DELAWARE TAX TRAP OPENS DOOR TO HIGHER BASIS FOR TRUST ASSETS (AND AVOID GST TAX PROBLEMS WITH NONEXEMPT INDIRECT SKIP TRUSTS)

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Synopsis: *Income and capital gain rates (when combined with the new 3.8% Tax on Net Investment Income) have increased substantially. (For example, trust federal capital gain and dividend tax rates have increased 59% on taxable income over $12,150.) On the other hand, estate, gift, and generation-skipping transfer tax exemptions have also increased permanently, which, of course, is very good. There are different methods that might be available to increase basis of assets in an irrevocable trust to reduce taxable gain on sale of the assets in the future, depending on the facts applicable to the trust. For example, if a trust is a grantor trust as to the settlor of the trust for income tax purposes, then perhaps that person can buy back or otherwise swap assets tax-free with the trust so that at the settlor's death the former trust assets' bases are stepped up to fair market value. If that opportunity is not available, then another method may be springing the* ***Delaware Tax Trap****, which is the topic of this article. Also, there may be generation-skipping transfer tax problems for which only the Delaware Tax Trap offers a secure fix.*

The increased estate tax exemption can be used to reduce taxable income through "step up" in basis of trust assets by having the assets includable in the gross estate of an elderly person (a volunteer) who passes away with a substantial unused estate tax exemption. This is done by causing such a volunteer to be given a "power of appointment" over assets in a trust to distribute to the same beneficiary or beneficiaries who would have receive the trust assets anyway. If the volunteer exercises the power by appointing to another trust in which the beneficiary is given his or her own power of appointment in a manner to spring the Delaware Tax Trap, then the trust assets so appointed are includable in the gross estate of the volunteer. As a result of the inclusion, the bases in the appointed assets are stepped up to the fair market of those assets upon the volunteer's death. The Delaware Tax Trap is sprung when the state law "Rule Against Perpetuities" that limits the period of time that the beneficiary may exercise his or her power of appointment runs from the date of exercise of the power rather than the date of the creation of the original trust.

States have different Rules Against Perpetuities. All states permit a powerholder to spring the Delaware Tax Trap if the powerholder exercises a power of appointment to create a presently exercisable general power of appointment in the beneficiary, but only a handful of states permit it to be sprung without giving a beneficiary the immediate

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power to take the assets out of trust, thereby additionally permitting the assets to remain protected from the beneficiary's creditors. Methods may be available to give a volunteer a power of appointment when the trust agreement does not so authorize. There are methods to change the state law governing the trust to restrict the beneficiary from taking the assets, protect the trust assets from the beneficiary's creditors, and still spring the Trap. Additionally, in states that have adopted the Uniform Statutory Rule Against Perpetuities, it might be possible to spring the Trap by appointing to another trust that grants another a special power of appointment.

Analogous planning can be applied to avoid the Generation-Skipping Transfer Tax that may apply to distributions from Non-GST Exempt "Indirect Skip Trusts." Generation-Skipping Transfer Tax planning can be done through exercise of a power of appointment during the lifetime of a volunteering powerholder as well as at death.

Introduction and Choices.

Assets are retained in long term trusts for many good reasons. One is asset protection. Another is to avoid inclusion in taxable estates of one or more beneficiaries or generations (so called "generation-skipping" or "dynastic trusts"). The total value of such trusts is growing significantly and continuously. Long hold assets in these trusts are not run periodically through the estate tax wringer as would be the case if they were held individually, and the basis in those assets is not reset ("stepped up") to fair market value free of income tax. The long term consequence is for much greater taxable gain when these assets are sold. Also, the combined state and federal marginal income tax rates are now higher than at any time in the last twenty years. For trusts, it can be generally stated that the federal tax rate on capital gains is 59% higher in 2013 than 2012. The consequence is higher income tax liability.

A more pressing problem may be an irrevocable trust that is a nonexempt trust (a trust that has no GST Exemption allocated to it and which has a 1.0 Inclusion Ratio). Generally, distributions from such a trust to grandchildren (or other skip persons) will create a Generation-Skipping Transfer Tax ("GSTT") of 40% of the distribution.

There is a way to step up the basis of selected assets tax-free in certain of those trusts to reduce the income tax when the assets are sold. There is way to allocate GST Exemption to such trusts or change who is the transferor of those trust for GSTT purposes. It is a newly considered technique because it is founded on the high federal estate tax exemption made permanent this year. It generally requires that a trustee or another have a discretionary power to distribute or appoint assets from the trust. It is the author's belief that the most important persons who can identify the situations in which trusts could significantly benefit from basis step up will be the Certified Public Accountants and others who regularly deal with the taxation of the trusts and prepare the trust tax returns. Their insight and awareness will be the primary reason any of the techniques described in this article will occur.

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Outright appointment. One appointment method to step up basis is to appoint the assets directly to a not so wealthy elderly but loyal family member who then is trusted to bequest the property back into trust for the benefit of desired persons. This is not without some risk, both volitionally and creditor-wise. Grantor trust status is also lost.

Granting a general power, and with it some downside. Another method is to grant a general power of appointment to the selected individual that is exercisable upon death. If a trustee without a personal economic interest in trust trust so appoints, the Delaware Tax Trap is not implicated, as will be discussed below. The provision of a general power of appointment offers significantly simpler analysis and availability of procedure. However, there is the unavoidable legal consequence of theoretical risk of creditors of the selected general powerholder having potential claims against the assets the subject of the power, even if the consent of nonadverse parties is required to exercise the power,[1] if the power is only exercisable in a Will or otherwise upon death of the powerholder, whether or not the power is exercised.[2] Additionally, the exercise of the general power of appointment causes the trust to no longer remain a grantor trust for income tax purposes. The loss of grantor trust status prevents the tax free substitution of assets between the grantor and the trust. One consequence is the inability to engage in the technique described later in this article referred to as the "***Grantor trust assets shuffle worked in reverse***."

Delaware tax trap. The other method is to spring the Delaware Tax Trap, discussed at length in this writing. With each method, the plan is to intentionally cause selected assets of an irrevocable trust to become subject to the estate tax of a decedent whose taxable estate tax is otherwise under $5,000,000 or so, and whose estate could absorb the trust assets in his or her taxable estate without creating an estate tax liability. By including the asset in the taxable estate, tax-free step up in basis of selected assets could occur. The method is not available in all situations. There must be a power of appointment or trustee discretionary power over the assets desired to be stepped up, or the ability (through court action or otherwise) to establish one.

[1] A power to appoint to oneself, even if the consent of a nonadverse party is necessary, is a general power of appointment. Restatement of Property, Third, Section 17.3 Comment e and Illustration 6. The power of the trustee or trust protector to change a power into a general power does not make a power a general power except to the extent and when it is then a general power. Comment d.

[2] Restatement Third of Property (Donative Transfers), Section 22.3; Restatement Third of Trusts, Section 56. This reflects a change of the American Law Institute from its prior position enunciated in Restatement of Property 337 and Restatement Property Second, 13.2, which required exercise of a general power to permit creditors to reach the subject property. The holder of presently exercisable power is treated as the owner of the subject assets for such purposes. Section 22.3(a). A creditor of the estate of a decedent who possessed to power exercisable in his Will may reach the assets upon the death of the powerholder. Section 22.3(b).

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Overview to Stepping Up Basis.

The estate tax exemption is in 2014 at an unprecedented $5,000,000 (inflation adjusted to $5,340,000 in 2014),[3] which is permanent, and has never been so high. It is also annually adjusted upward for inflation. Opportunity exists now that never existed before. That opportunity, when available, is to gratuitously cause low basis property in a trust to be included in the gross estate of a volunteer who is less than very wealthy. If the property is included in the volunteer's federal gross estate, then generally the basis the trust has in the property is stepped up to fair market value.[4]

For example, if a person (the volunteer) has a taxable estate of $2,000,000, and has or can be given a special power of appointment over some or all of the trust property, his or her gross estate could soak up over $3,000,000 in additional assets by causing trust property to be treated as part of the estate pursuant to Code Section 2041(a)(3) (the "Delaware Tax Trap") without incurring an estate tax liability. Alternatively, such a person could appoint during lifetime (using her gift tax exemption, also $5,000,000, inflation adjusted) or at death and be deemed the transferor to allocate the necessary portion of his or her GST Exemption (the same amount as the estate tax exemption described above).

Some stated have additional estate, inheritance, and gift taxes with differing exemptions and rates. Planning for the Delaware Tax Trap in those jurisdictions requires more analysis.

The plan to apply the Delaware Tax Trap to step up basis must be in place before the death of the volunteer. The volunteer would be ensconced in the position of a powerholder, if not already one, through the exercise by present powerholder of a special power of appointment by creating another special power of appointment for the volunteer. The first exercise to give the volunteer the power would be exercised so as

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[3] Section 2010(c)(3);Rev. Proc. 2013-35, 2013-47 IRB 537.

[4] Section 1014(b)(9); Reg. 1.1014-1(b)(1); CCA 200937028. If the property appointed pursuant to the exercise is a tax partnership interest, then the death of the powerholder, the distribution of the interest in further trust, or both, should implicate Sections 743 and 754. Sections 742, 743 and 761(e)(2)(deeming distributions as exchanges); Reg 1.742-1; Ltr. Rul. 200019029. The legislative history pertaining to Section 761(e) references distributions by corporations and partnerships, although the code section refers to distributions without any limitation. Cong. Conference Committee Report to P.L. 98-369, Section 75. See also Rev. Rul. 77-402, 1977-2 CB 222, and Rev. Rul. 79-84, 1979-1 CB 223 (tying Section 754 to change in grantor trust status) and CCA 200923024 (not so tying). Rev. Rul. 72-352, 1972-2 C.B. 395 (partnership year closes with respect to the transferor trust). Section 2041(a)(3) (the Delaware Tax Trap) applies in the same manner as Section 2044 (QTIP trust inclusion), so the entitlement to Section 754 treatment should be the same as was applicable to a transfer from a QTIP trust upon death of the spouse in Ltr. Rul. 200019029. Section 1014(b)(10) (enacted in the Technical Corrections Act of 1982 (H.R. 6056, P.L. 97-448, providing for corrections to ERTA, P.L. 97-34), Section 104(a)(1)(A)) "*clarifies* that qualified terminable interest property ('QTIP property') … is eligible for a 'step-up' in basis." (Emphasis added.) S. Rpt. 97-592 at Part II.D.1; H. Rpt. 97-794. The QTIP trust property is treated as is provided for other assets described in Section 1014(b)(9).

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not to spring the Delaware Tax Trap, but the second exercise by the volunteer would spring the trap if the volunteer so provides in the exercise.

The ability to elect or not elect to spring the trap with respect to a particular trust is not generally dependent in which of the United States the trust is administered or the law of the state that governs the Trust. However some states (Arizona is one such state and will be a reference in this discussion) offer a greater protection against creditors of beneficiaries of the trust and the option to restrict the beneficiaries' control of the assets of the trust, and still obtain the step up in basis.

Many joint revocable living trusts of husbands and wives have matured into A-B Trusts (Decedent's (a/k/a Bypass) Trust – Survivor's Trust) upon the first spouse's death. Typically the deceased spouse's share of the estate was intended to be available to the surviving spouse but designed not to be includable in his or her federal gross estate. When the surviving spouse has an exemption now greater than the combined value of the A-B Trust as a whole, and if the basis that the Bypass Trust has in its assets is less than fair market value of the assets, it is a shame that something cannot be done to include it in the surviving spouse's estate for federal estate tax purposes. The springing of the Delaware Tax Trap provides a remedy. When available it can be used to cause the step up in the basis of assets held in an irrevocable trust through exercise of the special power of appointment. The springing of the trap can be utilized in other irrevocable trusts (not just Bypass Trusts) so long as a person has a special power of appointment exercisable at his or her death. There are many aging long term irrevocable trusts out there with assets having many billions of dollars of difference between their respective fair market value and basis.

The technique to spring the Trap is discussed at length below.

Many trusts were created to be available to a spouse or children and other descendants, but designed not to be subject to estate tax when such persons die. That may prove costly if the assets in the trust had increased in value or had been depreciated, depleted, or otherwise expensed and are now worth much more than the basis the trust has in the property. It was generally just accepted that the basis could not be increased without paying the toll in the form of state and federal income tax on the inherent gain. That was the trade off to achieve future avoidance of federal estate tax, formerly at a rate as high as 55%, but which is now 40%.

<u>Now income tax rates can exceed estate tax rates</u>. Presently, lost step up in basis may cost about 28.8% in many circumstances (20% federal capital gain rate and assumed state income tax rate of 5%, plus the Tax on Net Investment Income of 3.8% (the "NIIT") of the portion of the property attributable to the appreciation. In other circumstances ordinary income tax rates may apply (e.g., deferred tax on IRAs and qualified plans interests, depreciation subject to IRC Sections 1245 and 1250 recapture). Therefore presently the income tax rate may be as 48.4% (39.6% federal rate and assumed state income tax rate of 5%, plus the NIIT of 3.8%). The federal

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estate tax rate is now 40%.[5] But that is applied to <u>all</u> property subjected to such tax (both represented by basis and appreciation as well).

As was discussed, the federal estate tax exemption, the generation-skipping transfer tax exemption, and the gift tax exemption have been permanently increased to $5,340,000 (and will be further increased for inflation). The increases in exemptions and the decrease in the estate tax rate have made the estate tax less of a concern. Correspondingly, the income tax rates have significantly increased. Therefore planning to avoid or reduce income tax is increased in importance, both in absolute terms and relative to transfer taxes. The importance of tax basis of assets is significantly increased. Planning to increase basis now has greater value.

CRITICAL POINT: Trusts that are Candidates.

The trusts that are ripe for the springing of the Delaware Tax Trap procedure would have certain characteristics:

1. Irrevocable trusts which (i) assets have value materially in excess of basis, or (ii) have a GST Inclusion Ratio of 1.0, or, in any event, significantly greater than 0.0 (sometimes called Non-GST Exempt Trusts) that may or will be distributed to skip persons,

2. Trusts that are not includable in anyone's estate, and

3. Trusts in which either: (i) a person has a special power of appointment or (ii) the Trustee has discretion to make distributions (the broader the power to appoint to others, the better).

4. Trusts that are either not grantor trusts for income tax purposes, or if they are grantor trusts: (i) the grantor cannot or will not exchange other assets for a low basis asset in the trust for which it is desired to step up basis, (ii) the grantor is likely to live for quite some time and basis step in the near term is important, or (iii) if the problem is lack of GST Exemption allocation the grantor cannot or will not allocate sufficient GST Exemption.

> **<u>Example:</u>** Assume Joe and Mary set up a standard A-B trust arrangement in 2001 when the estate tax exemption was $1,000,000 and Joe dies in 2008, and their total net estate then is $4,000,000, equally owned, whether or not community property. All of Joe's property is

[5] If the decedent died domiciled in Washington State and not in a state that has no estate tax, the additional marginal state estate tax rate could be 20% higher. State death taxes are deducted in computing the federal estate tax. So the effective highest Washington marginal rate may be 12% today, if the estate is subject to federal estate tax as well, and with the current 40% federal rate yields a 52% marginal rate.

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allocated to the Bypass Trust (a/k/a the Credit Shelter Trust or the Decedent's Trust). And all of Mary's property ends up in the Survivor's Trust. Mary is not doing well in 2013. The Bypass Trust is now worth $4,000,000 - and Mary's estate is $1,000,000, because it had the house and she has spent down the Survivor's Trust and did not deplete the Bypass Trust. Much of the Bypass Trust has appreciated assets – value materially in excess of its basis. The survivor, Mary, has a general power of appointment over the assets in the Survivor's Trust, but she also has a special power to appoint the assets of the Bypass Trust to anyone but her, her creditors, and the creditors of either. The design was to give maximum flexibility, but avoid inclusion of the Bypass Trust in the estate of Mary. But it turns out that the A-B structure is not now necessary to avoid estate taxation. The problem now is that the $2,000,000 in appreciation in the bypass trust assets will not be stepped up to fair market value on Mary's death as it would be if the A-B Trust arrangement had been forgone. If it could be stepped up on Mary's death then taxable gain of $2,000,000 could be avoided when the children sell the assets after Mary's death. Assuming a 30% net marginal tax rate, the tax savings would be $600,000 in after tax dollars. There may be a way to achieve this savings.

General Discussion.

There is opportunity to use the Delaware Tax Trap to select the assets of the Bypass Trust to be subject to estate tax upon the death of Mary to the extent that there is no tax, so as to permit the basis of the selected estate to be reset to fair market value to reduce future taxable gain or increased depreciation write-offs. However, the opportunity can only be exploited if the spouse, or child beneficiary, or even a poor relative who is not an initial beneficiary of the trust has a right in the trust agreement (or as decanted) to change the beneficiaries of the trust or the method a beneficiary enjoys the property held by the trust.

Joint Trusts of Husband and Wife. The typical trust that most will view as a candidate for step up in basis, if it could be had, is the Bypass Trust (a/k/a Credit Shelter Trust or Decedent's Trust).

Joint revocable living trusts are commonly drafted throughout the United States for married couples. Often the trust document provides that all or a portion of the assets of the first of the couple to pass away is not transferred to the survivor, but is instead held in a trust that is available to the survivor, but is not subject to estate tax when the surviving spouse passes away. This is true even if the surviving spouse has the power to change the beneficiaries if the power is a type called a "special power of appointment."

Such a trust was intended to shelter funds from estate tax of the surviving spouse when the Estate Tax Exemption was $1,000,000 or even when it was higher.

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But with the current Federal Estate Tax Exemption at $5,340,000, subject to inflation adjustment, all or a significant portion of the Bypass Trust now may not need to be sheltered from the Estate Tax. For example, if the assets owned by the survivor total $2,000,000, and the amount in the Bypass Trust also totals $2,000,000, then even if the assets were all owned by the survivor, there would still be no Estate Tax upon the survivor's death since the total estate would be $4,000,000 and the Estate Tax Exemption is well over that.

Why does this matter? Normally, when a person dies, the tax basis of assets he or she holds is "stepped up" to the fair market value of the assets at the date of death.

> Example: Assume a person bought an investment property, such as stock or land, for $100,000. Assume at death of the person the property is then worth $1,000,000. If the property were sold when the person was living then there would be taxable gain of $900,000. On the other hand, if the property were sold by the estate of the person immediately after death, then there would be no taxable gain – because the basis increased from $100,000 to $1,000,000. Even if the asset is not sold after death, there may be a great advantage in that basis step up if the asset is, for example, a building or rental property. Depreciation deductions can be reset to reflect the much higher basis resulting from high valuation of the improvement, when there may have been very little or no basis left to depreciate before the death.

Bypass Trusts. However, if the property was funded into the Bypass Trust of the deceased spouse so as not to be included in the federal gross estate of the surviving spouse, then no step up will occur upon the death of the surviving spouse. This is the result even if it turns out that there would have been no Estate Tax if there had been no Bypass Trust and the assets had been entirely owned by the survivor.

Generation-Skipping Trusts. The same low basis problem exists with so-called "dynasty trusts" or "generation-skipping trusts" that were set up by parents for their children designed to be available to them, but designed to both protect the assets from the creditors of the children and also to avoid being estate taxed on their death. The assets in those trusts may have value today far greater than the basis that the trust has in them. Because the assets are not included in the child's estate at his or her death, the basis of those assets is not increased to fair market value at the child's death. This lost opportunity is true even if the child's estate is much less than federal estate exemption today and it would be an advantage to have the asset included in the child's estate for the tax free step up in basis.

Technique to be Used: Delaware Tax Trap: Overview.

If assets in the Bypass Trust for a spouse or generation-skipping trust for a child are appointed at that person's death to another trust for others, then the Federal Estate Tax Code can be applied to cause the basis in the selected assets to be "stepped up" to

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fair market value. Many trusts that do not have such provisions can be successfully modified to permit this application. One important point to remember: The step up in basis technique cannot be applied AFTER the death of the spouse or child. It must be set up while the party is living. Another important point: Elderly family members who expect to have unused federal estate tax exemptions may be selected and their otherwise-unused exemptions aggregated in arrangements that cause more assets to be included in their gross estates and thus receive basis step up.

How can one get a step up in basis of assets in irrevocable generation-skipping trusts that will not realize a step up in basis for a long time? The answer is: Find some way to include those assets in the taxable estate of someone. Not just anyone - someone elderly or in poor health whose federal taxable estate will be able to absorb inclusion of the selected trust assets and not incur a federal estate tax or state estate or inheritance tax. But up until 2001 that ability was limited to less than $1,000,000, then slowly ramping up to $3,500,000, and is $5,340,000 in 2014. So now, many more decedents are expected to have taxable estates way under the current exemption. Most spousal Bypass Trusts created when the first spouse passed away years ago do not need to be in place today to save estate taxes when the survivor passes away. The surviving spouse could own the property in that trust and still not incur an estate tax. If property in the Bypass Trust, or even just specific property in the Bypass Trust, has a fair market value significantly greater than the trust's basis in the assets then it would be great if that asset could become includable in the surviving spouse's estate to obtain that step up in basis pursuant to Code Section 1014(b). If only it could.

There is at least one way. It is by springing the "Delaware Tax Trap."

Understanding the Delaware Tax Trap.

Few people, even among the estate planning community, understand it. It is generally thought of as something just plain bad. The Delaware Tax Trap is the nickname for Code Section 2041(a)(3) [when it would cause inclusion in the federal gross estate if a power is exercised to create another power at death] and its little brother, Code Section 2514(d) [when it would create a taxable gift if a power is exercised to create another power during life].

In a way the Delaware Tax Trap is like the income tax grantor trust rules of Code Section 671, et.seq., when a creator of a trust may remain taxed on its income even though she cannot benefit from it. The Treasury Department desired the grantor trust tax legislation to prevent abuse by perceived aggressive taxpayers sloughing off taxable income to their then low-taxed children. Later, the next generation of tax planners embraced the grantor trust rules to obtain beneficial tax results. It is the tax equivalence of turning lemons into lemonade. This is now the situation with respect to the Delaware Tax Trap.

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Code Section 2041(a)(3) provides that a decedent's gross estate includes:

> **Creation of another power in certain cases.**
> To the extent of any property with respect to which the decedent—
>
> (A) by will, or
>
> (B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037,
>
> exercises a power of appointment created after October 21, 1942, **by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power**.

Code Section 2041(a)(3) will cause certain exercises of a power of appointment by a powerholder to result in inclusion of assets in irrevocable trusts that will not be in the gross estate of a powerholder to become includable in the estate. A comparable Code Section 2514(d) causes an intervivos exercise of similar effect to be treated as a gift by the powerholder.[6]

These sections are called the Delaware Tax Trap because when the sections were enacted Delaware's Rule Against Perpetuities Statute ("RAP") was different than other states in an important regard. Delaware's RAP allowed a person having a special power of appointment to appoint property to another trust and give another a power to appoint in further trust such that the property did not have to vest in someone's absolute ownership within the RAP period beginning when the trust first became irrevocable. Mechanically this was accomplished because then Delaware's RAP by default caused the RAP period to begin again upon the exercise of the power, on the "creation" of the the nonvested interest or new power. Congress perceived this as abusive because it permitted avoidance of federal estate taxes by floating the ownership for potentially hundreds of years. It was a tax "trap" because someone could exercise a power over a Delaware trust and thereby incur and estate or gift tax liability without any intent to do

[6] The lifetime springing of the Delaware Tax Trap is not without the potential for great benefit, even though there is no step up in basis upon exercise. The exercising powerholder who springs the trap becomes the new transferor of the appointed assets for Gift Tax and GSTT purposes, and can allocate his or her unused GST Exemption to the trust. Subsequent distributions by the trust that would have been taxable distributions to skip persons that would incur a 40% GSTT are now tested to see if those persons are skip persons of the powerholder. Even if the beneficiaries remain skip persons as to the powerholder, if the powerholder allocates a sufficient amount if his remaining portion of his 2014 $5,340,000 GST Exemption, the GST Exemption allocation may make the Inclusion Ratio of the trust 0.0, thereby eliminating the potential for the GSTT.

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so. So if there was a resetting of the RAP clock on the exercise of the first power creating the new power or nonvested interest, the person exercising the power effective on his death, then the property the subject of the exercise would be included in the estate of the powerholder so exercising. One consequence is that the bases of most appointed assets are then stepped up to their fair market value that will, among other benefits, reduce subsequent gain on sale and permit greater depreciation and other deductions.

Another consequence is that if assets are included in the gross estate of a person for any reason, then that decedent is the transferor for GSTT purposes and the prior GSTT Inclusion Ratio is lost. That is not always necessarily a bad thing, because thereafter the beneficiaries are skip persons only if they are two or more generations down from the decedent, and are otherwise nonskip persons. Also the powerholder may have more than enough unused GST Exemption to "re-Exempt" the trust with a 0.0 Inclusion Ratio, obviating any concerns.

Exercise of Special Power of Appointment to create General Power of Appointment ("GPA"). (Half a loaf could be better than none.)

To spring the Delaware Tax Trap, it is necessary to exercise a special power of appointment to create another power of appointment. Is there a preferable kind of power of appointment to create? There are two fundamental types of powers of appointment that can be granted to spring the trap to step up trust assets bases: a general power of appointment ("GPA") and a special power of appointment ("SPA"). A GPA permits the powerholder to appoint the trust assets to any one or more persons, including the powerholder. An SPA permits the powerholder to appoint to any one or more persons, outright or in trust, but not directly or indirectly to or for the powerholder. The difference is important. For reasons discussed below, the preferable type is an SPA. It is generally preferable for at least three reasons: (1) it continues to permit protection of trust property from the creditors of all beneficiaries, (2) trust property does not have to be made available for the immediate taking by any beneficiary or other person, and (3) it will not require the trust assets to be included in new powerholder's estate for estate tax purposes or treated as a gift if appointed during his lifetime in whole or in part to others.

Unfortunately, in almost all states there is no choice, and the Delaware Tax Trap can only be sprung by creation of a presently exercisable GPA. Under the common law and the law of most states the creation date for purposes of measuring the RAP period when an SPA is exercised creating another power of appointment remains the date of funding of the irrevocable trust. So, the exercise creating an SPA would not spring the Delaware Tax Trap, and the assets would not be included in the powerholder's estate and the appointed asset bases would not be stepped up. There is an exception when the new power created is a power given to someone who can immediately take the assets out of the trust, a <u>presently exercisable GPA.</u> In that case, under the common law and in all states, the date of creation of the new GPA is date of <u>exercise</u> of the initial

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power creating the new GPA.[7] Under Kentucky or Wisconsin law, the creation of a general power of appointment exercisable at death will also start a new perpetuities period and therefore spring the Trap.[8] Consequently, the appointed asset will be includable in the gross estate of the powerholder potentially subject to federal estate tax, and the basis of the asset will be stepped up. However, when the only means to spring the Trap is to create a presently exercisable GPA, the price paid for basis step up is exposure of the assets to the sole control of the person granted the power, and to his creditors, as well as inclusion in his estate upon his death for estate tax purposes.[9]

Exercise of Special Power of Appointment to create another Special Power of Appointment ("SPA"). (The best of all worlds.)

Fortunately, in at least one state, the Delaware Tax Trap can be sprung and the bases of appointed assets can be stepped up when the new power created is an SPA. In other words, the creation date of the new special power of appointment is the date of the exercise of the power creating the power. Arizona is such a state. Under the law of Arizona the Trap can be sprung by exercising the initial SPA to create a second SPA, and the exercising powerholder can provide that the date commencing the RAP period for the second SPA is the date of exercise of the first SPA, i.e., the creation date of the second SPA. As stated above, this is neither the common law[10] nor the rule in almost all states. (Just so we don't forget, at common law the creation date for purposes of measuring the permissible duration of an SPA created from exercise of the original SPA is the date of the creation of the original trust, preventing the springing of the Trap.) Arizona is one state in which one can decide whether to spring the Trap by exercise of an SPA and do it by either giving another person an SPA or a GPA. Other states that have abolished their RAP might (or might not) permit the springing of the Trap (e.g., Delaware, Pennsylvania, and Rhode Island). Virginia's statute also might so permit.[11]

Some states have no RAP but have an alternate rule against suspension of absolute ownership or the power of alienation (e.g., Wisconsin, Kentucky, and Idaho, among others). In such states, a powerholder will be foreclosed from springing the Trap if the applicable rule does not permit the exercise of a power to suspend the power of alienation for a period measured from other than the date of the creation of the first

[7] Comment c. to Restatement of Property, Section 373; Restatement of Property, Section 391; Comment d., and Reporter's Note 5, to Restatement (Second) of Property (Donative Transfers), Section 1.2.

[8] Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law* (2012), http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. This tome is a handy resource, and useful for this article.

[9] This is a second inclusion in an estate or transfer tax base, and would not have to occur as a consequence to springing the trap if a new SPA could have been created in a state where date of creation of the new SPA for RAP purpose is the date of exercise of the first power.

[10] Restatement of Property, Section 392; Comment d., and its Illustration 11, to Restatement (Second) of Property (Donative Transfers), Section 1.2.

[11] Va. Code 55-12.4(a)(8).

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power.[12] Idaho also comes within this category, unless there is an unlimited power to terminate the trust "in one or more persons in being."[13]

So in states where the Trap can be sprung with either a GPA or an SPA, what is better? The answer is almost always: appoint to create another SPA, not a GPA. The appointment of an unvested interest with an SPA can avoid the vesting of the trust estate for another generation or more, both for asset protection from creditors of the beneficiary and, if desired, from the beneficiary's control and to avoid estate tax inclusion in the beneficiary's taxable estate. Having said that, the creation of an SPA means that, in addition to the powerholder's having sufficient estate tax exemption, there must be allocation of sufficient GST Exemption by the powerholder's estate so distributions to skip persons from that new trust do not trigger the GSTT. Obviously, if there is no GST Exemption available, then an unvested interest with SPA should be avoided if a skip person (of the powerholder, not the settlor) could receive distributions before the Delaware Tax Trap is sprung by a nonskip person. Even if the powerholder has no GST Exemption, skip persons of the trust after exercise of the power are determined from the powerholder's generation and not the settlor's generation.

The exercise should be able to be made in the form of a formula clause to exactly soak up the remaining Estate Tax Exemption (or GST Exemption, if desired) of the powerholder, like a marital deduction clause or charitable deduction clause. The exercise could be to appoint specific property having low basis in further trust with an SPA. Only then would the property be included in the estate of the powerholder in order to achieve basis step up. If a formula clause is used without more, it is possible the IRS might assert that the specific property selected by the trustee was not the property that is includable in the gross estate, but that a proration of all assets is what is includable. Therefore, the subsequent specific transfer could be a post-transfer taxable exchange, subject to grantor trust protection, if available.

See Specimen Exercise Of Power Of Appointment at the end of this outline.

What if a General Power of Appointment at Death of Powerholder is what you have?

This is not an issue, because the trust estate will be included in the gross estate of the powerholder regardless of whether or how the power is exercised.

Example: Arizona's Rule Against Perpetuities.

As stated above, a handful of states authorize a powerholder to exercise an SPA to create another SPA to step up basis in trust assets. Arizona has the same creation

[12] See Murphy v. Comm'r, 71 TC 671, 681 (1971), in which the Tax Court found then effective Wisconsin law prevented the springing of the Trap when an SPA was exercised to create another SPA. The relevant statute appears to remain unchanged. Wisc. Stat. Sections 700.16(1)(a) and (c).

[13] Idaho Code Section 55-111A.

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date rule as Delaware's RAP formerly had for irrevocable trusts, and with respect to creation of new powers of appointment resulting from exercises of powers under pre-1995 trusts.[14]

Arizona's creation date rule. Arizona's operative statute expressly permits the powerholder to determine whether to spring the Trap when exercising a special power of appointment creating another special power of appointment. There is a decent argument that Delaware's 2000 changes in its RAP by adding a new Section 504 in Title 25, Delaware Code does nothing to prevent the Delaware Tax Trap from to applying on every exercise of any power of appointment of a trust governed under Delaware law. This is because in the Delaware RAP there is no limitation on the length of time interests in property other than realty can remain unvested or powers to appoint such exercisable. Therefore, even though the creation date of a second power over a GST exempt trust is deemed (pursuant to Section 504) to be the date the first power arose, all subsequent powers of appointment created are validly exercisable under "applicable local law" for periods that can be determined "without regard to the date of the creation of the first power," since they are always valid, regardless of when created.[15]

ARS Section 14-2902(A) provides: "Except as provided in subsections B and C of this section and section 14-2905, subsection C, the time of creation of a nonvested property interest or a power of appointment is determined under general principles of property law." ARS Section 14-2905(A) provides: "Except as otherwise provided, this *article* applies to a nonvested property interest or a power of appointment that is created on or after December 31, 1994." (Emphasis added.) Together ARS Section 14-2902(A) and ARS Section 14-2905(C) have the effect of applying the Delaware "exercise is creation date" rule to post-1994 trusts. Furthermore, those provisions also have the

[14] Both the Model Uniform Statutory Rule Against Perpetuities ("USRAP," now Part 9, Subpart 1 of the Uniform Probate Code, which codification numbering is used herein) Section 2-905(a) and ARS Section 14-2901(C) cause application of the USRAP statutory regime to powers created after the effective date of the USRAP. Arizona's modified USRAP ("AZRAP") was changed as part of Arizona's 2008 enactment of the Arizona Trust Code (HB 2806) to provide that date of exercise of a special power under a trust to create another power became the creation date of the new power for all purposes of AZRAP, and not just to apply AZRAP to post-1994 trusts. The result was to create the Delaware Tax Trap opportunity in Arizona for all such exercises after 1994, regardless of when the trust became irrevocable.

[15] This issue was pointed out in an excellent discussion of the Delaware Tax Trap. Stephen E. Greer, The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities, 28 EST. PLAN. 68 at 74 (2001). An in depth article followed in which the author concluded that the trap is always sprung in no RAP states upon creation of another interest or power. James P. Spica, *A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute is Too Clever by Half (of Infinity)*, 43 Real Property, Trust and Estate Law Journal 673 (Winter 2009). See Topic below: "Designing Future Irrevocable Trust Agreements to Permit Basis Step Up" for a possible solution. But one commentator posits the opposite conclusion than Spica: the Delaware Tax Trap statutory language requires that the appointment create another power of appointment that can be exercised to validly "postpone" the vesting date, which literally cannot be done under the Delaware RAP because there is no limitation initially. Jerold I. Horn, Memorandum dated May 21, 2011, Limitation of Duration, Savings Clauses, Exercises of Powers of Appointment, and the Delaware Tax Trap, at 23, expanded from Chapter 13 of Flexible Trusts and Estates for Uncertain Times, 4th Edition (ALI-ABA 2010).

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effect of applying the Delaware "exercise is creation date" rule to exercises of pre-1995 trust powers creating new powers.

In addition, the Arizona decanting statute, ARS Section 14-10819, permits modification of trusts to have a different RAP than the original trust so long as the recipient trust "[d]oes not violate the limitations on validity under sections 14-2901 and 14-2905." There is no mention of any requirement or limitation upon decanting that would require the recipient trust to comply with the pre-1994 Arizona rule against perpetuities, which was the common law rule, or the pre-2009 Arizona rule against perpetuities. Arizona also has a unique set of provisions (ARS Sections 14-2901(A)(3), (B)(3), and (C)(3)) that are relevant only to trusts initially governed under Arizona law, and for the reasons below should not affect the springing of the Trap. The provisions cause the Arizona RAP periods not to apply to an interest under a trust (or to a power with respect to that interest), if the interest could be terminated at one or more times after its creation by persons living at the creation, and the trustee has the expressed or implied power to sell trust assets.

These provisions should not apply solely because the trust was a typical revocable living trust. This is because ARS Section 14-2905(C) (from USRAP Section 2-905(a)) by its terms prevents a trust from being deemed created until the trust is no longer revocable by the settlor. Most trusts do not both grant persons unfettered powers to terminate a trust interest (or an interest subject to a power) and mandate that persons be living when the trust is created, which are conditions to the application of the provisions.

Additionally, many trust agreements also set forth the RAP rule applicable when more than one regime is available under the RAP statutes, and that selection forecloses application of these provisions. (At least that seems to be a good idea in Arizona.) If deemed prudent, when appointing under either an existing power or a decanting statute, the exercise creating the appointment can confirm that the Arizona RAP period is applicable to limit duration of the successive power. Finally, under the most prevalent belief, the absence of a RAP period will cause the creation of a second power through exercise of a first power to spring the Trap (but see footnote15).

Statutory language. To really see how the Arizona statutory framework operates, ARS Section 14-2901, Section 14-2902, and Section 14-2905 have to be read together:

> **ARS Sec. 14-2901. Nonvested property interest; general power of appointment; validity; exception**
>
> ///
>
> **C. A nongeneral power of appointment or a general testamentary power of appointment is invalid unless at least one of the following is true:**

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1. At the time the power is created it is certain to be irrevocably exercised or otherwise to terminate not later than twenty-one years after the death of a person who is then alive.

2. The power is irrevocably exercised or otherwise terminates within five hundred years after its creation.

3. The power is with respect to an interest under a trust whose trustee has the expressed or implied power to sell the trust assets and at one or more times after the creation of the interest one or more persons who are living when the trust is created have an unlimited power to terminate the interest.

///

ARS 14-2902. <u>Nonvested property interest or power of appointment; creation</u>

A. Except as provided in subsections B and C of this section and section 14-2905, subsection C,[16] the time of creation of a nonvested property interest or a power of appointment is determined under general principles of property law.

///

ARS Sec. 14-2905. Nonvested property interest or power of appointment; creation; effective date; judicial reformation

A. Except as otherwise provided, this article applies to a nonvested property interest or a power of appointment that is created on or after December 31, 1994.

B. If a nonvested property interest or a power of appointment is determined in a judicial proceeding to violate this state's rule against perpetuities as that rule existed when the nonvested property interest or power of appointment was created, a court on the petition of an interested person may reform the disposition in the manner that most closely approximates the transferor's manifested plan of distribution and that is within the limits of the requirements of section 14-2901.

C. For the purposes of this article, if the person who exercises a power of appointment so provides in the exercise, a nonvested

[16] Amended by Laws 2013, Ch. 112, Sec. 1, effective September 13, 2013. Formerly referenced subsection A of ARS Section 14-2905.

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property interest or a power of appointment created by the exercise of a power of appointment is created when the power is irrevocably exercised or when a revocable exercise becomes irrevocable.[17]

Under Arizona's RAP, specifically ARS Section 14-2905(C), when read with either ARS Section 2901(B) or (C), the exercise of a special power of appointment to either: (i) create either a general or special power of appointment or (ii) postpone vesting (e.g., creating a series of life estates, generation to generation), can reset the RAP period, thereby Springing the Trap. This can be easily avoided by either not referencing ARS Section 14-2905(C) or specifying in the exercise that the RAP period will be measured from the date of the creation of the first power.[18]

Surprise Trap When Appointing to Existing Trust – Additional Method to Create SPA and Still Spring the Trap in Every USRAP State.

USRAP Section 2-902(c) [ARS Section 14-2902(C)] provides another method to spring the Trap. This provision permits any holder of an SPA in a typical USRAP state to cause inclusion of trust property in his or her gross estate for federal estate tax purposes:

> C. A nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or any other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created.

The purpose of Subsection C is to relieve the trustee of the recipient trust from the duty to keep separate record of the property subject to different RAP periods when the power of appointment over the property in the recipient trust has a different creation date than the creation date of the power exercised over the transferor trust.[19] It also provides an opportunity to truly become a Trap for the unwary. Someone desiring to spring the Trap can create and then fund an irrevocable trust T2 that grants person A an SPA. Thereafter, the powerholder of another irrevocable trust T1 (who may be the settlor of the new trust) appoints trust property to the newly settled trust T2 to the extent so empowered. The statute causes the T2 SPA to retain the T2 SPA creation date even if the property appointed from T1 to a new Trust T3 having identical terms as T2 would retain the T1 creation date instead of the T2 creation date. This by definition will spring the Trap since the permissible vesting period is determined without regard to the

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[17] Amended by Laws 2013, Ch. 112, Sec.2, effective September 13, 2013. Formerly, ARS Section 14-2905(C) read as follows:

> For purposes of this article, a nonvested property interest or a power of appointment created by the exercise of a power of appointment is created when the power is irrevocably exercised or when a revocable exercise becomes irrevocable.

[18] PLR 200124006; PLR 200219034; PLR 200243048.

[19] Comment to subsection(c) of USRAP Section 2-902: "This avoids an administrative difficulty that can arise at common law when subsequent transfers are made to an existing irrevocable inter vivos trust."

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vesting period applicable to the power exercised. This opportunity/trap may arise regardless of state law, so long as the state has enacted USRAP with its Section 2-902 unchanged.

Example:

> Person A desires to spring the Delaware Tax Trap as to a $1,000,000 trust (T1). Person A has an SPA to appoint the T1 trust property to anyone but himself, his estate or the creditors of either. A contributes $10,000 to a new trust (T2), in which he has a special power of appointment to anyone but himself, his estate or the creditors of either. A then appoints the property of T1 to T2. Pursuant to IRC Section 2514(d), if A appoints while living, or IRC Section 2041(a)(3), if A appoints T1 property effective upon his death, A has made either a taxable gift or has cause the $1,000,000 of T1 property to be includable in his gross estate for federal estate tax purposes. If the appointment is effective upon death, then the basis of T1 property is stepped up to the fair market value of the property, whether or not a federal estate tax is due.[20]

Powerholder with an Interest.

An important fact to note is that the powerholder holding a personal nonfiduciary power who can attract estate inclusion or incur a taxable gift initially might not have a connection with, right in, power over, or significant beneficial interest in the trust other than the power to appoint into another trust.[21]

To ameliorate any concern that a naked powerholder cannot spring the Trap, a person who is granted an SPA could, if possible be, or be made, a beneficiary of the trust to some extent. A few states permit a trust to be decanted to grant one not already a beneficiary a beneficial interest in the trust.[22] Also, the Uniform Trust Code may offer a remedy. (See discussion "**What if the Trust does not Qualify for Decanting?"** below.)

[20] From 1990 comment regarding subsection (c) to pre-UPC USRAP Section 2: "Example (5) -- Series of Transfers Case. In Year One, G created an irrevocable inter vivos trust, funding it with $20,000 cash. In Year Five, when the value of the investments in which the original $20,000 contribution was placed had risen to a value of $30,000, G added $10,000 cash to the trust. G died in Year Ten. G's will poured the residuary of his estate into the trust. G's residuary estate consisted of Blackacre (worth $20,000) and securities (worth $80,000). At G's death, the value of the investments in which the original $20,000 contribution and the subsequent $10,000 contribution were placed had risen to a value of $50,000.
"Were it not for subsection (c), the permissible vesting period under the Statutory Rule would be marked off from three different times: Year One, Year Five, and Year Ten. The effect of subsection (c) is that the permissible vesting period under the Statutory Rule starts running only once -- in Year One -- with respect to the entire trust."

[21] However, *see* S. Rep't 382, 82d Cong., 1st Sess., 1951 U.S. Code Cong. & Ad. Serv., Vol. 2 Legislative History, 1535, discussing trustee discretionary powers as not being powers of appointment for purposes of the Trap.

[22] SDCL Section 55-2-15 (South Dakota).

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What if there is no Special Power of Appointment?: Decant.

If there is no SPA held by anyone in a low basis high value trust or in a 1.0 Inclusion Ratio trust that will eventually distribute to skip persons, then how can a Delaware Tax Trap be sprung to do one or more of (i) step up basis in selected trust assets, (ii) bless a trust with GST Exemption, or (iii) otherwise mitigate a GST Tax? Answer: Decant – unless not permitted.

For instance, in Arizona, an irrevocable trust can be decanted by the trustee **if the trustee has the discretion under its terms to make distributions**. See ARS Section 14-10819 at the end of this Article. If the trust may be decanted, the trustee can now restate the trust so long as the conditions of ARS Section 14-10819(A) are met: (i) fixed income, annuity or unitrust payments must continue to be made, (ii) the trust must continue to be "for the benefit of the beneficiaries," (iii) the Arizona RAP must be followed, (iv) there is no adverse tax effect to the trust, trustee, settlor or beneficiaries, and (v) if the trustee is a beneficiary, she cannot liberalize the standards for distribution to herself. Otherwise, the statute provides no other limits to the changes that can be made. One of the requirements to decant is that there be no adverse tax effect to a trustee, settlor, or beneficiary. The granting of a Delaware Tax Trap power does not adversely affect anyone's taxation. It is the exercise thereafter that could do so. So it appears to be within the parameters of ARS Section 14-10819(A)5 to create such a power. To address the concern of whether a volunteer's exercise of a naked power of appointment can invoke the Delaware Tax Trap, the trustee's decanting of the trust to grant a modest beneficial interest to a volunteer might well be "for the benefit of the beneficiaries," within the scope of the section. ARS Section 14-10819(D) provides the ability to confirm the effectiveness of the decanting action.[23]

If the trust may be decanted under Arizona law it can be changed to apply the Arizona RAP, if that does not by itself cause adverse tax results to the beneficiaries, such as loss of GST grandfathering or GST Exemption 0.0 Inclusion Ratio to those trusts possibly affected.[24] Having an Arizona RAP using 500 years suggested above would permit a Delaware Tax Trap exercise if the volunteer holds a power of appointment or can acquire it through one or more of the methods described in this article.

[23] "The trustee, in the trustee's sole discretion, before or after the exercise of the trustee's discretion under this section, may request the court to approve the exercise."

[24] To the knowledge of the author, no ruling has held one way or the other on whether a non-grandfathered 0.0 Inclusion Ratio trust would become a nonexempt trust because the RAP period changed, although the IRS has specifically refused to address the issue on more than one occasion. The relevant regulation that would cause a trust to lose GST grandfathering literally does not extend to trusts created after October 21, 1986 for which GST Exemption was allocated. Treas. Reg. Section 26.2601-1(b)(4)(i). See Jonathan G. Blattmachr, Jerold I. Horn, and Diana S.C. Zeydal, *An Analysis of the Tax Effects of Decanting*, 47 Real Prop. Tr. & Est. L.J. 141, 168-170 (Spring 2012), wherein they cite PLR 200839025.

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Examples for Decanting to Create an SPA:

Example 1. If the trustee may make distributions to a beneficiary in the trustee's discretion, logic would dictate that it can be decanted to grant the beneficiary a special power to appoint trust assets under whatever conditions trustee determines, since that is within a subset of the powers and rights the trustee could grant to the beneficiary. See *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940); Restatement (Third) of Trusts, Section 10(d), Comment f; Restatement (Second) of Trusts, Section 17, Comments, including f; Restatement of Property, Sections 358 and 359.

Example 2. The trust agreement provides that the trustee is to distribute to the beneficiary amounts for the health, education, maintenance and support of the beneficiary, and after death to trust for the beneficiary's descendants under the same provision for generation after generation. The trustee decanted the trust to restate the trust with identical provisions, EXCEPT that beneficiary is given an SPA exercisable at death to appoint the trust property to an identical trust, with the unvested interest duration for Arizona 500 year RAP purposes to be measured from the exercise date. Then the beneficiary so exercises the power of appointment. Substantively there is no material change of beneficial interests. Technically the Trap is sprung as the condition described in Code Section 2041(a)(3) has occurred.

Example 3. Same as Example 2, EXCEPT Grandma having no net worth, instead of beneficiary, is given the SPA exercisable at death. She is intended to attract the estate tax inclusion.[25]

What if the Trust does not Qualify for Decanting?

If there is no trustee discretion such that the trust is not "decantable," then for those states that have adopted the Uniform Trust Code ("UTC"), there are other UTC Sections that may work to permit modification of the terms of the trust:

SECTION 411. Modification Or Termination Of Noncharitable Irrevocable Trust By Consent.
SECTION 412. Modification Or Termination Because Of Unanticipated Circumstances Or Inability To Administer Trust Effectively.[26]

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[25] But see S. Rep't 382, 1535, and note 19, supra.

[26] Model Uniform Trust Code SECTION 412. MODIFICATION OR TERMINATION BECAUSE OF UNANTICIPATED CIRCUMSTANCES OR INABILITY TO ADMINISTER TRUST EFFECTIVELY.

(a) The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.

(b) The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration.

(c) Upon termination of a trust under this section, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust.

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SECTION 415. Reformation To Correct Mistakes.
SECTION 416. Modification To Achieve Settlor's Tax Objectives[27]

The most appropriate of the above may be Section 416, along with Section 412.

To address the naked powerholder concern discussed in the text preceding footnotes 21 and 22, it may be helpful if he or she is also a beneficiary. Is the addition of a person as a beneficiary a modification of the trust in the furtherance of the settlor's tax objective to minimize taxation of the trust and its beneficiaries by confirming the beneficiary's power of appointment is one that can elicit the Delaware Tax Trap? It would seem apparent that if the trust and the beneficiaries realize more after tax economic benefit from the trust *because* another is added as a beneficiary, that modification would be within the court's authority under UTC Section 416. Section 412 also may well apply. The very large and permanent increase in the estate tax exemption was certainly not something that a layman could have anticipated or even considered as opening opportunities of utilizing the Delaware Tax Trap. The modification to grant modest trust beneficial interests to powerholders who could act to spring the Delaware Tax Trap to permit significant step up in basis and large future tax saving is certainly in furtherance of the purposes of the trust. Finally, the applicable decanting statutes and the UTC nonjudicial settlement agreement statute (UTC Section 111) or comparable rules might be applied in addition to or in conjunction with the above trust modification statutes.

Decanting an Out of State Trust.

A trust's beneficiaries cannot benefit from Arizona law, including its RAP, unless the trust law applicable and the RAP is that of Arizona. If a trust has transferred its governing jurisdiction to Arizona, then the trustee can decant a "decantable" trust under the Arizona Trust Code. ARS Section 14-10819(B). A trust is subject to the jurisdiction of the state as specified by ARS Section 14-10202. One of the ways a trustee, and therefore a trust, becomes subject to the jurisdiction of Arizona courts is by declaring that the trust is so subject. ARS Section 14-10202(A). Since this is a minimal connection, other connections should be established with Arizona, if practicable, such as possible co-trusteeship, administration, or assets or beneficiaries located or domiciled in Arizona.[28] Similarly, sufficient compliance with another state's law to attract its jurisdiction must occur.

Perhaps two sequential decantings are indicated. For example, to add a new beneficiary, the trust may be decanted and establish jurisdiction to properly adopt the law of a state which decanting statute permits the addition of beneficiaries to certain applicable trusts (e.g., South Dakota, SDCL Section 55-2-15) when another state's decanting statute may not permit such and alternative methods are not advised or

[27] Model Uniform Trust Code SECTION 416. MODIFICATION TO ACHIEVE SETTLOR'S TAX OBJECTIVES. To achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention. The court may provide that the modification has retroactive effect.
[28] Arizona income taxation attaches to a trust if a trustee is resident in Arizona. ARS Section 43-1301(5).

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acceptable. Thereafter, the trust is again decanted and sufficient actions taken to change the governing law to a state that permits the springing of the Delaware Tax Trap when appointing to a trust that grants a special power of appointment to a beneficiary (e.g., Arizona, ARS Section 14-2905(C)).

Bless with a Court Order.

The actions that may be taken by a trustee or exercises or powers by a powerholder might lack clear authorization. It is possible that bona fide disputes may arise to whether they are effective in whole or in part. Additionally, the IRS may question whether actions are effective to reach the desired tax result. Therefore, counsel may advise the trustee or other interested persons to get nonappealable court declarations binding on all relevant parties prior to the operative events. This comfort is provided in the famous Revenue Ruling 73-142, 1973-1 C.B. 405, which holds that binding court orders or effective agreements *prior to the tax event* are recognized by the IRS.[29] Retroactive or *nunc pro tunc* orders may not be sufficient.

Income Tax Grantor Trust Issues, Opportunities and Alternatives.

Many irrevocable trusts are designed to be grantor trusts for income tax purposes, such that the items of income, loss, deductions and credits are deemed those of the settlor (or possibly others) for federal and state income tax purposes. Code Section 671, et. seq. If such is the case or could be made the case with respect to the trust, then there are potentially important planning opportunities and consequences that should be considered. It appears that grantor trust status should have no effect on step up in basis in an asset included in the non-grantor powerholder's estate due to Code Section 2041(a)(3). Code Section 1014(b)(9); Treas. Reg. Section 1.1014-2(b)(1). However, that is not to say that there are no technical issues.[30] Because the effect of the exercise of the first power is to transfer the asset to another trust and the powerholder did not transfer any interest prior to the effectiveness of the exercise, there should be no basis reduction for depreciation or otherwise pursuant to Treas. Reg. Section 1.1014-6.

[29] In *Commissioner v. Estate of Herman J. Bosch,* 387 U.S. 456 (1967), Ct. D. 1915, 1967-2 C.B. 337, the U.S. Supreme Court previously held that federal courts in federal tax issues are not bound by a state court's determination after the tax facts have occurred, unless it was that of that state's supreme court. "If there be no decision by that court then federal authority must apply what it finds to be the state law after giving 'proper regard' to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court. *Bernhardt v. Polygraphic Co.,* 350 U.S. 198 (1955)." Revenue Ruling 73-142 explains the different holding from *Bosch*: "Unlike the situation in *Bosch*, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter."

[30] See Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death,* 97 J. Tax'n 149 (2002); PLR 201245006; CCA 200923024; CCA 200937028.

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Use of grantor trust status can be easier and more efficient that using the Delaware Tax Trap to step up basis. The first important planning issue is whether tax basis step up in assets in an irrevocable grantor trust can be affected by methods other than implicating the Delaware Tax Trap. Even if the if the irrevocable trust is not a grantor trust, perhaps it can become a grantor trust taxable to the settlor or another. For example, if the grantor's health is such that he may pass away soon, then the low basis asset in the grantor trust that is a candidate for the Delaware Tax Trap to step up basis could be purchased back by the grantor at its current fair market value by exchanging the asset for cash, a note, or another assets (which could be one or more high basis assets). Because the trust is a grantor trust as to the grantor, no gain or loss will be recognized and the bases in the assets transferred will remain unchanged.[31] Then the formerly low basis asset received by the grantor will be stepped up to fair market value at the grantor's death, but no net additional asset value will be subject to estate tax because other assets of the grantor had been removed from his gross estate in the exchange. Even if the if the irrevocable trust is not a grantor trust, perhaps it can become a grantor trust taxable to the settlor by decanting, settlement agreement or court authorization. The use of a grantor trust tax-free exchange is likely much less complicated and technical than teeing up for implementation of the Delaware Tax Trap. It also has the potential advantage of not increasing the net value of property run through the estate tax base.

Grantor trust assets shuffle worked in reverse. If the Delaware Tax Trap procedure is available and imminent, a grantor with respect to a grantor trust could swap a low basis asset to the grantor trust for adequate consideration tax-free. Then a Code Section 2041(a)(3) Delaware Tax Trap exercise could occur and the basis of that asset would stepped up to its fair market value. Thereafter, if desired, the asset could be reacquired by the grantor for adequate consideration. If the trust remains a grantor trust as to the grantor (see the next paragraph), then that exchange is also tax-free, and the basis of the asset reacquired by the grantor appears to be the re-set basis that the asset acquires due to inclusion in the powerholder's gross estate under Code Section 2041(a)(3). Code Section 1014(b)(9); Rev. Rul. 85-13. If grantor trust status had been terminated before reacquisition of the asset, then the although the reacquisition would be a taxable exchange, the taxable gain or loss to the trust would only arise to the extent the asset value at that time had changed from its value at date of death. Since the asset was not transferred to the powerholder by gift, Code Section 1014(e) (regarding gift transfers of appreciated property to the decedent within 1 year of death) should not apply to prevent step up in basis.

Grantor trust status should not terminate upon springing of the Delaware Tax Trap. The Delaware Tax Trap can apply to an irrevocable trust, whether or not it is a grantor trust for income tax purposes. Although the application of the Trap causes the appointed trust assets to be the subject of a taxable transfer, whether includable in the gross estate under Code Section 2041(a)(3) or as a taxable gift under Code Section

[31] Revenue Ruling 85-13, 1985-1 CB 184.

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2514(d), the deemed transfer in further trust should cause the grantor of the source trust to continue to be the grantor of the new trust for income tax purposes (with basis step up) to the same extent.[32]

Designing Future Irrevocable Trust Agreements to Permit Basis Step Up.

In states where the applicable Rule Against Perpetuities does not permit appointment creating another SPA to spring the Trap, it should be possible to fashion new trusts to be able to do so.

Example. Assume that Florida has a general 360 year required vesting period RAP and no ability to appoint granting another SPA to spring the Trap. A trust agreement of a trust governed under Florida law could provide that the required vesting period is 175 years, but otherwise the applicable Florida rule against perpetuities savings provisions are set forth in the trust agreement. In addition, the trust agreement provides that, if the powerholder elects, the creation date of a new SPA starting a new 175 year special RAP period with respect to a trust asset will be the date of first exercise of the initial SPA set forth in the trust agreement. Literally, this should permit the springing of the trap and re-setting of basis. The loss of a potential 175 years of suspended vesting (requiring vesting and estate taxation by the year 2188, instead of 2363) might be a little less onerous than foregoing an opportunity to step up trust asset basis anticipating a taxable sale or future deductible re-depreciation.

Why Trap would spring. Treas. Reg. Section 20.2041-3(1)(e)(ii) (the "Regulation"), text produced below in this outline, provides that if the second power's permissible period of exercise can be ascertained without regard to the date of the creation of the first power under the terms of the trust, the terms of the exercise, and applicable local law, then the Delaware Tax Trap will apply. The statute (text produced above in this outline) just referred to local law. Assume that the trust instrument stated that an SPA has to be exercised in 1 year from its creation or it lapses, but exercise to create a new SPA will result in that SPA creation date to be the beginning point for its year of validity. If the second power was created 6 months after the trust was created, would that trip the Delaware Tax Trap? Literally it appears so since the regulation implicates both the local law AND the operative instruments in the analysis to determine

[32] Treas. Reg. Section 1.671-2(e)(5) provides "If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code." Since the Trap is sprung by the exercise of an SPA, and not a GPA, whether not the new power created is an SPA or GPA, the implication from the regulation is that the grantor of the source trust remains the grantor of the new trust for income tax purposes even if the asset is includable in the gross estate of the powerholder as a result of the exercise. The author thanks ACTEC Fellows Jonathan Blattmachr, Esq. and Steven B. Gorin, Esq. for their analysis of the regulation and related authority.

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if the period of vesting of the second power may be ascertained without regard to the creation of the first power, even though Code Section 2041(a)(3) only mentions local law. In other words, will Code Section 2041(a)(3) be applied taking into account the rules of required vesting be made by the instruments of trust and exercise, if of shorter duration than the applicable state law RAP?

The private letter rulings referenced in footnote 18 all involved the exercise of the first power appointing to a trust that required vesting within the state RAP period measured from the time of creation of the first power, even though state law permitted the RAP period of the second power to commence at its exercise. Such rulings are consistent with the reading that the Regulation permits vesting limitation periods to be determined by the operative documents.

The rulings establish that "the terms of the instruments creating and exercising the first power and applicable local law" [the exact language in the Regulation] may provide a different date used to determine the beginning of the vesting period the state law creation date, for purposes of Code Section 2041(a)(3). Those same instruments, so long as not violative of the applicable state law RAP, logically may provide a different duration of the vesting period than the default state law duration, and should be controlling for purposes of Code Section 2041(a)(3).

In *Murphy*,[33] the Tax Court held that same clause (ii) of the Regulation, although varying in wording in a significant way from the statute with respect to which it was promulgated, controlled to interpret the same Code Section 2041(a)(3) and caused the court to find for the taxpayer.

Conclusion.

The value of the use of the Delaware Tax Trap is primarily due to the huge increase in the Estate Tax Exemption, and, when important, the GST Exemption, both now $5,340,000 in 2014. Not all trusts can be included in gross estates using the methods described in this discussion. Some trusts can be "fixed" without having to use the Trap. At least one state permits trustees and beneficiaries to dial in the Delaware Tax Trap and maintain the highest degree of asset protection.

Trustees may be able to decant or otherwise change the governing law of a trust to obtain both the benefit of basis step up and preserve asset protection. It is necessary to plan this technique carefully and well in advance of its expected use. But the most important task is identification of the low basis trust assets for which basis step up is merited.

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[33] 71 TC 671 (1971),

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RELEVANT REGULATION AND STATUTES

TREAS. REG. SECTION 20.2041-3(e)

(e) Successive powers.

(1) Property subject to a power of appointment created after October 21, 1942, which is not a general power, is includible in the gross estate of the holder of the power under section 2041(a)(3) if the power is exercised, and if both of the following conditions are met:

(i) If the exercise is (a) by will, or (b) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's gross estate under sections 2035 through 2037; and

(ii) If the power is exercised by creating another power of appointment which, **under the terms of the instruments creating and exercising the first power and under applicable local law**, can be validly exercised so as to (a) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (b**) (if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than of vesting)** suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

(2) For purposes of the application of section 2041(a)(3), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power. Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includible in the decedent's gross estate under section 2041(a)(3). If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $100,000 will be includible in the decedent's gross estate under section 2041(a)(3) if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

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ARS Section 14-10202. Jurisdiction over trustee and beneficiary

A. By accepting the trusteeship of a trust having its principal place of administration in this state or by moving the principal place of administration to this state, OR UNTIL OTHERWISE DECLARED BY THE TRUSTEE IF A PROCEEDING REGARDING A MATTER INVOLVING THE TRUST IS NOT PENDING IN A COURT OF THIS STATE, BY DECLARING THAT THE TRUST IS SUBJECT TO THE JURISDICTION OF THE COURTS OF THIS STATE, the trustee submits personally to the jurisdiction of the courts of this state regarding any matter involving the trust.
B. With respect to their interests in the trust, the beneficiaries of a trust having its principal place of administration in this state are subject to the jurisdiction of the courts of this state regarding any matter involving the trust. By accepting a distribution from such a trust, the recipient submits personally to the jurisdiction of the courts of this state regarding any matter involving the trust.
C. This section does not preclude other methods of obtaining jurisdiction over a trustee, beneficiary or other person receiving property from the trust.

ARS Section 14-10819. Trustee's special power to appoint to other trust

A. Unless the terms of the instrument expressly provide otherwise, a trustee who has the discretion under the terms of a testamentary instrument or irrevocable inter vivos agreement to make distributions, regardless of whether a standard is provided in the instrument or agreement, for the benefit of a beneficiary of the trust may exercise without prior court approval the trustee's discretion by appointing part or all of the estate trust in favor of a trustee of another trust if the exercise of this discretion:

1. Does not reduce any fixed nondiscretionary income payment to a beneficiary.
2. Does not alter any nondiscretionary annuity or unitrust payment to a beneficiary.
3. Is in favor of the beneficiaries of the trust.
4. Results in any ascertainable standard applicable for distributions from the trust being the same or more restrictive standard applicable for distributions from the recipient trust when the trustee exercising the power described in this subsection is a possible beneficiary under the standard.
5. Does not adversely affect the tax treatment of the trust, the trustee, the settlor or the beneficiaries.
6. Does not violate the limitations on validity under sections 14-2901 and 14-2905.

B. This section applies to a trust governed by the laws of this state, including a trust whose governing jurisdiction is transferred to this state.
C. The exercise of the power to invade the principal of a trust under subsection A of this section is considered to be the exercise of a special power of appointment.

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D. The trustee, in the trustee's sole discretion, before or after the exercise of the trustee's discretion under this section, may request the court to approve the exercise.
E. The trustee may exercise the discretion to appoint all of the trust estate pursuant to this section by restating the trust.

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SPECIMEN EXERCISE OF POWER OF APPOINTMENT (FOR DISCUSSION PURPOSES ONLY - NOT SUITABLE FOR ANY SPECIFIC SITUATION):

EXERCISE OF POWER OF APPOINTMENT (FORMULA CLAUSE)

Appointment. Pursuant Paragraph ________ of the JOE TRUST, u/t/a dated ________, I hereby appoint from the JOE TRUST (the "Source Trust") to the Appointment Trusts, as described below, effective upon my death, the greatest amount of the property of the Source Trust that is not allocated in the preceding provisions of this Agreement that would result in the least possible federal estate tax payable by reason of the death of the undersigned.

Intent and Purpose. The purpose of this Exercise is to appoint property of the Source Trust in a manner to obtain the greatest increase in basis of assets of the Source Trust at the death of the undersigned by inclusion of such assets in my gross estate that does not result in an increase in federal estate tax to my gross estate by application of Internal Revenue Code Section 2041(a)(3). It is the intent of the undersigned that the property appointed pursuant to this Exercise be included in the gross estate of the undersigned, but does not increase the federal estate tax of the estate of the undersigned.

Appointment Trust. The Appointment Trust is a trust having [the terms set forth in ARTICLE XX][exactly the same terms and provisions as the Source Trust would have in absence of this Exercise; except and provided that the rule against perpetuities saving clause of Paragraph __________ of the Source Trust shall apply the date of death of the undersigned as the creation date of the Appointment Trust.]

Dated:___________________, 2014.

____
JANE POWERHOLDER

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