figures imply that nearly $222 billion passed tax-free (i.e., $234 billion – $4.3 billion/35%).

The amount that passed tax-free in 2020 is likely to be considerably higher because (a) the gift tax and GST exemptions in 2020 were more than double the 2012 levels ($11.58 million vs. $5 million) and (b) asset prices increased significantly during the 2012-2020 interval (e.g., the S&P 500 gained more than 160 percent).

[79] If, as in this example, the beneficiary has not yet reached the age of majority, the trust distribution could be paid into a Uniform Transfers to Minors Act (UTMA) account. The assets would then transfer to the beneficiary when she reaches the UTMA account age of majority (21 in most states).

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escape federal wealth transfer taxation for many generations. The example above—in which assets grow for 168 years without undergoing any taxable transfer—is not even the most dramatic generation-skipping possibility. Depending on the timing of births and the length of lifespans, assets transferred to a 90-year trust could grow for more than 180 years without facing federal wealth transfer tax.[80]

Despite the gaps highlighted above, the Obama-Biden proposal carries considerable virtues. It zeroes in on the central problem: perpetual growth of assets in dynasty trusts outside the federal wealth transfer tax base. And it identifies a powerful tool that can be used to address the problem: limiting the duration of the GST exemption.

Building on the Obama-Biden Proposal. The proposal here aims to ensure that extraordinary fortunes do not escape from federal wealth transfer taxation for significantly longer than a single human lifetime. It thus takes the Obama-Biden administration's 90-year proposal as a target for the length of time that assets should be allowed to grow without the application of federal wealth transfer taxes. The proposal here also seeks to ensure that GST tax does not apply to the bottom 99 percent of the wealth distribution. For example, eliminating the GST exemption entirely would cause routine gifts from grandparents to grandchildren to be taxable. The proposal here eschews that approach. The GST tax should exist as a check on extraordinary dynastic wealth, not as a trap for the unwary.

Our proposal would provide that notwithstanding any allocation of GST exemption to a trust, distributions from a trust would be subject to GST tax if the beneficiary (a) is three or more generations below the transferor and (b) was not alive at the time that the GST exemption was allocated to the trust. A taxable termination would occur (i.e., trust assets would be subject to GST tax) when there is no remaining beneficiary of the trust to whom an exempt distribution could be made. For any trust created prior to January 1, 2022, the proposal would apply as if the GST exemption had been allocated to the trust on January 1, 2022. Portions of a trust attributable to separate contributions (whether or not from the same transferor) would be treated as separate trusts.[81]

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[80] For example, imagine that assets are distributed from a GST-exempt trust to the UTMA account of a newborn beneficiary immediately before the 90-year period expires. Those assets would be included in the beneficiary's estate at her death (which could be 90 years or more after her birth).

[81] The staff of the nonpartisan Joint Committee on Taxation proposed in 2005 to prohibit the allocation of the GST exemption to any "perpetual dynasty trust" except insofar as the trust provides for distributions to beneficiaries no more than two generations below the transferor. Under the JCT staff proposal, a "perpetual dynasty trust" would be defined as a trust in a state that had (1) repealed the rule against perpetuities, (2) allowed the creator to opt out of the rule against perpetuities (provided that the creator exercised that option), or (3) had "modified its rule against perpetuities to permit creation of interests for individuals more than three generations younger than the interest's creator." Staff of the Joint Committee on Taxation, JCS-02-05, Options to Improve Tax Compliance and Reform Tax Expenditures 393 (Jan. 27, 2005).

Our proposal is consistent with the JCT staff's suggestion with respect to trusts in states that have repealed the rule against perpetuities. (Indeed, our proposal is slightly more generous because we would allow distributions to beneficiaries more than two generations below the transferor if they were alive at the time of the initial GST exemption allocation.) However, unlike our proposal, the JCT staff's proposal would

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Three examples illustrate the proposal's operation:

Example 1. On January 1, 2022, T transfers $1 million to an irrevocable trust for the benefit of her descendants and allocates $1 million of her available GST exemption to the transfer. Under current law, the trust would never be subject to GST tax and distributions from the trust always would be GST tax-exempt. Under the proposal, the trust would be able to make GST tax-exempt distributions to any beneficiary who is no more than two generations below T or who was alive on January 1, 2022. Thus, a distribution to T's grandchild would not be subject to GST tax, but a distribution to T's great-grandchild would be subject to GST tax unless the great-grandchild was alive on January 1, 2022. A taxable termination would occur when there are no remaining beneficiaries who are within two generations of T or who were alive on January 1, 2022.

Example 2. On January 1, 1975, B established and funded an irrevocable trust for the benefit of her descendants. Under current law, distributions from the trust never would be subject to GST tax because the trust pre-dated September 25, 1985. Under the proposal, the trust would be treated as if it were a GST-exempt trust created by B on January 1, 2022. A distribution to B's grandchild would not be subject to GST tax. A distribution to any descendant of B who was alive on January 1, 2022 also would not be subject to GST tax. However, a distribution to B's great-grandchild or more distant descendant would be subject to GST tax if the great-grandchild or more distant descendant was not alive on January 1, 2022. GST tax would apply to trust assets when there are no remaining beneficiaries who either are within two generations of B or were alive on January 1, 2022.

Example 3. On January 1, 2022, C makes a $1 million taxable gift to an irrevocable trust and does not allocate any GST exemption to the trust (presumably because C already has exhausted her exemption). On January 1, 2052, the trust makes a distribution to D, who is the grandchild of C. Under current law, the distribution would be subject to GST tax. Under the proposal, the distribution would be subject to GST tax as well because the proposal limits but does not extend existing GST exclusions.[82]

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allow GST-exempt distributions to beneficiaries as many as six generations below the transferor in states that have retained the common-law rule. Recall that under the common-law rule, an individual who has living great-grandchildren can establish a trust that will distribute all of its assets to descendants who are alive 21 years after the last-to-die great-grandchild's death. See supra note 7 and accompanying text. The JCT staff's proposal would not affect GST-exempt trusts in states that have retained the common-law rule (e.g., Alabama, New York, and Texas). Those states would thus become magnets for long-duration trusts (and other states would be motivated to return to the common-law rule so that they could attract the trust business of high-net-worth individuals seeking to perpetuate large fortunes).

[82] For partially GST-exempt trusts (i.e., trusts with an inclusion ratio greater than zero but less than one), GST tax would continue to apply as under current law to distributions to beneficiaries who are within two generations of the transferor or who were alive at the time of the initial GST exemption allocation.

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The first part of our proposal is consistent with suggestions by law professors Ray Madoff and Lawrence Waggoner that the GST exemption be limited to two generations.[83]
The rationale for allowing GST tax-exempt transfers to all beneficiaries two generations below the transferor (regardless of whether the beneficiary was alive at the time of GST exemption allocation) is to protect relatively routine estate plans with no tax-avoidance motive. For example, consider a taxpayer who establishes a GST-exempt trust for the health, education, maintenance, and support of her grandchildren in 2022, but who then has a new grandchild born or legally adopted into her family in 2023. Under the proposal, distributions to the younger grandchild would be treated the same as distributions to other members of the same generation (i.e., would be exempt from tax). More generally, all grandparent-to-grandchild transfers would be unaffected by the proposal, as would transfers to other beneficiaries two generations below the taxpayer (including non-family members born within 62 ½ years of the taxpayer).

The rationale for allowing GST tax-exempt distributions to all beneficiaries alive at the time of the initial GST exemption allocation is to respect the non-tax motivations that might lead a taxpayer to establish a lifetime trust for an identifiable individual other than a grandchild. For example, consider a taxpayer who establishes a GST-exempt trust for the benefit of a great-grandchild with a severe disability. The proposal ensures that the trust can continue to make distributions to that beneficiary for the duration of the beneficiary's life. In this respect, the proposal is potentially less onerous than the Obama-Biden proposal, under which distributions would become taxable if the beneficiary lived for more than 90 additional years.

The proposal also would address the two gaps in the Obama-Biden administration's alternative. First, unlike the Obama-Biden proposal, the proposal here would bring the hundreds of billions of dollars already in dynasty trusts back into the federal wealth transfer tax system over the course of the next century. Second, except in unusual circumstances, the proposal here would ensure that assets do not remain outside the federal wealth transfer tax base for significantly longer than a single human lifespan.[84]

Distributions to more distant beneficiaries who were not alive at the time of the initial transfer would be fully taxable.

[83] See Ray D. Madoff, Op-Ed, America Builds an Aristocracy, N.Y. Times (July 11, 2020), https://www.nytimes.com/2010/07/12/opinion/12madoff.html; Lawrence W. Waggoner, Congress Should Impose a Two-Generation Limit on the GST Exemption: Here's Why (Univ. of Michigan Law School, Public Law Working Paper No. 205, July 2010).

[84] One exception would be in the case that the transferor has a child after establishing and funding a GST-exempt trust and then the child has a child very late in life. In that case, assets could continue to grow in the GST-exempt trust for approximately two lifetimes (the lifetime of the child and the lifetime of the grandchild). This pattern is rare enough that it may not require any specific policy response. If it does require a policy response, then the rule allowing GST-exempt distributions to individuals two generations below the transferor could be amended to provide that, e.g., the beneficiary must be born within 21 years of the trust's creation in order to receive a GST-exempt distribution.

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Additional Considerations. One potential counterargument to our proposal for a durational limit on the GST exemption is that it upsets the expectations of taxpayers who established and funded irrevocable trusts before the current GST tax came into existence. These pre-1985 trusts, though, are generally governed by the rule against perpetuities, and they would sacrifice their GST-exempt status if they were to be decanted into perpetual trusts in states that have abolished the rule.[85] In many and probably most cases, these pre-1985 trusts would reach the end of their perpetuities period before they would lose their GST exemption under our proposal.[86]

A second counterargument is that our proposal upsets the expectations of taxpayers who established and funded GST-exempt trusts between 1985 and 2021 in states that already had abolished the rule against perpetuities. This is concededly true. But there is simply no way to honor the expectations of those transferors while also honoring this country's centuries-old commitment to a society free from aristocracy. Our proposal seeks to strike a balance between the reliance interests of transferors and the value of democratic equality. Under the balance struck here, everyone alive today could continue to receive GST tax-exempt distributions as allowed under current law. At the same time, the challenge to democratic equality posed by dynasty trusts would be checked.

A potential counterargument to our proposal from the opposite direction is that our durational limit does not do enough. Even under the proposal, dynasty trusts in existence today could remain exempt from federal wealth transfer taxes until the early 22nd century. This is a legitimate concern. Arguably, the proposal here—in its attempt to protect estate plans that lack a tax avoidance motive while treating existing trusts no less favorably than new ones—errs too far on the side of allowing dynasty trusts to persist. That said, it goes further in this regard than the Obama-Biden proposal while remaining (we think) within the realm of political possibility.[87]

A final potential counterargument to the proposal is that it adds further complexity to the GST tax regime. That said, the additional complication is small compared to the complexity of the status quo: the rule can be stated and illustrated quite straightforwardly. Moreover, the additional complexity seems well worth the benefit of stemming the trend toward a society in which some individuals command truly extraordinary economic power by accident of birth.

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[85] See Treas. Reg. § 26.2601-1(b)(4)(i)(D).

[86] Consider a trust established in 1984 with a measuring life that began that year. If the measuring life ended at age 90, the trust would cease to exist in 2095. Under our proposal, the trust could continue to make GST-exempt distributions through 2095 to anyone who was born before 2021. Thus the trust would likely be able to make GST-exempt distributions through the end of its perpetuities period.

[87] Recent polling suggests widespread support for a return to the 2009 parameters. A February 2021 survey by Data for Progress, commissioned by the news outlet Vox, found that likely voters supported a $3.5 million exemption amount by a wide margin (57 percent to 33 percent). Even among Republicans, a plurality supported the $3.5 million exemption (48 percent of Republicans in favor of an estate tax with a $3.5 million exemption; 43 percent opposed). See Data for Progress/Vox, Estate Tax Toplines (Mar. 10, 2021), https://www.filesforprogress.org/datasets/2021/3/dfp-vox-estate-tax-toplines.pdf.

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V. REVENUE ESTIMATE

The GST tax seeks to secure the federal wealth transfer tax base over the long term, not to produce immediate tax collections. Thus, 10-year revenue estimates for GST tax reforms yield results that understate their ultimate budgetary impact. For example, the Treasury Department scored the Obama-Biden administration's 90-year GST exemption limit as having a "negligible revenue effect" over the 10-year window,[88] though it would almost certainly be a revenue-raiser in the long run. Treasury even scored the Obama-Biden administration's proposal to clamp down on HEETs as *reducing* revenues by $247 million over the 10-year window (presumably because some high-net-worth individuals fund HEETs through taxable gifts), though the short-term revenue loss almost certainly would be recouped over the long term. [89]

Nonetheless, some of the reforms laid out here—and in particular, a return to the 2009 estate, gift, and GST tax parameters—would have an immediate and large effect on revenue. The Treasury Department estimated in 2016 that a return to 2009 parameters would raise $202 billion over 10 years.[90] More recently, the Tax Policy Center estimated in 2018 that a return to 2009 parameters would raise $234 billion over a decade.[91] To be sure, the vast majority of the revenue from a return to the 2009 parameters will result from the estate and gift taxes, rather than the GST tax. But a functional GST tax is an integral part of a robust estate and gift tax regime.[92]

Ultimately, though, the case for GST exemption reform does not rise or fall on any revenue estimate. Congress should impose durational limits on the GST exemption in order to prevent the emergence of a hereditary plutocracy and the democratic distortions that would foreseeably follow. The revenue effects should not be ignored simply because they will manifest outside the 10-year window, but the long-term revenue effects are only one among several reasons for Congress to act.

CONCLUSION

Generation-skipping transfer tax reform requires difficult design choices and tradeoffs. However, the status quo—in which hundreds of billions of dollars in dynasty trusts can grow free

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[88] FY 2017 Greenbook, supra note 58, at 269.

[89] Id.

[90] Id.

[91] See Tax Policy Center, supra note 62.

[92] Moreover, under the Senate's Byrd rule, bills considered under the filibuster-free budget reconciliation procedure cannot increase the deficit in any year beyond the budget window. See 2 U.S.C. § 644(b)(1)(E). Accordingly, if lawmakers want to use the budget reconciliation process to enact permanent new programs (e.g., a permanent expansion to the child tax credit or Medicare coverage for dental care), they will need to find "out-year" revenue raisers. The inclusion of progressive GST tax reforms in a reconciliation package would make it easier to achieve deficit neutrality in the out-years while making some of the new spending items permanent.

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of federal wealth transfer tax forever—is clearly untenable. Our agenda for reform would address the present crisis by (1) lowering the exemption amount to 2009 levels, (2) closing loopholes in the transfer tax base that allow high-net-worth individuals to stuff GST-exempt trusts with assets worth multiples of the exemption amount, and (3) limiting the duration of the GST exemption to two generations, with an exception for any beneficiary who was alive at the time of the initial GST exemption allocation. Existing GST-exempt trusts would be brought back within the federal wealth transfer tax system under a reasonable transition rule that places these trusts on equal footing with GST-exempt trusts created today.

Ours is in many ways a modest proposal—and not in the Swiftian sense. The GST exemption still would be higher, in inflation adjusted terms, than the amount advocated by the Reagan administration. No living beneficiary would be negatively affected, and the estate plans of taxpayers in the bottom 99 percent of the wealth distribution would experience no impact. Yet despite its modesty, our reform agenda puts the GST tax on a path toward fulfilling its framers' core objectives: protecting the estate and gift tax base and ensuring that large fortunes bear their fair share of transfer tax burdens. As importantly, our reform agenda would counteract the extraordinary economic and political power that dynasty trusts confer upon their beneficiaries. Vast inequalities of wealth would (of course) continue to exist, but they would no longer be allowed to compound tax-free ad infinitum.

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