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# TAX LAW—HAVING YOUR CAKE AND EATING IT TOO: SECTION 1433(b)(2)(A) OF THE TAX REFORM ACT OF 1986: EFFECTING AN EXCEPTION WHERE ONE DOES NOT EXIST

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## NOTES

### TAX LAW—HAVING YOUR CAKE AND EATING IT TOO<sup>1</sup>: SECTION 1433(B)(2)(A) OF THE TAX REFORM ACT OF 1986: EFFECTING AN EXCEPTION WHERE ONE DOES NOT EXIST

#### INTRODUCTION

In 1986, Congress eliminated an estate-tax loophole that taxpayers had exploited through the use of generation-skipping transfers.<sup>2</sup> A generation-skipping transfer provides the present enjoyment of property in trust to intermediate generations<sup>3</sup> and transfers the remainder beneficiary interest to persons more than one generation below the transferor.<sup>4</sup> Today, nearly twenty-five years later, two circuit courts of appeals continue to allow taxpayers to escape generation-skipping transfer-tax liability through the use of a general power of appointment.<sup>5</sup> This Note explores how and why these circuits continue to allow taxpayers to use generation-skipping transfers to circumvent tax liability.

Benjamin S. Gerson married his wife, Eleanor, on November 6, 1938; they remained married until Mr. Gerson's death thirty-five years later.<sup>6</sup> In December of 1968, Mr. Gerson executed a revoca-

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1. Readers may ascribe more than one meaning to this proverb. However, in this context, it means taking advantage of a particular thing and, then, after that thing is no longer available, still attempting to benefit from or use it.

2. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)).

3. The intermediate generation is the set of beneficiaries one generation below the transferor. See WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, PRINCIPLES OF WILLS, TRUSTS & ESTATES MCGOVERN & KURTZ § 15.4, at 430-31 (2005).

4. See 26 U.S.C. §§ 2611-13. A generation-skipping transfer may also be effected by directly transferring property to a beneficiary two or more generations below the transferor. See *id.* §§ 2612(c)(1), 2613(a)(1).

5. See *Bachler v. United States*, 281 F.3d 1078, 1080 (9th Cir. 2002) (holding that exercising a general power of appointment over a trust that otherwise meets the requirements of § 1433(b)(2)(A) does not remove the trust from the scope of the exception); *Simpson v. United States*, 183 F.3d 812, 816 (8th Cir. 1999) (same).

6. *Estate of Gerson v. Comm'r*, 127 T.C. 139, 140 (2006), *aff'd*, 507 F.3d 435 (6th Cir. 2007).

ble trust,<sup>7</sup> known as the Benjamin Gerson Trust.<sup>8</sup> On July 19, 1973 Mr. Gerson executed the third and final amendment to this trust.<sup>9</sup> Mr. Gerson died three days later; his death rendered the Benjamin Gerson Trust irrevocable.<sup>10</sup> He was survived by his wife, four children, and five grandchildren.<sup>11</sup>

The Benjamin Gerson Trust provided for the trust property to be divided into three trusts.<sup>12</sup> One of those three trusts was at issue—a marital trust that was formed for the benefit of Mrs. Gerson.<sup>13</sup> Additionally, the marital trust granted Mrs. Gerson a general power of appointment,<sup>14</sup> which allowed her to dispose of the marital trust property as she desired.<sup>15</sup>

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7. In general, a trust is an instrument that creates a right of “beneficial enjoyment [in] property to which another person holds the legal title.” BLACK’S LAW DICTIONARY 1647 (9th ed. 2009). The settlor contributes property to the trust, which is overseen by the trustee, who maintains an interest in the property for the benefit of the beneficiary. *Id.*; see MCGOVERN & KURTZ, *supra* note 3, § 4.6, at 118-19. “[T]he term ‘trust’ as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries . . . .” Treas. Reg. § 301.7701-4(a) (as amended in 1996). The term “trust” in the generation-skipping transfer-tax context has a broader meaning than under section 7701. CAROL A. HARRINGTON, LLOYD LEVA PLAINE & HOWARD M. ZARITSKY, GENERATION-SKIPPING TRANSFER TAX ¶ 2.03[1], at 2-18 (2d ed. 2001). For generation-skipping transfer tax purposes, “any arrangement (other than an estate) that has substantially the same effect as a trust, such as a life estate, remainder interest, estate for years, insurance, and annuity contracts” is considered a trust. *Id.* A revocable trust enables the settlor to revoke the trust without the consent of the trustee or beneficiary. UNIF. TRUST CODE § 103(14) (2005). Conversely, an irrevocable trust is one “that cannot be terminated by the settlor.” BLACK’S LAW DICTIONARY 1651 (9th ed. 2009).

8. *Estate of Gerson*, 127 T.C. at 140.

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

14. The holder of a power of appointment has authority to designate recipients of the trust property. RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 (1986); see UNIF. TRUST CODE § 103(3)(b) (2005). The U.S. Code defines a general power of appointment as “a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.” 26 U.S.C. § 2041(b)(1) (2006). In general, the holder of a power of appointment has authority to dictate to whom to assign trust property. *See id.*

15. *Estate of Gerson*, 127 T.C. at 140.

Upon the death of my said wife, the balance remaining in Trust A [the marital trust], including any income therein received by the Trustee from the time of the last income payment and the date of death of my said wife, shall be distributed by the Trustee to such person or persons, and in such share or shares, in trust or otherwise, as my said wife shall, by her Last Will and Testament, or Codicil thereto, appoint by specific reference thereto. It is my intention that my said wife shall have an unlimited testamentary power of appointment in

Mrs. Gerson executed her will and created a revocable trust—the Eleanor Gerson Trust—on September 24, 1999.<sup>16</sup> Five weeks before her death, she amended her will and the Eleanor Gerson Trust.<sup>17</sup> In this amendment, she exercised her power of appointment in the marital trust in favor of her grandchildren through the Eleanor Gerson Trust.<sup>18</sup>

Upon her death, Mrs. Gerson's estate filed a tax return claiming that the trust formed for the benefit of the Gersons' grandchildren was exempt from the Generation-Skipping Transfer Tax (GSTT).<sup>19</sup> The government imposes the GSTT on property transfers that skip at least one generation between the transferor and beneficiary.<sup>20</sup> The estate made its claim contrary to promulgated

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respect of the whole of Trust A, including the power to appoint the same in favor of her own estate.

*Id.*

16. *Id.* at 141.

17. *Id.*

18. *Id.*

Under the terms of a certain Trust Agreement dated December 9, 1968, entered into between my spouse, BENJAMIN S. GERSON, AND NATIONAL CITY BANK, . . . I am granted a general power to appoint at the time of my death the property held in Trust A of my said spouse's Trust Agreement. I hereby exercise said power of appointment and direct that all property subject thereto shall be allocated to NATIONAL CITY BANK, Trustee, or any successor thereto, under my said 1999 Amended and Restated Revocable Trust Agreement, to be administered pursuant to the terms of *ARTICLE III* thereof (the Grandchildren's Trust) for the benefit of my grandchildren and more remote descendants.

*Id.* The Grandchildren's Trust divided the trust property "into five equal shares for the benefit of each [grandchild]." *Id.* Two grandchildren received their shares outright. *Id.* The shares of the remaining three grandchildren were held in trust, to be transferred to each upon the earlier of their reaching forty years of age or the twenty-first anniversary of Mrs. Gerson's death less one day. *Id.*

19. *Id.* The value of the trust at Mrs. Gerson's death was \$6,244,627.16. *Id.* The estate reported a federal estate tax of \$7,168,531.02, which did not include the tax for the generation-skipping transfer that the commissioner later claimed a deficiency against. *Id.* at 142.

20. See MCGOVERN & KURTZ, *supra* note 3, § 15.4, at 428-29. The GSTT removes many of the tax incentives of creating trusts that allocate income to intermediary generations and then disperse the property to skip persons. *Id.* See *infra* note 54 for an explanation of "skip person."

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tax regulations.<sup>21</sup> Unsurprisingly, the Commissioner of Internal Revenue issued Mrs. Gerson's estate a deficiency of \$1,144,465.<sup>22</sup>

*Estate of Gerson v. Commissioner*<sup>23</sup> is the latest case to address the reading and application of section 1433(b)(2)(A)<sup>24</sup> of the Tax Reform Act of 1986 (the "1986 Act").<sup>25</sup> The 1986 Act contains three exceptions to the GSTT: (1) section 1433(b)(2)(A) exempts generation-skipping transfers under trusts that were irrevocable on September 25, 1985; (2) section 1433(b)(2)(B) exempts generation-skipping transfers under wills executed before the enactment of the 1986 Act if the decedent died prior to January 1, 1987; and (3) section 1433(b)(2)(C) exempts generation-skipping transfers under trusts where the grantor was under mental disability continuously from the date of enactment until the date of the grantor's death.<sup>26</sup>

The Sixth Circuit and other federal courts of appeals have wrestled with the problem of how the GSTT grandfather exception should treat a general power of appointment in a trust that otherwise satisfies section 1433(b)(2)(A).<sup>27</sup> The Eighth and Ninth Circuits held that the grandfather exception's plain meaning dictates that exercising a general power of appointment over a trust that otherwise meets the requirement of section 1433(b)(2)(A) does not remove the trust from the scope of the exception.<sup>28</sup> At the other

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21. *Estate of Gerson*, 127 T.C. at 141. The Internal Revenue Service promulgated Treasury Regulation section 26.2601-1(b)(1)(i), which states "that the grandfather exception 'does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12 [of the United States Internal Revenue Code].'" *Estate of Gerson v. Comm'r*, 507 F.3d 435, 437 (6th Cir. 2007) (quoting Treas. Reg. § 26.2601-1(b)(1)(i)).

22. *Estate of Gerson*, 127 T.C. at 139.

23. *Estate of Gerson*, 507 F.3d 435.

24. This Note commonly refers to the section as the "grandfather exception," or simply, the "exception."

25. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)); Eric G. Lanning, *The Service Visits the Sins of the Grandfathers upon the Grandchildren: The Application of the Generation-Skipping Transfer Tax to Grandfathered Irrevocable Trusts That Include General Powers of Appointment*, 34 MICH. TAX LAW. 11, 11-12 (2008). See generally *Estate of Gerson*, 507 F.3d 435 (addressing grandfather exception in 2007); *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002) (addressing exception in 2002); *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999) (addressing exception in 1999); *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795 (2d Cir. 1996) (addressing exception in 1996).

26. Tax Reform Act of 1986 § 1433(b)(2).

27. See *Estate of Gerson*, 507 F.3d at 439; *Bachler*, 281 F.3d at 1079-80; *Simpson*, 183 F.3d at 813-15; *Peterson*, 78 F.3d at 798-99; Lanning, *supra* note 25, at 11.

28. *Bachler*, 281 F.3d at 1080; *Simpson*, 183 F.3d at 813.

end of the spectrum, the Second and Sixth Circuits found that the grandfather exception was ambiguous and stated that Treasury Regulation § 26.2601-1 correctly interprets section 1433(b)(2)(A).<sup>29</sup> Treasury Regulation § 26.2601-1(b)(1)(i) removes trusts that incorporate a general power of appointment, whether exercised or lapsed, from section 1433(b)(2)(A).<sup>30</sup>

This Note argues that (1) the Eighth and Ninth Circuits' holdings are contrary to the wealth-transfer tax and generation-skipping tax schemes, (2) Treasury Regulation § 26.2601-1 correctly interprets section 1433(b)(2)(A), and (3) Congress could not have intended for the grandfather exception to apply to irrevocable trusts accompanied by a general power of appointment when it promulgated section 1433(b)(2)(A) of the 1986 Tax Reform Act. The exception's September 25, 1985 effective date is nearly twenty-five years old and a new generation has been born. This new generation can now receive the trust property by the holder of a general power of appointment even when the underlying trust did not contemplate a generation-skipping transfer. Reading the grandfather exception along with the statute's other exceptions reveals that Congress did not intend to permit taxpayers to continue benefiting from a tax advantage that it had every intention of eliminating in the 1986 Act.

Part I of this Note provides background on the estate tax, gift tax, and the GSTT. Part II focuses on the history and purpose behind section 1433(b)(2)(A) and the development of Treasury Regulation § 26.2601-1. Part III examines the application of section 1433(b)(2)(A) to general powers of appointment by comparing the holdings of the Second and Sixth Circuits and those of the Eighth and Ninth Circuits. Finally, Part IV demonstrates that Treasury Regulation § 26.2601-1(b)(1)(i) comports with the GSTT scheme and addresses the shortcomings of the Eighth and Ninth Circuits' holdings.

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29. *Estate of Gerson*, 507 F.3d at 436; *Peterson*, 78 F.3d at 796. The Second Circuit followed Temporary Treasury Regulation § 26.2601-1(b)(1)(v)(A), which is now Treasury Regulation § 26.2601-1(b)(1)(v)(A). See Treas. Reg. § 26.2601-1(b)(1)(v)(A) (as amended 2004).

30. See Treas. Reg. § 26.2601-1(b)(1)(i); T.D. 8912, 2001-1 C.B. 452.

I. THE DEVELOPMENT OF THE AMERICAN WEALTH-TRANSFER TAX SYSTEM

A. From Death Tax to Wealth-Transfer Tax

The roots of the death tax are deep and its primitive form can be traced back to the Egyptians, Romans, and Greeks.<sup>31</sup> The death tax, commonly known today as an estate or inheritance tax, is an excise tax on the privilege of transmitting or receiving property at the time of death.<sup>32</sup> The estate tax is calculated based on the value of the decedent's estate.<sup>33</sup> The inheritance tax is measured by the value of property received by the recipient.<sup>34</sup>

Early in our nation's history, wealth-transfer taxes were imposed primarily as a means to generate revenue in times of war.<sup>35</sup> The earliest American transfer tax was the Stamp Act of 1797.<sup>36</sup> This act taxed wills in probate in an effort to generate revenue to build the United States Navy in response to French attacks on American ships.<sup>37</sup> The Act was short lived, lasting only five years before Congress repealed it, but its effect resonated as similar taxes were later legislated to raise revenue in times of war.<sup>38</sup>

31. Louis Eisenstein, *The Rise and Decline of the Estate Tax*, 11 TAX L. REV. 223, 223 (1956).

32. JOHN K. McNULTY & GRAYSON M.P. MCCOUCH, FEDERAL ESTATE AND GIFT TAXATION 1 (6th ed. 2003). The estate tax taxes the transmission of property at the time of death, whereas the inheritance tax taxes the receipt of property from the deceased. *Id.*

33. *Id.*

34. *Id.*

35. *Id.* at 3.

36. Stamp Act of July 6, 1797, ch. 11, 1 Stat. 527 (laying duties on stamped vellum, parchment, and paper); McNULTY & MCCOUCH, *supra* note 32, at 3. The Stamp Act of 1797 is believed to be the first death tax imposed within the United States. Mary R. Wampler, *Repealing the Federal Estate Tax: Death to the Death Tax, or Will Reform Save the Day?*, 25 SETON HALL LEGIS. J. 525, 529 (2001).

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37. McNULTY & MCCOUCH, *supra* note 32, at 3; Wampler, *supra* note 36, 529-30 (taxation of wills in probate taxed the beneficiary, not the deceased, and the Act provided for tax exemptions to the decedent's widow, children, and grandchildren); *see also* Eisenstein, *supra* note 31, at 225.

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38. J.D. Trout & Shahid A. Buttar, *Resurrecting "Death Taxes": Inheritance, Redistribution, and the Science of Happiness*, 16 J.L. & POL. 765, 777 (2000); *see also* Wampler, *supra* note 36, at 530. Congress enacted the Tax Act of 1862 in response to the Civil War and enacted the War Revenue Act of 1898 in response to the Spanish-American War. *Id.* Each was repealed at the conclusion of the war. *Id.* at 530-31.

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1. The Birth of the Estate Tax and Gift Tax

In response to World War I and the need to raise revenue once again, Congress enacted the first estate tax in 1916.<sup>39</sup> The estate tax differed from death taxes by taxing the right to transfer ownership of property at death, effectively taxing the decedent rather than the beneficiary.<sup>40</sup> Unlike death taxes, the estate tax remained in effect after the conclusion of World War I.<sup>41</sup>

The estate tax was amended in 1918 to increase revenue and to close loopholes.<sup>42</sup> As a part of the 1918 amendment, Congress extended the estate tax to property subject to an exercise of “a general power of appointment over it, equating the power of disposition with ownership of the property.”<sup>43</sup> This amendment inherently laid the groundwork for future transfer-tax modifications.<sup>44</sup>

Congress’s work in the 1918 amendments did little to protect its taxation efforts because wealthy individuals discovered that the estate tax could be avoided by inter vivos gifting.<sup>45</sup> Congress realized that that estate tax could not be effectively enforced without a gift tax, for without the protective nature of the gift tax, it would be too easy to eliminate the transfer of property at death through the use of lifetime gifts.<sup>46</sup> Recognizing that Americans were avoiding the estate tax system, Congress enacted the federal gift tax as gap-

39. McNULTY & MCCOUCH, *supra* note 32, at 3; Nina R. Bohan, *Proposed Regulations Applying Generation-Skipping Transfer Tax to Nonresident Aliens Go Too Far*, 19 SUFFOLK TRANSNAT’L L. REV. 473, 481 (1996); *see* Revenue Act of 1916, Pub. L. No. 64–271, 39 Stat. 756. The estate tax taxed the wealthy, initially allowing a \$50,000 exemption. Eisenstein, *supra* note 31, at 230. The constitutionality of the estate tax was upheld by the Supreme Court in *New York Trust Co. v. Eisner* in 1921. *N.Y. Trust Co. v. Eisner*, 256 U.S. 345 (1921); McNULTY & MCCOUCH, *supra* note 32, at 3.

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40. Wampler, *supra* note 36, at 531. Congress foresaw that taxpayers would attempt to avoid the tax. John T. Gaubatz, *A Generation-Shifting Transfer Tax*, 12 VA. TAX REV. 1, 4-5 (1992). Therefore, in enacting the first estate tax Congress ensured that the tax was assessed on all the property owned by the decedent at death, including transfers made in contemplation of death, transfers intended to be made after death, and property owned by the decedent jointly with another person. *Id.*

41. Bohan, *supra* note 39, at 482-83.

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42. Gaubatz, *supra* note 40, at 5; *see* Revenue Act of 1918, Pub. L. No. 65–254, § 401, 40 Stat. 1057, 1096 (1919).

43. Gaubatz, *supra* note 40, at 5 (citations omitted).

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44. *Id.* at 7.

45. Christopher E. Erblich, *To Bury Federal Transfer Taxes Without Further Adieu*, 24 SETON HALL L. REV. 1931, 1932 (1994).

46. *Sanford’s Estate v. Comm’r*, 308 U.S. 39, 44 (1939); *see* McNULTY & MCCOUCH, *supra* note 32, at 4.

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filling legislation in the Revenue Act of 1924.<sup>47</sup> The gift tax served as a companion to the estate tax.<sup>48</sup> Its purpose was to protect the integrity of the estate tax.<sup>49</sup> To this end, the gift tax continues to be a partner to the estate tax today.<sup>50</sup>

## 2. The Implementation of the Generation-Skipping Transfer Tax

The public policy underlying the GSTT is akin to the policy for enacting the gift tax—“to bring uniformity and consistency to Federal transfer taxes . . . by imposing a transfer tax upon all transfers” that detrimentally seek to evade the estate tax.<sup>51</sup> In 1976, Congress overhauled the federal wealth-transfer tax system.<sup>52</sup> The Tax Reform Act of 1976 (the “1976 Act”) merged the estate tax and gift tax and created a unified framework for taxing the transfer of property.<sup>53</sup> Under the 1976 Act, Congress closed a loophole that allowed for the transfer of property from one generation to a person at least two generations below the transferor—termed a *skip person*.<sup>54</sup> This type of transfer bypassed taxation upon the death of the

47. Revenue Act of 1924, Pub. L. No. 68-176, § 319, 43 Stat. 253, 313; McNULTY & MCCOUCH, *supra* note 32, at 4; Gaubatz, *supra* note 40, at 7-8.

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48. *Sanford's Estate*, 308 U.S. at 44.

49. Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759, 761 (2007). The gift tax also functions as a backstop to the income tax. *Crown v. Comm'r*, 585 F.2d 234, 235 (7th Cir. 1978).

50. McNULTY & MCCOUCH, *supra* note 32, at 4; Gans & Soled, *supra* note 49, at 762. This first iteration of the gift tax was repealed two years later but then reinstated in 1932. See Revenue Act of 1932, Pub. L. No. 72-154, § 501(a), 47 Stat. 169, 245.

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51. *Estate of Gerson v. Comm'r*, 127 T.C. 139, 142 (2006), *aff'd*, 507 F.3d 435 (6th Cir. 2007); see also H.R. REP. NO. 99-426, at 824 (1985); *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795, 796 (2d Cir. 1996).

52. JOHN R. LUCKEY, A HISTORY OF FEDERAL ESTATE, GIFT, AND GENERATION-SKIPPING TAXES 11 (2001), available at <http://www.policyarchive.org/handle/10207/bitstreams/270.pdf>; see McNULTY & MCCOUCH, *supra* note 32, at 6.

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53. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520; LUCKEY, *supra* note 52, at 12. The Tax Reform Act of 1976 unified the gift and estate tax by creating a single tax table for transfers occurring during life and death. *Erblich*, *supra* note 45, at 1932.

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54. See *Bohan*, *supra* note 39, at 486-87. A skip person in the context of trusts is “a natural person assigned to a generation which is [two] or more generations below the generation assignment of the transferor.” 26 U.S.C. § 2613(a)(1) (2006). A typical skip-person relationship is formed when grandparents transfer property to their grandchild, skipping the intermediate generation of the grandparent’s child. See McGOVERN & KURTZ, *supra* note 3, at 430-31. The loophole was typically exploited by creating a trust that paid income to the creator’s child for the child’s life and at the child’s death transferred the remainder of the trust property to the grandchild without subjecting the property to an estate tax on the transfer to the grandchild. McNULTY & MCCOUCH, *supra* note 32, at 7. “Prior to the 1976 Act, the character of the interests

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intermediary generation while allowing the intermediate generation to collect income or exhibit power over the trust during its life. This practice is known as a generation-skipping transfer.

A generation-skipping transfer [is] defined as one which split[s] the enjoyment and ownership of property between two individuals. The first level of beneficiaries, usually the donor's children, received the right to use and benefit from property during their lifetime. The second level of beneficiaries, usually the settlor's grandchildren, received the out-right ownership of the property at the termination of the interests of the first level of beneficiaries.<sup>55</sup>

The GSTT taxed trust property as if “it had passed through the estate of the skipped generation.”<sup>56</sup> The GSTT imposed a tax on “taxable terminations” and “taxable distributions.”<sup>57</sup> Dr. Dennis R. Lassila, a leading tax professor,<sup>58</sup> defines “taxable termination” and “taxable distribution” as follows:

[A] taxable termination is the complete termination of the interests or powers of the last person belonging to a generation younger than that of the grantor when there are trust beneficiaries belonging to even a younger generation at the time. A taxable distribution is a distribution by the trust of other than trust income to a beneficiary more than one generation younger than the grantor when at least one person in an older generation,

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held by the different beneficiaries had resulted in estate or gift taxation of the property to the donor and the ultimate, second level of beneficiaries, but not the intervening, first level of beneficiaries.” LUCKEY, *supra* note 52, at 14. The GSTT was “enacted to ensure taxation of generation skipping transfers in a comparable manner to outright transfers from one generation to the next, and to remove the estate planning tool of escaping taxation by skipping a generation in an estate transfer.” *Comerica Bank, N.A. v. United States*, 93 F.3d 225, 228 (6th Cir. 1996). The estate and gift taxes applied only to transfers of ownership in property or situations where there was unrestricted control over property. The wealthy created trusts that would provide for the benefits to flow to subsequent generations without taxing the passing of property from generation to generation. See also HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 1.02.

55. LUCKEY, *supra* note 52, at 14.

56. McNULTY & MCCOUCH, *supra* note 32, at 7.

57. Dennis R. Lassila, *Income Shifting and Generation Skipping Under the House Tax Bill: Simplification and a Cop-Out*, 30 TAX NOTES 1147, 1152 (1986). The 1976 Act and subsequent 1986 Act “were designed to subject the transfer of the beneficial enjoyment of property from one generation of beneficiaries to another to a tax in lieu of the estate or gift taxes that were inapplicable.” HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 1.01, at 1-2.

58. Dr. Dennis R. Lassila is a Deborah D. Shelton Professor in Taxation at Texas A&M's Mays Business School. Mays's Business School, Faculty/Staff Directory, <http://mays.tamu.edu/directory/employees/8/> (last visited May 13, 2010). Dr. Lassila's tax research has been published in over sixty articles and fifteen books on taxation. *Id.*

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but not in the grantor’s generation or above, has an interest or power in the trust.<sup>59</sup>

The GSTT applied a tax rate at the estate or gift tax rate that would have been imposed on the skip person’s estate.<sup>60</sup> However, the GSTT under the 1976 Act did not apply when property was directly transferred to beneficiaries two or more generations younger than the grantor.<sup>61</sup>

Congress recognized that the GSTT under the 1976 Act was unworkable<sup>62</sup> and replaced it with chapter 13 of the Tax Code in the Tax Reform Act of 1986.<sup>63</sup> The 1986 Act made extensive changes to the GSTT. Most notably, the 1986 Act repealed the existing GSTT retroactively to June 11, 1976, and replaced it with the 1986 iteration, which taxed all generation-skipping transfers, including direct skips—“transfers which directly skipped a generation without the intervening generation enjoying any beneficial interest in the transferred property.”<sup>64</sup> The GSTT now imposes a tax on every successive generation of trust beneficiaries except where the succeeding generation predeceases the beneficiary.<sup>65</sup>

59. Lassila, *supra* note 57, at 1152; Bohan, *supra* note 39, at 488 (“For example, if the grantor set up a trust for his only son and grandchild, a ‘taxable termination’ occurred when the son’s interest terminated and the property passed to the grandchild. A ‘taxable distribution’ resulted when the grandchild received a distribution of corpus from the trust . . .”).

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60. HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 1.02[2], at 1-9 (“The 1976 GSTT was designed to levy a tax that was equivalent to the tax that would have been imposed had the trust property been owned by and transferred outright by each successive generation.”); Bohan, *supra* note 39, at 488-89.

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61. Lassila, *supra* note 57, at 1152.

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62. Generation-Skipping Transfer Tax, 57 Fed. Reg. 61,356 (Dec. 24, 1992) (reporting the background of the GSTT). “The Tax Reform Act of 1986 retroactively repealed the generation-skipping transfer tax that had been enacted in 1976, replacing it with chapter 13 of the Code, a simplified tax determined at a flat rate.” *Id.* at 61,356-57; McNULTY & MCCOUCH, *supra* note 32, at 7 (noting that the GSTT in the 1976 Act imposed administrative complexity and did not tax direct transfers which skipped generations); Bohan, *supra* note 39, at 489.

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63. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1431, 100 Stat. 2085, 2717 (codified as amended at 26 U.S.C. §§ 2601-2663 (2006)); Bohan, *supra* note 39, at 489.

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64. LUCKEY, *supra* note 52, at 19; *see* 26 U.S.C. § 2601. The 1986 Act now taxed three types of generation-skipping transfers: “(1) direct skips, (2) taxable distributions, and (3) taxable terminations.” HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 1.01, at 1-3; *see* 26 U.S.C. § 2603.

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65. 26 U.S.C. § 2651(e)(1). The GSTT is not applied in cases where the grandparent transfers property to a grandchild whose parent predeceased the grandparent. Ronald Skipper, *Real Property, Probate and Trust Law: Should You Be Recommending Generation-Skipping Trusts to Your Clients?*, 70 FLA. B. J. 61, 62 (1996).

Particular difficulty arises in cases where a general power of appointment accompanies a trust that otherwise satisfies section 1433(b)(2)(A). In Eighth and Ninth Circuit cases, trusts that did not contemplate a generation-skipping transfer were allowed to avoid the GSTT well after Congress had enacted it, while the Second and Sixth Circuits have held the opposite.<sup>66</sup> As a result of these conflicting holdings, the Commissioner proposed treasury regulations that had the intent of carrying out the objective of the GSTT.<sup>67</sup>

## II. THE COMMISSIONER OF INTERNAL REVENUE WEIGHS IN

The 1986 Act contains a reliance exception that exempts taxation of certain transfers under trust that cannot be amended on the effective date of the GSTT. That exception, section 1433(b)(2)(A), exempts “any generation-skipping transfer under a trust which was irrevocable<sup>68</sup> on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985.”<sup>69</sup> Through litigation, opposite interpretations of section 1433(b)(2)(A) have emerged when a general power of appointment accompanies a trust that otherwise satisfies the exception.<sup>70</sup> In 1995, the Commissioner promulgated Temporary Treasury Regulation § 26.2601–1 in an effort to create a consistent interpretation of section 1433(b)(2)(A).<sup>71</sup> The divide between the circuits lies in the Commissioner’s promulgation of Treasury Regu-

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66. See *Estate of Gerson v. Comm’r*, 507 F.3d 435, 437 (6th Cir. 2007); *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002); *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999); *E. Norman Peterson Marital Trust v. Comm’r*, 78 F.3d 795, 796-97 (2d Cir. 1996).

67. Temp. Treas. Reg. § 26.2601-1 (1995).

68. A trust is irrevocable for the purpose of the GSTT if it was in existence on September 25, 1985, unless “[t]he grantor retain[ed] a power that would cause the trust to be included in the grantor’s gross estate for federal estate tax purposes by” retaining a right to “alter, amend, revoke or terminate” the trust if the grantor died on September 25, 1985. HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 7.03[2], at 7-6.

69. Tax Reform Act of 1986, Pub. L. No. 99–514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)); see *Estate of Gerson*, 507 F.3d 435; *Bachler*, 281 F.3d 1078; *Simpson*, 183 F.3d 812; *E. Norman Peterson Marital Trust*, 78 F.3d 795.

70. Compare *Estate of Gerson*, 507 F.3d 435, and *Peterson*, 78 F.3d 795 (focusing on the date of the exercise or lapse of the general power of appointment, which enables the generation-skipping transfer), with *Bachler*, 281 F.3d 1078, and *Simpson*, 183 F.3d 812 (focusing solely on the date of irrevocability of the underlying grantor’s trust). The courts differ in the exception’s meaning of *under* a trust when the trust confers a general power of appointment on an individual. See discussion *infra* Part III.C.

71. Temp. Treas. Reg. § 26.2601–1 (1995).

lation § 26.2601–1(b)(1)(i), which states that section 1433(b)(2)(A) “does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12.”<sup>72</sup> The Treasury Regulation effectively removes from the scope of the exception a trust that otherwise facially satisfies section 1433(b)(2)(A) when accompanied by a general power of appointment.<sup>73</sup>

A. *The Purpose of Section 1433(b)(2)(A)*

The purpose behind the grandfather exception is as unsettled as its application to a trust with a general power of appointment. The Second Circuit stated that the purpose of the exception was to create a limited rule “to protect . . . taxpayers who, on the basis of pre-existing rules, made arrangements from which they could not reasonably escape,” not to “allow taxpayers who, in good faith and without intent to evade taxes, seek to continue benefitting from a tax advantage that Congress has eliminated.”<sup>74</sup> The court supported its statement by referring to the two other provisions of the exception.<sup>75</sup> Section 1433(b)(2) also provides that

the GST[T] would not apply to transfers made by wills that had been executed before the date of enactment . . . if the decedent died before January 1, 1987. This exception ensured that an individual who did not have a reasonable time between the enactment of the law and his death to alter his will would not be penalized by the new provision. Second, the effective date rule allowed an exception for any individual who was “under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death.”<sup>76</sup>

The Ninth Circuit asserted the exception “was never intended to provide an exemption from the GSTT . . . where the holder of the general power of appointment was not locked into a situation where the GSTT was inescapable.”<sup>77</sup> The Eighth Circuit held that “the provision was obviously intended to protect taxpayers who had, before September 25, 1985, taken certain irrevocable action in reliance upon the state of the tax law existing at the time of the

72. Treas. Reg. § 26.2601–1(b)(1)(i) (as amended 2004).

73. *See id.*

74. *Peterson*, 78 F.3d at 801.

75. *Id.* at 802.

76. *Id.* at 801 n.6 (citations omitted).

77. *Bachler v. United States*, 281 F.3d 1078, 1079 (9th Cir. 2002).

action.”<sup>78</sup> Congressional records do not express a distinct purpose for section 1433(b)(2)(A).<sup>79</sup> Thus, because of the lack of congressional intent, it will be necessary to ascertain the exception’s purpose by reviewing it in the context of the entire statutory exception’s scheme.<sup>80</sup>

#### B. *Treasury Regulation § 26.2601–1*

Treasury Regulation § 26.2601–1 provides an interpretive reading of section 1433(b)(2)(A).<sup>81</sup> Until the Eighth Circuit’s *Simpson* ruling in 1999, the regulation removed otherwise satisfactory trusts from the exception only where a portion of the trust property remained in the trust following the exercise, release, or lapse of a general power of appointment.<sup>82</sup> The regulation treated the disposal of the power as a constructive addition.<sup>83</sup> However, it did not apply to the exercise of a power that removed all property from the trust.<sup>84</sup> The temporary regulation required a portion of the property to remain in the trust after the exercise, release, or lapse in order to constructively add property after the effective date, thus removing the transfer from section 1433(b)(2)(A).<sup>85</sup>

Following the Eighth Circuit’s decision in *Simpson*,<sup>86</sup> the Internal Revenue Service (IRS) issued an Action on Decision recom-

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78. *Simpson v. United States*, 183 F.3d 812, 814 (8th Cir. 1999). The court later proceeded to say that the fact that “the transferor[ ] could have avoided the GST tax by giving the property to someone other than her grandchildren[ ] is not relevant.” *Id.*

79. “The parties debate the breadth of reliance the legislature intended to protect, but the legislature gave no guidance other than its ambiguous words.” *Estate of Gerson v. Comm’r*, 507 F.3d 436, 441 (6th Cir. 2007); *see also* H.R. REP. NO. 99–426, at 820–30 (1985) (no mention as to the purpose of section 1433(b)(2)).

80. *See infra* Part IV.A.1.

81. *See* *Treas. Reg. § 26.2601–1* (as amended 2004).

82. *Simpson*, 183 F.3d at 815–16.

[W]here any portion of a trust remains in the trust after the release, exercise, or lapse of a [general] power of appointment over that portion of the trust . . . the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed will be treated as an addition to the trust.

*Id.* at 815 (omission and second alteration in original) (citing *Temp. Treas. Reg. § 26.2601–1(b)(1)(v)(A)*).

83. *See id.*

84. *See id.*

85. *See* *Tax Reform Act of 1986*, Pub. L. No. 99–514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)); *Temp. Treas. Reg. § 26.2601–1(b)(1)(v)(A)* (1995).

86. *Simpson*, 183 F.3d at 816 (holding that section 1433(b)(2)(A) applies to exercises of powers over irrevocable trusts that otherwise satisfy the statutory provision).

mending nonacquiescence in the *Simpson* holding.<sup>87</sup> After the Action on Decision, the Department of the Treasury amended and finalized the treasury regulation interpreting section 1433(b)(2)(A).<sup>88</sup> The amended and final regulation states that any exercise, release, or lapse of a general power of appointment is not considered a transfer under a trust that was irrevocable on September 25, 1985.<sup>89</sup> Such transfer pursuant to the exercise, release, or lapse of a general power of appointment is treated as a transfer made by the power holder and is not exempt from the GSTT.<sup>90</sup> The promulgation of the amended regulation was just the first step in its adoption; questions about the amended regulation's validity remained.<sup>91</sup>

The Eighth and Ninth Circuits have rendered decisions inconsistent with section 1433(b)(2)(A) and the Treasury Regulation. The following section details the current split between the relevant circuits and how each has handled the application of the exception and regulation.

### III. THE FEDERAL CIRCUITS CONSIDER A GENERAL POWER OF APPOINTMENT'S APPLICATION UNDER SECTION 1433(B)(2)(A)

#### A. *The Second Circuit Adopts Treasury Regulation § 26.2601-1*

The Second Circuit addressed the application of section 1433(b)(2)(A) to a trust accompanied by a general power of appointment in *E. Norman Peterson Marital Trust v. Commissioner*.<sup>92</sup> In *Peterson*, the trustees petitioned the Tax Court after the IRS issued a tax deficiency of \$810,925 against the estate.<sup>93</sup> Mr. Peter-

87. *Simpson*, 183 F.3d 812, *action on dec.*, 2000-003 (Feb. 28, 2000). The IRS stated that it did not agree with the *Simpson* holding that the grandfather exception applies to irrevocable trusts that provide a general power of appointment but would follow the Eighth Circuit's decision in future analogous cases in that Circuit unless regulations addressing the issue were promulgated. *Id.* The IRS made it clear that it would continue to litigate its position in other circuits. *Id.*

88. See T.D. 8912, 2001-1 C.B. 452 ("These regulations are necessary to provide guidance to taxpayers so that they may properly determine if chapter 13 of the Code is applicable to a particular trust.").

89. Treas. Reg. § 26.2601-1(b)(1)(i) (as amended in 2004); T.D. 8912, 2001-1 C.B. 452.

90. T.D. 8912, 2001-1 C.B. 452.

91. See *Estate of Gerson v. Comm'r*, 127 T.C. 139, 151-57 (2006), *aff'd*, 507 F.3d 435 (6th Cir. 2007); *E. Norman Peterson Marital Trust v. Comm'r*, 102 T.C. 790, 796-800 (1994), *aff'd*, 78 F.3d 795 (2d Cir. 1996); Lanning, *supra* note 25, at 12-13.

92. *Peterson*, 78 F.3d 795.

93. *Id.* at 797.

son's will created a marital trust that provided his wife, Eleanor, income and a general power of appointment over the trust property.<sup>94</sup> In the event Mrs. Peterson did not exercise her power, the property was to be equally divided among Mr. Peterson's grandchildren.<sup>95</sup> Mrs. Peterson died in 1987, never having exercised her power of appointment.<sup>96</sup> The trustees of her estate asserted that the GSTT did not apply because the marital trust satisfied section 1433(b)(2)(A).<sup>97</sup> The IRS disagreed, maintaining that the GSTT applied because Mrs. Peterson's lapse of power created a constructive addition to the trust on September 5, 1987, two years after the effective date.<sup>98</sup> The IRS pointed to Temporary Treasury Regulation § 26.2601-1(b)(1)(v)(A) in support of its argument.<sup>99</sup>

The trustees first argued that the temporary regulation was contrary to the plain meaning of section 1433(b)(2)(A).<sup>100</sup> They contended that the lapse of power did not "add" property to the trust. According to *Webster's Dictionary*, they argued, "add" required an increase in the trust's size.<sup>101</sup> The court disagreed.<sup>102</sup> Legislative history illustrated that the trustees' definition of "added" was not consistent with the scheme of transfer tax laws.<sup>103</sup> Ac-

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94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 798. The trust became irrevocable eleven years prior to the effective date. *Id.*

98. *Id.*

99. *Id.* Temporary Treasury Regulation section 26.2601-1(b)(1)(v)(D), Example 1, generally states that the lapse of a general power of appointment over trust property that otherwise satisfies the exception in section 1433(b)(2)(A) is subject to the GSTT. See Treas. Reg. § 26.2601-1(b)(1)(v)(D) example 1 (as amended 2004).

100. *Peterson*, 78 F.3d at 799 (emphasis omitted).

101. *Id.* *Webster's* defines "add" as "to join, annex, or unite . . . so as to bring about an increase (as in number, size, or importance) . . ." WEBSTER'S DICTIONARY 24 (3d ed. 1976).

102. *Peterson*, 78 F.3d at 799-800.

103. *Id.* at 800-01.

When the Treasury regulations were promulgated, the Department examined—and rejected—precisely the interpretation . . . here put forward by the taxpayer. In fact, the appropriate interpretation of the word "added" in the statute was discussed. . . during the promulgation of regulations designed for the 1976 precursor to today's GST[T]. The Department noted that "[a] number of commentators stated that 'additions' to the corpus of a trust should only occur where property is conveyed to the trust from an outside source." After considering this view, along with the opinions of other commentators, and examining the legislative history, the Department concluded that this narrow dictionary definition of "added" would not be consistent with the entire scheme of the gift and estate tax laws.

*Id.* at 800 (citations omitted).

ording to the long-standing view that a general power of appointment is tantamount to ownership of property, any exercise, release, or lapse of such power constitutes a constructive addition to the trust and is therefore treated as a taxable transfer for estate and gift tax purposes.<sup>104</sup>

The trustees then argued that the grandfather exception's purpose was "to avoid punishing individuals who established trusts in reliance on the old legal rules."<sup>105</sup> The court disagreed, finding that the purpose of the exception was to protect taxpayers who made arrangements based on then-existing rules and could not reasonably escape from such arrangements.<sup>106</sup> Mr. Peterson's trust provided a general power of appointment that Mrs. Peterson had the option to exercise so as to modify the trust and avoid the GSTT.<sup>107</sup>

The Second Circuit held Temporary Treasury Regulation § 26.2601-1(b)(1)(v)(A) as a valid interpretation of section 1433(b)(2)(A).<sup>108</sup> Accordingly, the transfer was not exempt due to the power of appointment; the lapse created a constructive addition to the trust.<sup>109</sup> The court adopted a narrow view of the exception. It would only apply to irrevocable trusts that could not be reasonably amended to comply with the GSTT.<sup>110</sup> As a result, the estate

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104. *Id.* ("For tax purposes, a general power of appointment has for many, many years been viewed as essentially identical to outright ownership of the property."). Essentially, the courts view the constructive addition in the following manner: the grant of power removes the property from the trust into the possession of the power holder. When the holder of the general power of appointment refuses to exercise that power and allows it to lapse, this property is transferred back into the trust and dispersed through it: thus, creating a constructive addition to the original trust. *Estate of Gerson v. Comm'r*, 507 F.3d 435, 440-41 (6th Cir. 2007).

105. *Peterson*, 78 F.3d at 801.

106. *Id.* at 801. Mr. Peterson died before the promulgation of the GSTT, intending the trust property to benefit his grandchildren. *Id.* at 797.

107. *Id.* at 801-02. The court's holding was bolstered by the fact that section 1433(b)(2)(B) exempted the application of the GSTT to testamentary transfers executed prior to the enactment of the GSTT if the testator died before January 1, 1987, "ensur[ing] that an individual who did not have a reasonable time between the enactment of the law and his death to alter his will would not be penalized by the new provision." *Id.* at 801 n.6. Section 1433(b)(2)(C) similarly supported the court's holding by stating that the GSTT would not apply "for any individual who was 'under a mental disability to change the disposition of his property and did not regain his competence to dispose of such property before the date of his death.'" *Id.* at 802 n.6 (citation omitted).

108. *Id.* at 802.

109. *Id.*

110. *Id.* at 801-02.

was taxed in excess of \$800,000 for executing a generation-skipping transfer.<sup>111</sup>

B. *The Pendulum Swings in Favor of Section 1433(b)(2)(A)'s Facial Meaning*

The Eighth Circuit in *Simpson v. United States* addressed the issue in 1999.<sup>112</sup> There, Mrs. Simpson<sup>113</sup> received a general power of appointment over a trust created by Mr. Simpson.<sup>114</sup> Unlike the Second Circuit in *Peterson*, Mrs. Simpson exercised her power in favor of her grandchildren, rather than allowing it to lapse.<sup>115</sup> Siding with the taxpayer, the court concluded that the plain language of section 1433(b)(2)(A) exempted transfers effected by the exercise of a general power of appointment if the underlying trust satisfied the irrevocability and effective date requirements stated in the statutory provision.<sup>116</sup>

The taxpayer argued that the relevant action to which the exception's effective date provision applied was the creation date of the trust.<sup>117</sup> Mr. Simpson's trust became irrevocable upon his death in 1966, almost twenty years before the GSTT's effective date provision.<sup>118</sup> The IRS asserted that the relevant action, the exercise of the general power of appointment, was not completed until eight years after the effective date.<sup>119</sup> The Eighth Circuit found the IRS's argument misplaced because the plain meaning of the exception could not support such an assertion.<sup>120</sup> Recalling the language of section 1433(b)(2)(A) ("any generation-skipping transfer under a trust which was irrevocable on September 25, 1985"), the court found that "trust," not "transfer," was the antecedent of "which."<sup>121</sup> Therefore, the court held the relevant action in question was the date of irrevocability, not the subsequent exercise of the general power of appointment creating the generation-skipping transfer.<sup>122</sup>

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111. *Id.* at 797.

112. *Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999).

113. Mrs. Simpson became Mrs. Bryan by virtue of a subsequent marriage after Mr. Simpson's death. *Id.* at 813. However, to avoid confusion, she will be referred to as Mrs. Simpson throughout the Note.

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.* at 814.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

The court acknowledged Mrs. Simpson could have avoided the GSTT by exercising her power differently, but it stated that this was irrelevant under the statutory provision.<sup>123</sup>

The *Simpson* court bolstered its holding by factually distinguishing *Peterson*.<sup>124</sup> Mrs. Simpson exercised her power as opposed to allowing it to lapse.<sup>125</sup> This was a critical fact in the court's application of Temporary Treasury Regulation § 26.2601-1(b)(1)(v)(A).<sup>126</sup> The *Peterson* transfer did not fall within the exception because the lapse of the general power of appointment created a constructive addition to the trust.<sup>127</sup> The property that was transferred to the grandchildren was that portion that remained in the trust after the lapse of the power,<sup>128</sup> thus creating a constructive addition to the trust.<sup>129</sup> In *Simpson*, the general power of appointment was exercised.<sup>130</sup> No portion of the trust property remained in the trust after its exercise; therefore, no argument could be made that property was added to the trust after the effective date, constructively or otherwise.<sup>131</sup> The court had no quarrel with the holding in *Peterson* but distinguished it from the facts in *Simpson*.<sup>132</sup>

Following *Simpson*, the Ninth Circuit summarily decided *Bachler v. United States*.<sup>133</sup> In a factual situation similar to *Simpson*, Mrs. Wunderlich<sup>134</sup> exercised her general power of appointment for the benefit of her grandchildren.<sup>135</sup> The court held for the taxpayer and analogized the case to *Simpson*.<sup>136</sup>

In reaching its holding, the *Bachler* court rejected the government's contention that the *Peterson* analysis controlled.<sup>137</sup> The court distinguished *Peterson* on the fact that Mrs. Wunderlich exer-

123. *Id.* at 814-15.

124. *Id.* at 815.

125. *Id.*

126. *Id.*; see *supra* note 82.

127. *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795, 800 (2d Cir. 1996) (holding lapses or releases of a general power of appointment are constructive additions to a trust); see also *Treas. Reg. § 26.2601-1(b)(1)(v)(A)* (as amended 2004).

128. *Simpson*, 183 F.3d at 815 (discussing *Peterson*).

129. *Peterson*, 78 F.3d at 800; see also *supra* Part II.B.

130. *Simpson*, 183 F.3d at 813.

131. *Id.* at 815-16.

132. *Id.* at 816.

133. *Bachler v. United States*, 281 F.3d 1078 (9th Cir. 2002).

134. Martin Wunderlich predeceased his wife, Murielle, leaving her as beneficiary of trust income with a general power of appointment. Robert Bachler, for whom the plaintiff is named, was the executor of Mr. Wunderlich's estate. *Id.* at 1078-79.

135. *Id.*

136. *Id.* at 1078, 1080.

137. *Id.* at 1080.

cised her power rather than allowing it to lapse.<sup>138</sup> The court adopted the Eighth Circuit's *Simpson* analysis, which entitled the taxpayer to an exemption where the general power of appointment was exercised under an otherwise grandfathered, irrevocable trust.<sup>139</sup> No circuit addressed this issue again until five years later in *Estate of Gerson v. Commissioner*.

C. *The Sixth Circuit Adopts Treasury Regulation § 26.2601-1(b)(1)(i) and Discusses "Added" Versus "Under" Cases*

The Sixth Circuit decided *Estate of Gerson v. Commissioner* in 2007.<sup>140</sup> The taxpayer challenged the applicability of Treasury Regulation § 26.2601-1(b)(1)(i), asserting it was contradictory to the plain language of section 1433(b)(2)(A).<sup>141</sup> The court disagreed and applied *Chevron*<sup>142</sup> deference to review the validity of the treasury regulation.<sup>143</sup> Under *Chevron*, the court found section 1433(b)(2)(A)'s terms ambiguous and the IRS's amended and finalized treasury regulation a reasonable interpretation of the statutory exception.<sup>144</sup>

*Gerson* reviewed the Tax Court's holding de novo.<sup>145</sup> The court confirmed the treasury regulation was issued "after notice and comment pursuant to the Treasury Department's general authority to issue regulations under I.R.C. § 7805(a)."<sup>146</sup> The court

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138. *See id.* The court stated that "[h]ere nothing was added to the corpus." *Id.* This referenced Temporary Treasury Regulation section 26.2601-1(b)(1)(v)(A), which created a constructive addition where a general power of appointment is allowed to lapse and disallows grandfathering under section 1433(b)(2)(A). *Id.*; *see* Temp. Treas. Reg. § 26.2601-1(b)(a)(1)(A) (1995).

139. *Bachler*, 281 F.3d at 1080.

140. *Estate of Gerson v. Comm'r*, 507 F.3d 435 (6th Cir. 2007).

141. *Id.* at 437.

142. *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

*Chevron* created a two-part test to be used in reviewing an agency's construction of a statute it administers. The test asks,

[w]hether Congress has directly spoken to the precise question at issue. If . . . the court determines [it] has not . . . , the court does not simply impose its own construction . . . , [r]ather, if the statute is silent or ambiguous with respect to the issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

*Id.* at 842-43.

143. *Estate of Gerson*, 507 F.3d at 438.

144. *Id.* at 436.

145. *Id.* at 438.

146. *Id.* at 437-38. Section 7805(a) reads,

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary shall

further held that a regulation promulgated pursuant to notice and comment has the force of law, and it must be sustained unless clearly unreasonable or if Congress has addressed the precise question at issue.<sup>147</sup> It then addressed the first step in the *Chevron* analysis and found that section 1433(b)(2)(A) was ambiguous due to the differing meanings applied to the word “under” in the statutory provision.<sup>148</sup> The taxpayer argued that the transfer occurred under the trust, which granted the general power of appointment.<sup>149</sup> The Commissioner argued that the transfer occurred under Mrs. Gerson’s will, not under the trust.<sup>150</sup>

The Sixth Circuit began its analysis of the first factor by reviewing the two lines of reasoning other courts had used—“added” and “under.”<sup>151</sup> The “added” line of cases addressed the lapse of the holder’s general power of appointment.<sup>152</sup> Three transfers result from a lapsed power and create an addition of trust property after the effective date.<sup>153</sup> The creation of the power amounts to the first transfer; the power holder is treated as the owner of the trust property for tax purposes.<sup>154</sup> The lapse triggers the second transfer as the assets flow back through the trust, leading to the third transfer as the property reaches the intended skip persons under the trust’s terms.<sup>155</sup> *Peterson* is an illustration of an “added”

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prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

26 U.S.C. § 7805(a) (2006).

147. *Estate of Gerson*, 507 F.3d at 438.

148. *Id.* at 441. The taxpayer reads “under” in the statutory provision as implying that the trust is the root of the general power of appointment and exercises of power fall under the trust. The Commissioner reads the provision as transfers by exercise of the power not occurring under the trust creating the power of appointment but rather under the instrument exercising the power of appointment. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.* at 440-41.

154. *Id.*

First, a decedent’s taxable estate includes assets over which the decedent had a power of appointment on the date of death. . . . Though . . . the holder of the . . . power may not have the right to use the property, the [code] treats the power . . . as if it were full ownership [over the property].

*Id.* at 439; see also 26 U.S.C. § 2041(a)(2) (2006); *Estate of Kurz v. Comm’r*, 101 T.C. 44, 47-48 (1993) (discussing general power of appointment as part of the estate); *E. Norman Peterson Marital Trust v. Comm’r*, 78 F.3d 795, 800 (2d Cir. 1996) (stating general power of appointment is “essentially identical to outright ownership of the property”).

155. *Estate of Gerson*, 507 F.3d at 441.

case, which results in a “constructive addition” to the trust and thus does not satisfy section 1433(b)(2)(A).<sup>156</sup> In contrast, *Gerson*, *Simpson*, and *Bachler* involved the exercise of a general power of appointment and are therefore classified “under” cases.<sup>157</sup>

In “under” cases, an exercise of a power of appointment occurs “under” a trust that was irrevocable on the effective date. “Under” cases effect two transfers.<sup>158</sup> “In the first transfer, the power holder becomes the owner of the trust assets for tax purposes. In the second transfer, the power holder transfers the assets to a skip person. If the second transfer occurs after the GSTT became effective, [the exception does not apply].”<sup>159</sup> Following this logic, the Commissioner argued that the property was, in fact, transferred under Mrs. Gerson’s will, not under the irrevocable trust, which therefore could not have been a transfer under a *trust* that was irrevocable before September 25, 1985.<sup>160</sup> The court found the Commissioner’s argument in *Gerson* and the courts’ holdings in *Bachler* and *Simpson* plausible but contrary interpretations of section 1433(b)(2)(A).<sup>161</sup> This ambiguity satisfied the first step in its *Chevron* analysis.<sup>162</sup>

Subsequently, the court found the second step of the *Chevron* analysis satisfied, stating that the treasury regulation was a reasonable interpretation of section 1433(b)(2)(A).<sup>163</sup> In support, the court indicated that the treasury regulation “conforms the grandfather clause to other elements of the tax scheme,” and that the “other exceptions to the GST[T] . . . surrounding the irrevocable trust provision all represent inescapable contingencies that justify grandfathering.”<sup>164</sup>

By failing to consider both the scheme of the GSTT exceptions and the general scheme of tax law, the Eighth and Ninth Circuits did not appropriately analyze the application of a general power of appointment to an irrevocable trust that otherwise satisfies section

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156. See *Peterson*, 78 F.3d 795.

157. *Estate of Gerson*, 507 F.3d at 441; *Bachler v. United States*, 281 F.3d 1078, 1079 (9th Cir. 2002); *Simpson v. United States*, 183 F.3d 812, 813 (8th Cir. 1999).

158. See *Estate of Gerson*, 507 F.3d at 440.

159. *Id.* (citations omitted).

160. *Id.* at 441. It was the trust that provided the general power of appointment, but the exercise of that power actually transferred the property under Mrs. Gerson’s will. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.*

1433(b)(2)(A). The exception should not apply to trusts accompanied by a general power of appointment, whether exercised or permitted to lapse, because such trusts do not comport with tax law and the statutory scheme of the GSTT.

IV. TRUSTS ACCOMPANIED BY A GENERAL POWER OF APPOINTMENT SHOULD NOT RECEIVE SECTION 1433(B)(2)(A) EXEMPTION

The key issue in this Note is whether section 1433(b)(2)(A) should apply to otherwise conforming trusts, when such trusts provide a general power of appointment over the disposition of trust property. The following analysis argues that it should not; rather, the Sixth Circuit's decision in *Gerson* should control in the disposition of the issue.<sup>165</sup> This result is correct because it (1) complies with Treasury Regulation § 26.2601-1(b)(1)(i), (2) is consistent with Congress's intent to tax generation-skipping transfers of property, and (3) is congruent with the narrow exceptions contemplated in section 1433(b)(2)(B) and (C).

Furthermore, the Eighth and Ninth Circuits' application of section 1433(b)(2)(A) allows the exercise of a general power of appointment to disperse trust property to skip persons decades after Congress promulgated the GSTT. In support of the estate tax, the gift and generation-skipping transfer taxes play an important role by eliminating loopholes that arise through the use of imaginative estate planning tools.<sup>166</sup> The Eighth and Ninth Circuits' holdings have construed section 1433(b)(2)(A) in a manner that is inconsistent with the general scheme and purpose of the GSTT and estate taxation. The following sections will uncover the inconsistencies and fallacies relied upon by the Eighth and Ninth Circuits.

This analysis begins by examining the Eighth Circuit's holding in light of the scheme of the statutory exceptions found in section 1433(b)(2). The Eighth Circuit's holding is inconsistent with the general scheme of the GSTT exceptions. A transfer effected by a general power of appointment cannot be deemed a transfer *under a trust* as contemplated by section 1433(b)(2)(A). Notwithstanding the Eighth and Ninth Circuits' holdings, Treasury Regulation § 26.2601-1 and the Sixth Circuit's application of it should prevent

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165. *Estate of Gerson* held that Treasury Regulation section 26.2601-1 removes trusts accompanied by a general power of appointment from section 1433(b)(2)(A). *Id.* at 442.

166. *See supra* Part I.A.1-2.

the application of the grandfather exception to irrevocable trusts that provide a beneficiary a general power of appointment over the disposition of trust property.

A. *The Eighth and Ninth Circuits Take a Stance Contrary to Treasury Regulation*

*Simpson v. United States* held that the purpose of the grandfather exception was to protect taxpayers who had, before the effective date, taken irrevocable action in reliance upon the law at that time.<sup>167</sup> If Mr. Simpson had created an irrevocable trust for the benefit of skip persons before the effective date without providing a beneficiary a general power of appointment, such transfer would be exempt from the GSTT under section 1433(b)(2)(A).<sup>168</sup> However, Mr. Simpson provided his wife a general power of appointment over his trust.<sup>169</sup> Mrs. Simpson exercised this power in 1993, and the transfer then became subject to the GSTT.<sup>170</sup> In other words, it was not until eight years after the effective date in section 1433(b)(2)(A) that this transfer became reliant on the tax law as it existed prior to the enactment of the GSTT. Was this the type of reliance or generation-skipping transfer Congress had in mind when it enacted section 1433(b)(2)(A)? This Note contends it is not under the scheme of the statutory exception.

1. Analyzing the Statutory Scheme to Ascertain the Correct Application of Section 1433(b)(2)(A)

In light of the general purpose and scope of the exceptions enumerated in the GSTT, the Eighth Circuit's application of the rule of last antecedent<sup>171</sup> to section 1433(b)(2)(A) was incorrect. The rule of last antecedent treats a limiting clause or phrase as "modifying only the noun or phrase that it immediately follows."<sup>172</sup>

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167. *Simpson v. United States*, 183 F.3d 812, 814 (8th Cir. 1999).

168. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)).

169. *Simpson*, 183 F.3d at 813.

170. *Id.*

171. *Black's Law Dictionary* defines the rule of last antecedent as "[a]n interpretive principal by which a court determines that qualifying words or phrases modify the words or phrases immediately preceding them and not words or phrases more remote, unless the extension is necessary from the context or the spirit of the entire writing." BLACK'S LAW DICTIONARY 1449-50 (9th ed. 2009).

172. *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003).

Though this rule may be helpful in statutory interpretation, it should not apply if doing so would be impractical.<sup>173</sup>

Construing the words of the exception “any generation-skipping transfer under a trust which was irrevocable on September 25, 1985,”<sup>174</sup> the Eighth Circuit applied the rule of last antecedent to rebuff the government’s reading that the word “which” refers to “transfer.”<sup>175</sup> It stated the government’s contention was a meaning that the statutory provision could not bear.<sup>176</sup> The court maintained that the antecedent of “which” was “trust,” not “transfer”; therefore the relevant irrevocable action was the creation of the trust and not the occurrence of the generation-skipping transfer.<sup>177</sup>

The court’s application of the rule of last antecedent, though reasonable, is neither practical nor consistent with the general scheme of the wealth-transfer tax system. As the following sections will demonstrate, the government’s reading is more reasonable and captures the purpose of the GSTT.

*a. A look at the context surrounding the section 1433(b)(2)(A) exception*

“[A]ny generation-skipping transfer under a [trust or will]”<sup>178</sup> should have the same meaning under all three section 1433(b)(2) exceptions.

A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.<sup>179</sup>

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173. See *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 330-31 (1993); see also LAWRENCE M. SOLAN, *THE LANGUAGE OF JUDGES* 31 (1993). “[T]he last antecedent rule requires that a limiting clause be confined to the last antecedent ‘unless the context or evident meaning requires a different construction.’ In this sense, the rule is best viewed as a strategy for interpreting modifying clauses as opposed to an absolute prohibition against certain interpretations.” *Id.* (emphasis omitted).

174. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)); *Simpson*, 183 F.3d at 814.

175. *Simpson*, 183 F.3d at 814.

176. *Id.*

177. *Id.*

178. Tax Reform Act of 1986 § 1433(b)(2)(A)-(C).

179. *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 371 (1988); see *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 54 (1987); *Sorenson v. Sec’y of Treasury*, 475 U.S. 851, 860 (1986); *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303,

Indeed, “identical words used in different parts of the same act are intended to have the same meaning.”<sup>180</sup> Sections 1433(b)(2)(B) and (C) narrowly apply where the transfer is contemplated within the testamentary instrument. Under sections (B) and (C), juxtaposing the words “any generation-skipping transfer under a [trust or will]” to the remainder of each respective exception—both exempting generation-skipping transfers where the decedent is unable to amend the instrument—implies that the “generation-skipping transfer under [the trust or will]” is anticipated *within the instrument itself* without the possibility of being amended to avoid the GSTT.<sup>181</sup> Under (B) and (C), if the generation-skipping transfer was not anticipated within the instrument, the transfer would not fall within the scope of the 1986 Act.<sup>182</sup> Therefore, in construing the exceptions in concert, it must be inferred that Congress contemplated three basic preexisting factors: (1) that the generation-skipping transfer was created within the base instrument, (2) that it could not be amended to avoid the GSTT, and (3) that it was not effected by the exercise or lapse of a general power of appointment.

The proposition that there be contemplation of a generation-skipping transfer within the trust is further bolstered by dialogue among the legislators in the Joint Committee of Taxation’s discussion on the Tax Reform Act of 1986.<sup>183</sup> The authors of the excep-

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307-08 (1961); *see also* *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 132-33 (2000).

180. *Sorenson*, 475 U.S. at 860 (quoting *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934)).

181. *See* Tax Reform Act of 1986 § 1433(b)(2)(B), (C).

182. *See id.* If a decedent’s will or trust did not contemplate a generation-skipping transfer prior to the effective date, none of the exceptions would apply because there wouldn’t be a generation-skipping transfer to tax. *See id.*

183. 132 CONG. REC. 26,679 (1986) (colloquy between Chairman Packwood and Senator Bentsen).

Mr. BENTSEN. Mr. President, with respect to the new generation-skipping transfer tax, the grandfather provision of the prior law was intended to apply to:

A trust which includes a limited power of appointment, so long as the exercise of the power (including the creation of a trust) cannot result in the creation of an interest which postpones, or a new power which can be validly exercised so as to postpone, the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust. . . .

The concepts of this legislation history have been embodied in Treasury Regulation, section 26.2601-1(e)(3).

Would the chairman confirm my understanding that the same result would obtain under the new generation-skipping tax provision.

tion understood for it to apply to a limited power of appointment<sup>184</sup> in conjunction with a grandfathered trust, so long as the exercise of the power did not extend the vesting time of beneficiary interests in the trust.<sup>185</sup> Judge Thornton explained,

From these statements, one may draw two negative inferences: First, that the transitional rule was not meant to apply to a limited power of appointment that ran afoul of the vesting requirements; and second, and of more relevance here, *that the transitional rule was not meant to apply to the exercise of a general power of appointment under an otherwise grandfathered trust.*<sup>186</sup>

Reviewing the legislative history, the statutory scheme, and the language of the statute illustrates that the Eighth and Ninth Circuits' holdings are inconsistent with Congress's intent in enacting section 1433(b)(2)(A). The trusts in *Simpson* and *Bachler* did not contemplate a generation-skipping transfer.<sup>187</sup> The trusts did not become subject to the GSTT until *after* the general power of appointment was exercised.<sup>188</sup> It begs to be asked: at the time it became irrevocable, how can a trust that did not contemplate a generation-skipping transfer rely on an exemption from the GSTT? It cannot, and, therefore, the only logical conclusion is that section 1433(b)(2)(A) exempts those irrevocable trusts that do not grant a

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Mr. PACKWOOD. The understanding of the Senator from Texas is correct. As in the case of the old provision, the new provision will not apply to the exercise of a limited power of appointment under an otherwise grandfathered trust or to trusts to which the trust property is appointed provided that such exercise cannot postpone vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the original trust.

*Id.* (citation omitted); 132 CONG. REC. 26, 209 (1986) (colloquy between Chairman Rostenkowski and Representative Andrews) (House expressing the same sentiment as the Senate in applying the grandfather exception to limited power of appointments over irrevocable trusts that otherwise satisfy the grandfather exception); *see* Estate of Gerson v. Comm'r, 127 T.C. 139, 165 (2006) (Thornton, J., concurring), *aff'd*, 507 F.3d 435 (6th Cir. 2007).

184. A limited power of appointment is “[a] power of appointment that . . . restricts to whom the estate may be conveyed; esp., a power by which the [power holder] can appoint to only the person or class specified in the instrument creating the power, but cannot appoint to oneself or one’s own estate.” BLACK’S LAW DICTIONARY 1290 (9th ed. 2009).

185. *See* Estate of Gerson, 127 T.C. at 165 (Thornton, J., concurring).

186. *Id.* at 165-66 (emphasis added).

187. *Bachler v. United States*, 281 F.3d 1078, 1078 (9th Cir. 2002) (wife of decedent was the beneficiary, remainder to those as she may appoint under her power); *Simpson v. United States*, 183 F.3d 812, 813 (8th Cir. 1999) (wife of decedent was the beneficiary).

188. *Bachler*, 281 F.3d at 1079; *Simpson*, 183 F.3d at 813.

general power of appointment and explicitly contemplate a generation-skipping transfer within the trust terms.

*b. A general power of appointment leads to a windfall for skip person beneficiaries under the Eighth Circuit's analysis*

In the Eighth and Ninth Circuits' jurisdiction, a power holder over a trust that otherwise satisfies section 1433(b)(2)(A) has the ability to disperse trust property to skip persons GSTT-free years after the promulgation of the GSTT. This ability creates a windfall at the government's expense. Furthermore, it is fundamentally unfair to allow skip-person beneficiaries to profit simply because they have the fortune to be situated downstream from a trust that provided a general power of appointment. The reading proposed by the Eighth Circuit creates an *incentive*, not an *exception*, to exercising a general power of appointment in favor of skip persons, bypassing the GSTT at the intermediate generation. This outcome is contradictory to the purpose of the GSTT and estate-tax law.<sup>189</sup>

The Eighth and Ninth Circuits allow the GSTT-free transfer of property to skip persons nearly twenty-five years after the enactment of the GSTT, even where the irrevocable trust does not contemplate a generation-skipping transfer.<sup>190</sup> This application of section 1433(b)(2)(A) creates a much broader "exception" than Congress intended in the scheme of exceptions codified in section 1433(b)(2). The exceptions focus on the generation-skipping transfer being contemplated, immutable, and reliant on the pre-GSTT law within the testamentary instrument prior to the effective date.<sup>191</sup> Congress gave no indication that it wished to construe the section 1433(b)(2) exceptions so broadly as to exempt general-

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189. *Comerica Bank, N.A. v. United States*, 93 F.3d 225, 228 (6th Cir. 1996) (explaining that the GSTT was "enacted to ensure taxation of generation skipping transfers in a comparable manner to outright transfers from one generation to the next, and to remove the estate planning tool of escaping taxation by skipping a generation in an estate transfer."); see HARRINGTON, PLAINE & ZARITSKY, *supra* note 7, ¶ 1.02[1], at 1-6 to -7; Bohan, *supra* note 39, at 486-87.

190. See *supra* Part III.B. See generally *Bachler*, 281 F.3d 1078; *Simpson*, 183 F.3d 812.

191. See generally Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433, 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)). Sections (b)(2)(B) and (C) provide exceptions where the generation-skipping transfer was contemplated by the instrument and it could not have been modified to avoid the GSTT. See *id.*

power-of-appointment-granting instruments that did not contemplate an immutable generation-skipping transfer.<sup>192</sup>

The Eighth Circuit stated that “words do not always mean what they seem, and that they receive their meaning only from the context in which they are used.”<sup>193</sup> Therefore, section 1433(b)(2)(A) must derive its meaning in concert with subsections (B) and (C). The immediately preceding section of analysis discussed the purpose of the exceptions—to protect the intentions of taxpayers whose irrevocable trusts cannot be amended to avoid GSTT.<sup>194</sup> Trusts accompanied by general powers of appointment can be exercised to conform to current tax law.

The exercise or lapse of a general power of appointment under a trust (1) creates the intent or acquiesces to the intent to make a generation-skipping transfer, and (2) executes the generation-skipping transfer where such transfer was not contemplated under the trust or acquiesces to such transfer when contemplated under the trust.<sup>195</sup> Where the trust contemplates a generation-skipping transfer, the power of appointment may be exercised in favor of non-skip persons to avoid the imposition of the GSTT.<sup>196</sup> The general scheme of the exceptions is to protect the reliance of the transferor only where the instrument contemplates the generation-skipping transfer and may not be amended to avoid GST-taxation. The Eighth and Ninth Circuits’ holdings cut against this scheme.

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192. See 132 CONG. REC. 26,679 (1986) (exempting trusts that grant limited powers of appointment); 132 CONG. REC. 26,209 (1986) (same).

193. *Simpson*, 183 F.3d at 815. Judge Calabresi expressed this particularly well: “Language does not have a ‘plain meaning’ outside of its particular context. ‘You should have passed, dummy,’ means something entirely different at a bridge table from what it means on Superbowl Sunday.” *E. Norman Peterson Marital Trust v. Comm’r*, 78 F.3d 795, 796 (2d Cir. 1996).

194. See *supra* Part IV.A.1.a. These exceptions “ensured that an individual who did not have a reasonable time between the enactment of the law and his death to alter his will [or trust] would not be penalized by the new provision.” *Peterson*, 78 F.3d at 801 n.6.

195. See *Simpson*, 183 F.3d 812. Mr. Simpson named Mrs. Simpson as the beneficiary of the trust and included a general power of appointment, which Mrs. Simpson exercised in favor of her grandchildren. *Id.* at 813. Mr. Simpson did not transfer the property to his grandchildren; he left that decision to Mrs. Simpson. *Id.*; see also *Estate of Gerson v. Comm’r*, 507 F.3d 435, 437 (6th Cir. 2007) (had Mrs. Gerson not exercised her power, the trust property would have gone to Mr. Gerson’s children); *Bachler*, 281 F.3d at 1079 (Mrs. Wunderlich’s exercise of her power transferred the trust property to her grandchildren); *Peterson*, 78 F.3d at 797 (Mrs. Peterson allowed her power to lapse, sending the trust property to Mr. Peterson’s grandchildren under the terms of his trust).

196. *Simpson*, 183 F.3d at 814.

## 2. The Exercise or Lapse of a General Power of Appointment Is Not a Transfer Under a Trust

It is well-settled in tax law that the assets over which a person has a power of appointment are taxable in that person's estate.<sup>197</sup> The tax code equates powers of appointment to outright ownership of trust property.<sup>198</sup> Furthermore, under the gift tax, which shares a similar role to the GSTT,<sup>199</sup> general powers of appointment are treated as taxable transfers of property by the power holder.<sup>200</sup> Therefore, for GSTT purposes, it is the power holder who should be deemed the transferor of trust property.<sup>201</sup> It is unreasonable to label the grantor of the trust as the transferor where the generation-skipping transfer was created and carried out by the appointed power holder. This proposition is further supported considering (1) the power holder "owns" the property, (2) the property is included in the power holder's estate, (3) the transfer of that property is a taxable transfer, and (4) the transfer is created or acquiesced by the power holder after the effective date.

Within the scope of cases addressed in this Note, two possibilities exist for those possessing a general power of appointment: the power may be exercised or it may be allowed to lapse. In each instance, the transfer of trust property to skip persons is effectuated by the power holder, not the settlor.<sup>202</sup> This situation can be reasonably classified as a transfer by the *power holder* under the *power holder's will* and not a transfer *under a trust* that was irrevocable by September 25, 1985. In transfers of this sort, the trust forms the basis for the exercise of the general power of appointment in the decedent's will.<sup>203</sup> The following sections further analyze this pro-

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197. 26 U.S.C. § 2041(a)(2) (2006); *Simpson*, 183 F.3d at 814; *see also* Estate of Kurz v. Comm'r, 101 T.C. 44, 47-48 (1993).

198. *Estate of Gerson*, 507 F.3d at 439; *Peterson*, 78 F.3d at 800; *see Simpson*, 183 F.3d at 814.

199. *See supra* Part I.A (discussing the history of the development of the gift and estate taxes, namely to reinforce the estate tax by closing loopholes through creative estate planning).

200. *Peterson*, 78 F.3d at 800; *see* 26 U.S.C. § 2514(b).

201. *Peterson Marital Trust v. Comm'r*, 102 T.C. 790, 805 (1994), *aff'd*, 78 F.3d 795 (2d Cir. 1996).

202. *See Estate of Gerson*, 507 F.3d at 440; *see also supra* Part III.C (discussing the exercise of a power as effecting two transfers and the lapse of a power effecting three transfers).

203. *See Simpson*, 183 F.3d at 813 ("The trust gave Mrs. Simpson a general power of appointment by will."); *Peterson*, 78 F.3d at 797 ("According to the terms of the trust, Mrs. Peterson was to receive all of the income of the trust, and was given a general testamentary power of appointment over the [corpus] of the trust.").

position in cases where the underlying trust does or does not contemplate a generation-skipping transfer.

*a. General powers of appointment in trusts that do not otherwise contemplate a generation-skipping transfer*

The *Simpson* trust did not contemplate a generation-skipping transfer but provided Mrs. Simpson a general power of appointment over the trust property.<sup>204</sup> Had Mrs. Simpson allowed her power to lapse, the trust property would have naturally flowed to the default taker provided by the trust terms.<sup>205</sup> The trust, standing alone, was not subject to the GSTT.<sup>206</sup> It was through Mrs. Simpson's exercise of power, under *her* will, that the generation-skipping transfer was executed.<sup>207</sup> Her estate then exempted the transfer from the GSTT pursuant to section 1433(b)(2)(A).<sup>208</sup>

However, as the intended beneficiary under Mr. Simpson's trust,<sup>209</sup> had Mrs. Simpson not exercised her power, the trust property would have flowed through her estate and been disposed of according to the terms of her will. Had she bequeathed the property to her grandchildren as a direct skip, the GSTT would have applied.<sup>210</sup> This testamentary transfer is procedurally no different than a testamentary exercise of a power over a trust.<sup>211</sup> The transfers in both situations are executed under the terms of a will. It is both unreasonable and inconsistent to exempt transfers under an exercise of a general power of appointment while applying the GSTT to testamentary transfers not effectuated by a power, especially considering that the transfers are created by the same person and the beneficiaries are the same.

This Note argues that section 1433(b)(2)(A) should not apply to irrevocable trusts accompanied by a general power of appointment because it elevates form over substance. In this situation, the exception creates a windfall to those who are fortunate enough to

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204. *Simpson*, 183 F.3d at 813.

205. *Id.* Under the trust terms, Mrs. Simpson was the beneficiary. Had she not exercised her power, the trust property would have been disposed under the terms of her will. *Id.*

206. *Id.*

207. *Simpson v. United States*, 17 F. Supp. 2d 972, 973 (W.D. Mo. 1998), *rev'd*, 183 F.3d 812 (8th Cir. 1999).

208. *Id.* at 974.

209. *Simpson*, 183 F.3d at 813.

210. *See* 26 U.S.C. § 2601 (2006).

211. In each case, Mrs. Simpson's will is controlling the disposition of property to skip persons.

be downstream from a trust that provides a beneficiary a general power of appointment to dispose of trust property. The irrevocable trust merely conveys a power of appointment, and it is the exercise of that power that creates and executes the generation-skipping transfer. The following section reviews the effect of powers of appointment over trusts that contemplate a generation-skipping transfer.

*b. General powers of appointment in trusts that do contemplate a generation-skipping transfer*

In situations similar to that presented in *Peterson*,<sup>212</sup> a power holder's lapse of power is tantamount to her acquiescence to the transfer. The power holder has the ability to change the disposition of property to avoid the GSTT, and her inaction should be treated as a choice to transfer the property to skip persons and subject the transfer to the GSTT. *Black's Law Dictionary* defines acquiescence as "[a] person's tacit or passive acceptance; implied consent to an act."<sup>213</sup> The power to comply with the changed state of law having been recognized, it is neither appropriate nor of sound policy to allow taxpayers to avoid a tax that Congress has enacted.

Policy considerations support imposing the GSTT to lapsed general powers of appointment over trusts. A general power of appointment is equal to outright ownership of the trust property under estate-tax law.<sup>214</sup> The power has "effective control over the disposition of the property";<sup>215</sup> hence, the power holder has the ability to avoid a generation-skipping transfer. "Consequently, the power holder has no legitimate expectation of immunity from the 1986 GST[T] . . . [and] the purpose of the [grandfather exception] would not be served by providing . . . relief in these circumstances."<sup>216</sup> The power holder has too much control over trust

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212. See *Peterson*, 78 F.3d at 797 (generation-skipping transfer was contemplated in the trust).

213. BLACK'S LAW DICTIONARY 26 (9th ed. 2009).

214. *Estate of Gerson v. Comm'r*, 127 T.C. 139, 165 (2006) (Thornton, J., concurring), *aff'd*, 507 F.3d 435 (6th Cir. 2007); see also *Morgan v. Comm'r*, 309 U.S. 78, 81 (1940); *Estate of Kurz v. Comm'r*, 101 T.C. 44, 50-51 (1993).

215. *Estate of Gerson*, 127 T.C. at 165 (Thornton, J., concurring) (quoting *E. Norman Peterson Marital Trust v. Comm'r*, 102 T.C. 790, 800 (1994)).

216. *Id.* Judge Thornton applied this language as policy support for the refusal to permit exception to an exercise of a general power of appointment. However, Judge Thornton's concurrence provides just as much support in the context of a lapsed general power of appointment under a trust that otherwise provides for a generation-skipping transfer. See *Chase Nat'l Bank v. United States*, 278 U.S. 327, 338 (1929) ("[T]he non-

property to take advantage of a statutory exception whose intent was to protect taxpayers who made arrangements from which they could not reasonably escape. Treasury Regulation § 26.2601-1 appropriately addresses and disposes the question of whether the grandfather exception should be applied to a trust providing a power holder such control over trust property.

Treasury Regulation § 26.2601-1(b)(1)(i) treats the transfer of property under lapsed powers as a constructive addition to the trust.<sup>217</sup> Consequently, section 1433(b)(2)(A) does not apply because the transfer creates a constructive addition of property to the trust after the effective date.<sup>218</sup> The treasury regulation appropriately recognizes the unfettered control over the disposition of property the power holder maintains and correctly applies the GSTT to lapsed general powers of appointment.

### 3. Federal Circuits Should Adopt Treasury Regulation § 26.2601-1

The last four sentences of Treasury Regulation § 26.2601-1(b)(1)(i) were not in effect at the time of the Eighth Circuit's opinion,<sup>219</sup> and the Ninth Circuit did not opine on the application of the amended and final regulation in its 2002 ruling.<sup>220</sup> The amendment, in relevant part, reads as follows:

Further, [section 1433(b)(2)(A)] does not apply to a transfer of property pursuant to the exercise, release, or lapse of a general power of appointment that is treated as a taxable transfer under chapter 11 or chapter 12. The transfer is made by the person holding the power at the time the exercise, release, or lapse of the power becomes effective, and is not considered a transfer under a trust that was irrevocable on September 25, 1985.<sup>221</sup>

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exercise of [a general] power may be as much a disposition of property testamentary in nature as would be its exercise at death." (citations omitted)).

217. Treas. Reg. § 26.2601-1(b)(1)(i), (b)(1)(v)(B) (as amended 2004); *see supra* Part III.B. *See generally Peterson*, 78 F.3d 795.

218. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (codified at 26 U.S.C. § 2601 note (2006) (Effective Date of 1986 Amendment)).

219. The last four sentences were amended to the section by T.D. 8912 and effective as of November 18, 1999. T.D. 8912, 2001-1 C.B. 452. *Simpson* was decided on July 23, 1999. *Simpson*, 183 F.3d 812.

220. *Bachler v. United States*, 281 F.3d 1078, 1080 n.1 (9th Cir. 2002) ("We do not express any opinion on the validity of Treas. Reg. § 26.2601-1(b)(1)(i) . . . which was not at issue in this case.").

221. Treas. Reg. § 26.2601-1(b)(1)(i); *see also* T.D. 8912, 2001-1 C.B. 452.

The treasury regulation now applies the GSTT to both lapsed and exercised powers whether or not the totality of trust property is removed.<sup>222</sup> The circuit courts should follow the Second and Sixth Circuits' lead in adopting the regulation. It appears that the Eighth Circuit, by its own admission, should follow suit.<sup>223</sup>

The Eighth Circuit's 1999 disposition of *Simpson v. United States* was the catalyst for this amendment. The court addressed the government's argument asserting Temporary Treasury Regulation § 26.2601-1's import in deciding *Peterson* but ultimately dismissed it, finding the regulation, as drafted, did not apply to the facts in *Simpson*.<sup>224</sup> At the time of the decision, the regulation removed the exercise or lapse of a general power of appointment from grandfathering

where any portion of a trust *remains in the trust* after the release, exercise, or lapse of a [general] power of appointment over that portion of the trust . . . [.] [T]he value of the entire portion of the trust subject to the power that was released, exercised, or lapsed will be treated as an addition to the trust.<sup>225</sup>

*Simpson's* analysis distinguished *Peterson* on its facts. In *Peterson*, property remained in the trust after the power lapsed, triggering a constructive addition to the trust in accordance with Temporary Treasury Regulation § 26.2601-1(b)(v)(A).<sup>226</sup> Under the *Simpson* facts, Mrs. Simpson's exercise of power over the totality of trust property left no property in the trust postexercise.<sup>227</sup> The court found the temporary regulation inapplicable to its set of facts since it applied only when trust property remained in the trust after a power's exercise or lapse.<sup>228</sup>

While *Simpson* did not address the treasury regulation's validity, it did state that it had "no quarrel with the holding of *Peterson*,"<sup>229</sup> which held that the treasury regulation was a valid interpretation of section 1433(b)(2)(A).<sup>230</sup> This implies that, if the Eighth Circuit is once again faced with this issue, it would not be

222. See Treas. Reg. § 26.2601-1(b)(1)(i).

223. See *infra* text accompanying notes 229-230.

224. See *Simpson*, 183 F.3d at 815-16.

225. *Id.* at 815 (emphasis added) (quoting Temp. Treas. Reg. § 26.2601-1(b)(1)(v)(A)).

226. See *id.*

227. *Id.*

228. *Id.* at 815-16.

229. *Id.* at 816.

230. See *E. Norman Peterson Marital Trust v. Comm'r*, 78 F.3d 795, 802 (2d Cir. 1996).

averse to applying the amended and final treasury regulation to the facts before it. In so doing, the regulation would remove all exercises or lapses of powers from section 1433(b)(2)(A), irrespective of whether property remains in the trust.

#### CONCLUSION

The issue this Note presents is unique with respect to its ongoing validity in tax law. Yet, the Supreme Court has denied certiorari.<sup>231</sup> This denial is likely because the issue will die as the number of irrevocable trusts with general powers of appointment currently subject to the effective-date provision naturally decreases over time. However, the potential impact of the grandfather exception can result in millions of dollars either going to a decedent's beneficiaries or to the government. To that end, it is important to educate individuals who potentially fall subject to the exception and inform them of the possible consequences of their actions.

The taxpayer desires tax laws to be construed and applied in the taxpayer's favor. However, correct application of the grandfather exception must be made according to its circumstances and the general scheme of wealth-transfer tax laws. The wealth-transfer tax laws support the taxation of wealth from generation to generation. Reading the grandfather exception in context with the other exceptions has illustrated the requirement of an immutable generation-skipping transfer within the trust instrument.

The application adopted by the Eighth and Ninth Circuits is misplaced because it cuts across these schemes and defies logic; the transfers made under general powers of appointment, whether exercised or lapsed, do not occur under a trust as contemplated by section 1433(b)(2)(A). Treasury Regulation § 26.2601-1 addresses the issue in a manner consistent with the statutory scheme and wealth-transfer tax law. Treasury Regulation § 26.2601-1 must be adopted by courts confronted with applying a general power of appointment to an otherwise grandfathered irrevocable trust to achieve this consistency in tax law, as it was by the Sixth Circuit in *Gerson*.

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231. See, e.g., *Kleinman v. Comm'r*, 128 S.Ct. 2502 (2008) (mem.).

\* I dedicate my Note to my mom and dad for their love and support.