THE RULE AGAINST PERPETUITIES AND PENSION TRUSTS—AN OBSTACLE IN TAX PLANNING

One of the most noteworthy economic developments of the past twenty years has been the tremendous growth of employee benefit programs. Current estimates place reserves held to secure retirement benefits at over 67 billion dollars.[1] A variety of factors has contributed to this imposing growth.[2] Clearly of major if not paramount importance are the tax benefits incident to the creation of a plan which qualifies under the Internal Revenue Code.[3] An employer's contributions to a qualified plan are deductible from gross income.[4] Employees realize taxable income only as benefits are actually received[5] and, in case of lump sum distributions, capital gains treatment is accorded.[6] Furthermore a qualified trust is exempt from taxation.[7]

Qualified plans are funded through reserves held in trust[8] or by purchase of employee annuities.[9] Choice of the trust device makes state trust and property law an important consideration in pension planning.[10] Draftsmen have, for example, been troubled with a possible application of the Common Law Rule Against Perpetuities to pension trusts.[11] Several state legislatures have responded by exempting pension trusts from the operation of this and other rules of property law which are hereinafter referred to collectively as the restrictive rules of property.[12] These include the Rule Against Perpetuities, the Rule Against the Duration of Trusts, the Rule Against Accumulations, the Rule Against Suspension of the Absolute Power of Alienation, and the Rules Against Restraints on the Power of Alienation.

The statutes passed in these jurisdictions do not, however, solve all

[1] The TALLY OF LIFE INSURANCE STATISTICS, December, 1956, published by the Institute of Life Insurance. EMPLOYEE BENEFIT PLAN REVIEW 2:57, page 31 reports S.E.C. estimates that individual savings in form of pension reserves increased at a rate of one billion dollars per quater 1956, first three quarters.

[2] Retirement and pension plans were held subject to mandatory collective bargaining in Inland Steel Company v. N.L.R.B., 170 F.2d 247 (1948), *cert. denied* 336 U.S. 960 (1949). For an appraisal of the social forces behind the quest for economic security in old age, see DEARING, INDUSTRIAL PENSIONS 1 (1954).

[3] INT. REV. CODE OF 1954 §401 *et seq.*

[4] INT. REV. CODE OF 1954 §404; 2 CCH FED. TAX REP. ¶2600.

[5] INT. REV. CODE OF 1954 §§402 and 403.

[6] INT. REV. CODE OF 1954 §402(a)(2).

[7] INT. REV. CODE OF 1954 §501(a).

[8] INT. REV. CODE OF 1954 §401.

[9] INT. REV. CODE OF 1954 §403.

[10] Use of the trust device is customary. See CCH PENSION PLAN GUIDE ¶2600.

[11] See, *e.g.*, CLARK, PROFIT SHARING AND PENSION PLANS §6 (1946); CCH PENSION PLAN GUIDE ¶1105 *et seq.*; Lauritzen, *Perpetuities and Pension Trusts*, 24 TAXES 519 (1946).

[12] See CCH PENSION PLAN GUIDE ¶1116 which reproduces all current legislation.

the problems which may be faced in this area by one who contemplates funding a pension program in conjunction with the trust device. Indeed thirteen states have no exempting legislation and not all of the states which have enacted such statutes exempt pension trusts from all of the rules enumerated above. Moreover, even if a pension trust is executed in a jurisdiction which has enacted a comprehensive exempting statute, the validity of the trust provisions, under the rules of conflict of laws, may be determined by the law of another state.[13]

The scope of this comment is limited to an examination of a possible application of the Rule Against Perpetuities to the pension trust though brief reference to the other restrictive rules is included.

THE COMMON LAW RULE AGAINST PERPERUITIES

The Common Law Rule Against Perpetuities is no doubt the most familiar of the restrictive rules. John Chipman Gray's statement of the Rule has been accepted as the standard.[14]

> No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest.[15]

There appears to be no reported case in which the Rule has been applied to a pension trust[16] and only one commentator, Christian M. Lauritzen, has ventured into the area of perpetuities and pension trusts in any great detail.[17] He presents a convincing argument, indorsed by the American Law of Property,[18] that the Rule should be confined to the field of family trusts and not extended to invalidate pension trusts. He does however suggest a possible violation of the Rule committed in the creation of a pension trust.

> It would be theoretically possible for an employee to become entitled to a retirement pension even though he was born more than twenty-one years after the death of the last beneficiary alive when the trust was created. Thus the interest of this employee would vest at a date beyond the limit fixed by the Rule. . . .[19]

Lauritzen proceeds on the assumption that if the Rule were applied

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13 VI AMERICAN LAW OF PROPERTY §24.5A (Casner ed. 1952); Lauritzen, *supra* note 11, 523-4.

14 VI AMERICAN LAW OF PROPERTY §24.1 (Casner ed. 1952).

15 GRAY, RULE AGAINST PERPETUITIES §201 (1915).

16 See however CLARK, *op. cit. supra* note 11, 24 n. 6. The author sets forth a B.T.A. Memo. Op. which considered a perpetuities question incident to the creation of a pension trust.

17 Lauritzen, *supra* note 11.

18 VI AMERICAN LAW OF PROPERTY §24.61 (Casner ed. 1952).

19 Lauritzen, *supra* note 11 at 520. See also SIMES AND SMITH, LAW OF FUTURE INTERESTS §1247 (1956); "It would seem that, since these trusts are for the benefit of present and future employees, there may be included as beneficiaries unborn or unascertained persons who will become employees in the future, and whose equitable interests may not vest within the period of the rule against perpetuities".

to a pension trust, it would be applied as though the trust served as a vehicle for a class gift. Thus, under the rule of *Leake v. Robinson*,[20] the consequence of the violation is that the entire gift fails since the interest of a potential member of the class may vest remotely. The class gift analysis raises further difficulties. A savings clause inserted in the trust instrument calling for termination of the trust twenty-one years after the death of the survivor of those beneficiaries in being at the creation of the trust would be of questionable effect.[21] If the number of measuring lives assumes major proportions the clause may be ignored and the trust held void for uncertainty.[22] The tax consequence of such a holding is a matter for conjecture.[23]

But it is questionable whether an employer's contribution to a pension trust should be placed in the category of limitations traditionally designated as class gifts. It is no doubt true that the beneficiaries have in common their employment[24] and that the employer in making contributions is "group minded."[25] The retirement of disability benefits paid to the beneficiary of a pension trust do not, however, depend for their amount on the ultimate number of employees who are covered under the plan.[26] Per capita gifts to the members of a class have always been exempt from the rigor of the rule of *Leake v. Robinson*. Indeed

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[20] 2 Mer. 363. See also Leach, *The Rule Against Perpetuities and Gifts To Classes*, 51 HARV. L. REV. 1329 (1938), where the rule is severely criticized.

[21] Such clauses are used often in pension trusts in an attempt to avoid violation of the Rule. SIMES AND SMITH, *op. cit. supra* note 19, §1247.

[22] Leach, *Perpetuities in a Nutshell*, 51 HARV. L. REV. 638, 642 (1938). The author cites a case in which the measuring lives (120) were "all the lineal descendants of Queen Victoria now living." *In re* Villar, (1929) 1 Ch. 243, "The gift was held valid but it certainly represents the outside limit of the permissible number of lives."

[23] Lauritzen, *supra* note 11, 519, suggests that contributions made to such void trusts would have to be disallowed as deductions from gross income, resulting in higher corporate income for the years in question. INT. REV. CODE OF 1954 §401(a)(2) states as a requirement for qualification that it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, for any part of the corpus or income to be diverted to purposes other than the exclusive benefit of employees or their beneficiaries. It might be argued, if the trust were declared void, that the corpus, since it represents compensation for services actually rendered, is held on a resulting trust for the employees and that a transfer immediately thereafter to an express trust, identical in provision to the former pension trust except for the violative provision, constitutes substantial compliance with the requirements of §401.

[24] GRAY, *op. cit. supra* note 15, §369 n. 1.

[25] SIMES AND SMITH, *op. cit. supra* note 19, §612. Protection of this group interest could serve as additional justification for not applying the Rule.

[26] Under the generally accepted definitions of Jarman and Gray the share of each person of the alleged class must be dependant for its amount on the ultimate membership of the class. JARMAN, WILLS 310 (7th ed. 1930); GRAY, *op. cit. supra* note 24. Otherwise the gift is *per capita*.

Professors Simes and Smith do not agree that the size of each beneficiary's share must depend upon the ultimate membership of the group before it is possible

"it may be said that a per capita gift is not a class gift for the purposes of the rule against perpetuities."[27]

Since there seems to be little basis for analyzing the pension trust in terms of class-gift concepts, those contributions which vest in interest within the period of the Rule would be saved even if it were deemed initially applicable.[28]

By far the more important question concerns this initial applicability. Lauritzen offers two approaches to a solution which avoids the operation of the Rule. First he finds an original purpose for the Rule and concludes that:

> As a device to restrain the dynastic impulses of great land owners, the Rule against Perpetuities was a necessary and desirable development of the common law. Its application. however, should be confined to the field of family trusts, and the Rule should not be extended beyond its original purpose to invalidate pension trusts designed to provide a decent old age for the faithful employees of modern industry.[29]

Lauritzen's approach is sound though his point might be strengthened through a minor change in form. The *original purpose* of the Rule is not necessarily decisive in defining the desirable limits to its operation. A more plausible criterion is available in the *present day need and justification* for a rule which invalidates reomtely vesting interests. Unfortunately this yardstick is elusive.

Various commentators have suggested that the Rule finds its current justification in the restraint which it imposes on the creation of family dynasties, as a means in furtherance of the free alienability of property,[30] and as insurance that persons less fit in the social struggle will not be assured incomes by the creation of obnoxious future interests.[31] The *Restatement* concludes:

> From this review of diverse purposes served by the rule against perpetuities, it is fair to conclude that the social interest in preserving property from excessive fettering rests partly upon the necessities of maintaining a going society controlled primarily by its living members, partly upon the social desirability

to have a class gift. SIMES AND SMITH, *op. cit, supra* note 19 at §615. They do. however, deny the utility of a rigid criterion which purports to separate per capita from class limitations without regard to context. As the class gift is a product of the family settlement involving gifts to children, sons, daughters, brothers, sisters, and the like, it is possible that the authors' analysis would lead to the conclusion that a group of participants in an employee benefit program is outside the scope of the designation.

[27] SIMES AND SMITH, *op. cit. supra* note 19, §1266.

[28] *Ibid.* See also CLARK, PROFIT SHARING AND PENSION PLANS §6 (1946). This holding would substantially mitigate the drastic tax consequences to the employer foreseen by Lauritzen; see *supra* note 23.

[29] Lauritzen, *supra* note 11.

[30] GRAY, RULE AGAINST PERPETUITIES §268 (4th ed. 1942).

[31] RESTATEMENT, PROPERTY p. 2132.

> of facilitating the utilization of wealth, partly upon the social desirability of keeping property responsive to the current exigencies of its current beneficial owners, and partly upon the competitive basis of modern society[32]

Professor Lewis M. Simes in his contribution to the Thomas M. Cooley Lectures, Public Policy and the Dead Hand, presents a cogent analysis of the social interest served by the Rule. He suggests that undue concentration of wealth is an evil which can best be combatted by tax legislation, rather than perpetuity rules. Furthermore, the Rule is concerned primarily with equitable interests in trust where usually liberal powers of sale and investment in trustees insure that the corpus is not taken wholly out of commerce.[33] As to the justification aimed at preserving a natural balance in the social struggle, Simes succintly points out that if such is the object of the Rule it simply does not accomplish its purpose. "Modern society with its elaborate welfare machinery, is not organized on a theory of survival of the fittest." Simes finds a need for the Rule in the natural balance it maintains between desires of present generations to control the wealth of the world and the respect to be accorded the dead hand. In other words the Rule provides compromise and coexistance for two socially desirable policies: a power of testation (including its inter vivos equivalent) and control of society's wealth by its living members.

Pension trusts occasion no comparable policy considerations. If a funded pension trust is actuarially sound, its corpus at any given point in time represents wealth attributable to the labor of current employee participants which will furnish retirement benefits for use during their lifetimes. An employer's contribution to the trust in 1958 is not intended to secure the retirement of an employee who might be hired in the year 2000. Indeed it is difficult to isolate a contingent interest arising out of a qualified trust which could be attributed to unborn or unascertained employees. Contributions by an employer are deductible under I.R.C. §104 only to the extent that they represent compensation for personal services actually rendered.[34] Further, that amount of the corpus of a trust which is in excess of the amount necessary to carry out the purposes of the trust is traditionally viewed as held by the trustee on a resulting trust for the settlor.[35] Unanticipated appreciation of corpus assets and contributions which exceed the statutory criterion should fall

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[32] *Ibid.*

[33] It is true, however, as the author points out, that the corpus is taken out of commerce to the extent that it cannot be used as a source of venture capital or for the purchase of consumer's goods. See also RESTATEMENT, PROPERTY, p. 2130: "As to intangibles this socially desirable consequence of the rule is not so clear, since shares and bonds constitute an important bulk of intangibles, and as to intangibles of these types, restrictions operative as to shares or bonds would in no way hamper the ultilization of its assets by the issuing corporation."

[34] CCH PENSION PLAN GUIDE ¶2602.

[35] See, *e.g.*, BOGERT, TRUSTS §76 (3d ed. 1952).

in this category to the extent that they are not taken into account by the actuary in computing the employer's subsequent contributions.

If a violation of the rule were to be hypothesized, it would seem necessary to equate the trust provision extending coverage to subsequent employees to a special power of appointment (exercised each time an employee is hired) which could be exercised remotely and to view the corporate settlor as retaining a power to augment corpus.[36] Conceding this equation the rule is literally applicable but the necessary exercise of the power to augment each time the power to appoint is exercised is so similar to the creation of an entirely new trust that the existence of these powers can hardly be said to run afoul of any of the purposes which have been attributed to the rule.

So, too, in many respects the pension trust is similar to the common trust fund, a method of putting into one fund the moneys of many trusts, for the general purpose of obtaining greater stability of income and principal values through diversity of investment, and also for reducing the cost of trust administration.[37] In fact it is difficult to distinguish substantively the common trust fund from a wholly contributory pension trust. The presence of employers' contributions does not detract from this strong collection-of-individual-trusts characteristic. An employer's contributions to a pension trust constitute deferred compensation to his employees[38] and pension benefits like wages are subject to collective bargaining.[39] Why not then view the employer merely as an agency for transmittal of his employees' contributions to a common trust fund? Looked at in this light, provision in the trust instrument availing subsequent employees of the trust facilities raises no perpetuities problem.

A second approach advanced by Lauritzen which avoids the operation of the rule likens the pension trust to the charitable trust.[40] While there appears to be some slight justification in case law that pension trusts are charitable,[41] this analogy has not escaped sound criticism.[42] Further-

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[36] VI AMERICAN LAW OF PROPERTY §24.32 (Casner ed. 1952).

[37] AMERICAN BANKER'S ASSOCIATION, COMMON TRUST FUNDS 9 (2d ed. 1948). The Association has adopted the following definition: "The term common trust fund means a fund established by a corporate trust institution, in which is combined for the purpose of facilitating investment, money belonging to various trust accounts in its care, the participating contributory interests of said accounts being appropriately evidenced." *Id.* at 10.

[38] See CCH PENSION PLAN GUIDE ¶2602. "Contributions deductible under section 404, as in the 1939 Code, may be deducted only to the extent that they are necessary business expenses and are compensation for personal services actually rendered."

[39] See *supra* note 2.

[40] Lauritzen, *supra* note 11, 528.

[41] *Ibid.* 530, 531.

[42] SIMES AND SMITH, *op. cit. supra* note 19, §1247. The authors do add: "It does seem highly desirable, however, not to apply the rule against perpetuities to them. For it is very unsatisfactory to fix an arbitrary date for termination of the

more, strong arguments have been advanced for subjecting the charitable trust to rules limiting its duration and regulating its provision for the accumulation of income.[43] The bases of these contentions do not necessarily extend to the pension trust; and until the status of the charitable trust is clarified, it would seem preferable to maintain a sperate identity for the pension trust.

The search for an analogous property device suggests very strongly that pension trusts are *sui generis*. They bear little more resemblance to the private express trust than Social Security does to the family settlement. As a receptacle for reserves which secure retirement benefits, the trust serves a novel function—one for which it is well suited *with regard to administrative convenience*. This new use, alien to the family settlement, together with the imposing growth of the institution, suggests that considerable restraint should be exercised in the application of law which was designed to accommodate private arrangements. Provisions for extension of coverage to subsequent employees in "master policies" under which employee annuities are issued raises no apparent perpetuities problem. There is no reason why similar pension trust provisions should invite operation of the Rule. The Rule, while applied strictly, should be applied to substance and not form.[44]

Other Restrictive Rules

Most of the other restrictive rules pose no real problem in drafting a qualified pension trust. It is difficult to conceive of a *practical* direction to accumulate income which would violate any orthodox rule against accumulations.[45] It would seem too that the absolute power of alienation over the corpus is never suspended.[46] Furthermore it is generally agreed

trust at a time twenty-one years after the death of a group of persons entirely unconnected with the business of the corporation. It may well be that the social policy in favor of such trusts is so strong that they should be held to be exempt even though they are not charitable trusts".

[43] Committee on the Law and Practice Relating to Charitable Trusts, Report Cmd. No. 8710 (1952). See also Simes and Smith, *op. cit. supra* note 19, §1467.

[44] VI American Law of Property §24.9 (Casner ed. 1952).

[45] Assuming a potentially violative provision, strong arguments could be advanced for excepting the pension trust from the most rigorous statutes. The first line of defense against obnoxious accumulations is the income tax. Yet pensions trusts, like charitable trusts (which are generally exempted from rules restricting accumulations) are exempt from taxation. See *supra* note 7. Furthermore, the practical solution to dangerous accumulations is a limitation on the maximum reserves which can be built up to secure benefits. The Code and Regulations accomplish this to the extent that deductions must be intended for deferred compensation, meet the ordinary and necessary business expenses test and be reasonable compensation for services actually rendered. CCH Pension Plan Guide ¶2601 *et seq.*

[46] The absolute power of alienation is said to be suspended by the creation of future interests in unborn persons so that it is impossible for persons in being to join in the conveyance of a fee simple absolute. The rule prohibiting absolute

that the common law imposes no general restrictions on the duration of trusts[47] although one commentator predicts the emergence of a rule avoiding provisions which prohibit the beneficiaries from terminating the trust if the provision is applicable beyond the period of the Rule Against Perpetuities.[48]

The variety of rules against restraints on the power of alienation do, however, merit close attention. None is more firmly entrenched than the rule that a settlor cannot create a spendthrift trust for his own benefit, thereby putting the income and corpus beyond the reach of his creditors.[49] Provisions which forbid an employee to anticipate his interest in a pension trust are not rare.[50] Under such a provision, an employee, to the extent of his own contributions, has apparently come within the ban of the rule. Yet creditors have experienced little success in attempting to satisfy their claims out of an employee's contributions subject to a spendthrift restraint. One case gives reason to believe that the courts will develop a vague public policy exception for employees' contributions and ignore the spendthrift trust analogy.[51] It would seem that this judicial attitude merits scrutiny by creditors' representatives. If 67 billion dollars of the nation's wealth were to be tied up in deferred compensation free from valid claims of creditors, (and there is every indication that coverage will increase)[52] liberal credit policy may stand reviewing. Furthermore, stronger forces could press for state exempting legislation than was mobilized to obtain exemptions for many private annuities.[53]

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suspension is not coextensive in application with the rule against perpetuities. *E.g.*, to the church so long as used for church purposes, then to B (a living person). B's executory interest is subject to the rule but the absolute power of alienation is not suspended since the church and B can join presently to convey an absolute fee. Similarly it would seem that the employer and his present labor force could at all times join in the termination of a pension trust and cause a complete disposition of the corpus.

[47] I SCOTT ON TRUSTS §62.10 (2d ed. 1956).

[48] SIMES AND SMITH, THE LAW OF FUTURE INTERESTS §1465 (1956); see also I SCOTT ON TRUSTS §62.10 (2d ed. 1956).

[49] GRISWOLD, SPENDTHRIFT TRUSTS §557 (2d ed. 1947) II SCOTT ON TRUSTS §156 (2d ed. 1956); 1A BOGART, TRUSTS AND TRUSTEES §224 (1951).

[50] CCH PENSION PLAN GUIDE ¶1118; A spendthrift restraint on the rights of employees under a pension plan does not disqualify the plan under the Internal Revenue Code. Rev. Rul. 56-432.

[51] *In re* Baxter, 104 F.2d 318 (6th Cir. 1939). *Cf.* TVA v. Kinzer, 142 F.2d 833 (1944). GRISWOLD, SPENDTHRIFT TRUSTS §112.1, §577 (2d ed. 1947).

[52] Note, *e.g.*, the currently pending Jenkins-Keough Bill, H.R. 9, 85th Congress, 1st Session, "Self-Employed Individuals' Retirement Act of 1957," which would extend tax benefits now enjoyed by participants in qualified plans to the self-employed through restricted retirement funds and non-assignable annuities.

[53] See GRISWOLD, SPENDTHRIFT TRUSTS §114.1. "Such payments are closely analogous to the situation where a person attempts to create a spendthrift trust for his own benefit. . . . [O]f course the answer is that people who take out in-

CONCLUSION

As the use of the trust device in pension funding rises, it becomes apparent that there is no convenient niche in the law of private arrangements in which to place it. Applying the restrictive rules of property to the pension trust illustrates an analytical problem with several facets. A tremendous wealth has suddenly been subjected to prudent man and legal list rules of investment, placing a conceivable strain on sources of venture capital and investment outlet.[54] The fiduciary relationship has been abused at shocking levels.[55] There have even been warnings that conservative vesting policies threaten the mobility of the nation's labor force.[56] Perhaps most intriguing are the predictions that we stand on the threshold of an era of devolution of wealth on a group basis in which a man's estate will be planned for him on his employer's IBM machine.[57]

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surance policies have a legislative spokesman in the insurance companies, while people who want to create spendthrift trusts for their own benefit do not."

[54] See, *e.g.*, DEARING, INDUSTRIAL PENSIONS 176 *et seq.*

[55] See, *e.g.*, FINAL REPORT OF SUBCOMMITTEE ON WELFARE AND PENSION FUNDS. S. Rep. No. 1734, 84 Cong., 2d Sess. (1956).

[56] NATIONAL PLANNING ASSOCIATION STAFF REPORT, SPECIAL REPORT No. 44 (1956).

[57] Lynn, *Legal and Economic Implications of the Emergence of Quasi-Public Wealth*, 65 YALE L.J. 786 (1956).