**ESTATE ASSET BASIS MANAGEMENT: MINIMIZING TAX ON TRUST TRANSFERS THROUGH BASIS ADJUSTMENT**

**Trust Transfer Methods, Credit Shelter Trusts, and Post-Mortem Actions**

Les Raatz, Dickinson Wright PLLC

Strafford

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**NEED A STEP UP IN BASIS?**

Les Raatz, Dickinson Wright PLLC

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**Synopsis:** Income and capital gain rates (when combined with the 3.8% Tax on Net Investment Income) have increased substantially. **For example, trust federal capital gain and dividend tax rates have increased over 50% on taxable income over $12,500 from where they were in 2009.** More than ever, we want to reduce taxable gain and increase tax write-offs. This is done by increasing basis.

**THE PROBLEM – LOW BASIS:**

Assume today’s present 30% total capital gain rate and 40% ordinary rate (which includes Net Investment Income Tax of 3.8%);

Asset A basis is $100,000, and its Fair Market Value (FMV) is $1,100,000.

If sold, there would be $1,000,000 in gain, and a Tax of $300,000. **If basis could have been stepped up to FMV, then $300,000 in tax is saved.**

If Asset A was depreciable property with a 20 year life, then $1,000,000 in basis step up would generate $50,000/yr increased depreciation, or **$20,000 in tax savings every year** **for 20 years.**

**THE OPPORTUNITY – REALLY HIGH ESTATE TAX EXEMPTION:**

On the other hand, estate, gift, and generation-skipping transfer tax exemptions have also increased to $5,490,000 by 2017. This is, of course, very good. Beginning January of 2018, Congress TEMPORARILY DOUBLED the estate and gift tax exemption amounts ($11,580,000 in 2020) per person adjusting every year for inflation. For a married couple the exemption is potentially double that amount, or $23,160,000 (for 2020). **However, this amount will return to pre-act numbers for gifts and deaths occurring after 2025, although still inflation adjusted.** This would still leave an estimated exemption amount of about $6,250,000 or so ($12,500,000 per married couple). It is possible that change in party control of the government (possible as early as 2021) could cause earlier dramatic changes substantially reducing estate and gift tax exemptions. **So there could be a “use it or lose it” decision to make ahead.**

**OPPORTUNITY KNOCKS - BUT YOU MUST OPEN THE DOOR – INCLUSION IN ESTATES:**

**So, there is opportunity to exploit when there was not before.**  If property is includable (or can be made to be includable) in the federal gross estate of a decedent, then generally the basis of the asset (the cost of property used to determine capital gain and depreciation) is changed to be the federal estate tax value of the property at the date of death of the decedent. Section 1014; Reg. Section 1.1014-2(b).[[1]](#footnote-1)

There is an exception to this rule if the property is “income in respect of a decedent (“IRD”). IRD includes, among other things, IRAs, installment sale notes that generate capital gain, and accrued but not taxed ordinary income, such as trade receivables. Reg. Section 1.1014-1(c).

**RECAP:** The common theme in obtaining tax-free step up in basis is to plant the asset in a manner to cause it to be includable in the gross estate of a decedent that does not generate estate tax. If it is, then one of the consequences is to cause the basis in the assets to become the FMV of the asset that would be applicable for estate tax valuation purposes (excluding an asset that is considered to be income in respect of a decedent (IRD) or a gift to another who pass away within a year of the gift and devises it back to the donor). Code Section 1014. So one of the Estate Tax Code provisions that cause inclusion of the asset must apply. These provisions are Code Sections 2031 through 2044 (the so-called Estate Tax String Sections). The most important ones that can be implemented are:

Sec. 2031 direct ownership

Sec. 2036(a) the donor retaining power to direct benefit of the asset or retaining benefits

Sec. 2038(a)(1) the donor holding the power to amend or revoke interests in the asset

Sec. 2041(a)(2) possession of general power of appointment

Sec. 2041(a)(3) springing the Delaware Tax Trap

Sec. 2044 QTIP trust

So, in the simplest case involving Code Section 2031, transferring ownership to someone who then dies causing the basis adjustment. But that leaves the asset totally unprotected from the whims, foibles, mistakes and creditors of the donee. So other Estate Tax String Sections provide protection, but each has its issues.

**TWO SCENARIOS – PLANNING AND REACTING:**

The issue presents itself in primarily 2 scenarios. The first, planning prospectively. This would include drafting in language to newly created trusts or other instruments, such as exercises of powers of appointment.

The second, to take already irrevocable arrangements, such as irrevocable trusts, and modify them by one means or another in order to cause inclusion in estates of “volunteers.” The modifications can be through exercise of already available powers of appointment or options already built into the trust agreement **through statutory methods**, many of which may be implemented without the necessity of court proceeding or orders.

These include:

**A. Trustee Acts Alone pursuant to a Trust Decanting Statute.** **A Great Tax-Friendly Power (Ex: Arizona A.R.S. Section 14-10819).**

**B. Settlors and Beneficiaries Act to do anything, without Trustee. Common Law: Restatement (Third) of Trusts, Sec 65. Statute: Uniform Trust Code (“UTC”) Section 411(a).**

**C. Beneficiaries Act with Court if not violate a Material Purpose: Common Law: Restatement (Third) of Trusts, Section 65. Statute: Uniform Trust Code (“UTC”) Section 411(b).**

**D. Beneficiaries Act with Court when would violate a Material Purpose: Statutory Array under UTC: Sections 411 through 416.**

**E. Nonjudicial Settlement Agreement when not violate a material purpose: Statute: UTC Section 111.**

**F. Vicarious representation to facilitate the above: Statute: UTC ARTICLE 3 (Sections 301 through 305).** Permits parties to act for others similarly situated without appointment of attorneys ad litem to act for unknown, unborn, and minor beneficiaries.

**G. Trust combination and division: UTC Section 417.**

**BASIS CONSISTENCY RULES.**

Recent Tax Acts made it critical to identify all property that is includable in the gross estate for estate tax purposes. Form 8971 is generally required to be completed and list the basis of assets. Failure to do so may cause the assets to have zero basis. Better to report more than necessary, then err the opposite way.

**LIFETIME GIFTS REQUIRE CARRYOVER BASIS:**

Gifting property to another during life causes the basis in the property to remain unchanged. Section 1015. There are special basis adjustments for gift taxes paid and other unique situations. With unusual exceptions, this limits basis step up planning to require inclusion in the gross estate of a person to apply Section 1014 basis adjustment.

SPECIAL RULE EXCEPTION: If a “taxable termination” occurs with an irrevocable trust as a result of the death of an individual, then the basis of its assets is stepped up as provided in Code Section 1014(a) to the extent the Inclusion Ratio of the trust is less than 1.0. In other words, basis is adjusted only to the extent the generation-skipping transfer tax is imposed on trust assets. If the trust is GST exempt, then no basis adjustment will occur. Code Section 2654(a)(2). A taxable termination occurs the first time there are no nonskip persons who can receive distributions from the trust and there remain skip person beneficiaries. Code Section 2612(a).

**METHODS TO INCREASE BASIS TAX-FREE:**

There are different methods that might be available to increase basis of assets, **either owned outright by an individual or in an irrevocable trust,** to reduce taxable gain on sale of the assets or increase tax deductible depreciation.

First, I will go over means to increase basis of assets presently held by individuals. Next, I will discuss methods for increasing the basis of assets already in irrevocable trusts.

**INDIVIDUALS WITH LOW BASIS ASSETS:**

**1. UPSTREAM OUTRIGHT GIFT TO ELDERLY OR ONE IN POOR HEALTH.**

This is the simplest plan. Consequences of this will be discussed below. Risk is obvious. Don’t forget the Section 1014(e) one year rule: if a property owner gifts property to someone who dies with a year of the gift and devises it back to the owner, there is no basis step up.

**2. UPSTREAM POWER OF APPOINTMENT TRUST WITH IDGT SALE.**

Child creates an irrevocable grantor trust for the benefit of his children, and which gives a parent a general power of appointment (GPA). If the parent dies without exercising the power, then technically the child has not lost dominion and control over the property, and there may be no taxable gift. However, the parent had died with a GPA so the assets should be includable in the parent’s estate under Code Section 2041. Looks like basis step up. What if the parent remained a beneficiary? Basis adjustment should be permitted.

Further assume that the child had instead made a relatively small gift to fund the trust and thereafter sold the asset to the trust for a note, guaranteed by the parent, and pledged with the asset sold. After death of the parent the child receives the property back in satisfaction of the note. No gift or taxable transfer is being made back to the child. The child’s basis in the asset should be stepped up upon the death of the parent, and no gain on the note payment is recognized, since it is a grantor trust. The grantor trust status is not changed, even though the parent had a general power of appointment. This is the rule under the Treasury regulations. Grantor trust status remains with the child unless the general power of appointment is exercised. Reg. Section 1.671-2(e)(5).

**Risk 1 – death within a year.** If a person is gifted property, dies within a year of the gift, and the donor reacquires the property, then Section 1014(e) applies to prevent the basis in that property to increase as a result of the person’s death.

**Risk 2 - when there is a GPA or direct ownership**. The risk associated with giving one a GPA is the either it could be exercised in an unintended manner or creditors of the powerholder could reach the assets over which the powerholder held the power. Under the older restatement of laws, creditors could not reach assets subject to the GPA if the GPA was not exercised by the powerholder, but creditors can reach assets subject to the power under the latest restatements, even if the power was not exercised. To mitigate this risk, the GPA exercise could be made dependent upon approval of any nonadverse party. It still remains a GPA to cause inclusion in the gross estate of the powerholder under Code Section 2041. It also is a GPA for purposes of nontax law, so theoretically it could still be reached by creditors. However, there is no case located by me or all those I have inquired that held one way or another regarding this issue. However, there is a means to further protect the asset from creditors, and still realize basis step up, discussed further below.

**3. PORTABILITY**.

Since 2012 a surviving spouse may acquire the deceased spouse’s unused estate and gift tax exemption amount (“DSUE Amount”), which is added to the surviving spouse’s available estate and gift tax exemption equivalent. Portability is not available to acquire the GST exemption.

For example, assume husband dies in 2020 (without having made any taxable gifts) and leaves all his property (say $30,000,000) to his wife, except for a $1,000,000 gift to their daughter. His DSUE Amount is $10,580,000 (his $11,580,000 estate and gift exemption, less the $1,000,000 gift made to his daughter). If a federal estate tax return is filed for his estate, and there is no election otherwise, she will add the DSUE Amount to her unused exemption. If she had not used any of her exemption, her exemption will be $22,160,000 in 2020. Her portion of the exemption continues to be inflation adjusted, but the DSUE Amount does not.

The question now is: is it better to leave of the deceased spouse’s property such that it will be included in the survivor’s estate (whether because it is given outright or because it is funded into a QTIP trust to be assets protected and/or removed from the surviving spouse’s control or power of disposition), so that it will again receive a step up in basis at her death, and also have the increased exemption? The QTIP trust also offers the ability to preserve the deceased spouse’s GST exemption by making a reverse QTIP election. The unused GST exemption cannot be passed to the surviving spouse like the estate tax exemption permitted with portability.

Or instead, is it better to use the deceased spouse’s exemption to fund a credit shelter trust (also with the deceased spouse’s GST exemption allocated to it) so that the property and its appreciation in the trust will not be subject to federal estate tax upon the surviving spouse’s death?

Howard Zaritsky and Lester Law, ACTEC members, have written a few articles about the pros and cons of either method. But as a general default rule, they would start with the all to spouse (whether outright or as a QTIP trust) and no credit shelter trust, unless it is otherwise shown that a credit shelter trust is more beneficial.

**Vose case.** The portability election may be a valuable right for the surviving spouse and his estate. Can the personal representative of the deceased spouse’s estate demand consideration from the surviving spouse to file an estate tax return if none is required (because the gross estate is less that the available election)? And then to make (or at least not check the box not to make) the portability election? In Estate of Vose, the Oklahoma Supreme Court held that the executor must file an estate tax return making the portability election, even though the surviving husband had signed a prenuptial agreement waiving “all claims and rights, actual, inchoate, vested, or contingent” in the estate. In re Matter of the Estate of Anne S. Vose v. Lee, 390 P.3d 238 (Okla. Jan. 17, 2017). There is no benefit to the estate for not allowing the surviving spouse the DSUE Amount. However, in certain circumstances, filing an estate tax return when one is not required might be detrimental to the estate.

**4. CREDIT SHELTER TRUST WITH TRUST PROTECTOR OR INDEPENDENT TRUSTEE.**

A simple variation is to design the credit shelter trust so that an independent trustee or trust protector can grant the surviving spouse or other person, whether or not a beneficiary, a general power of appointment exercisable upon death. This would cause inclusion in the estate of the powerholder, whether or not the power is exercised. To prevent the possible exercise otherwise than as planned, the consent of a nonadverse person to the exercise can be required.

Alternatively, the trustee or trust protector could have the power to distribute directly any property for which step up in basis is desired.

Upside: It is simple. Best technique to obtain asset protection if estates are modest, but permits freeing up of assets and step up of basis on the second death.

Downside: There is a waste of estate tax exemption and GST tax exemption. There was no marital deduction on funding the trust, even though the surviving spouse was the beneficiary and the property could be included in the survivor’s gross estate. An additional party is required to act as trust protector or independent trustee. More efficient structures are either a Disclaimer Trust option or a Clayton Trust option if it is important to preserve the exemptions. But if there is no need to preserve the exemptions, then there may be no downside

**5. DISCLAIMER TRUST TO BACK INTO CREDIT SHELTER OR QTIP TRUST.**

A single trust for the surviving spouse who retains or obtains full powers and rights is the default. If the surviving settlor spouse disclaims, then the disclaimed property falls to the Disclaimer Trust. The Disclaimer Trust give the survivor an income right, HEMS distribution, 5&5 power of withdrawal, a special power of appointment to all except the survivor, her estate, and creditors of either, and on death to the same residual beneficiaries. The survivor can further disclaim some or all of these rights and powers. To be a qualified disclaimer and not be deemed a taxable gift by the surviving spouse, the disclaimer must be made within 9 months after the death of the deceased spouse, and the survivor cannot have a power to appoint trust property.

Upside: This simplest structure with the greatest flexibility without the requirement of an additional trustee, and no waste of exemptions. It also can capture the deceased spouse’s GST exemption through a credit shelter trust or a QTIP Trust with a reverse QTIP election (Code Section 2652(a)(3)). The GST exemption is not “portable” to the surviving spouse as is the unused estate and gift tax exemption.

Downside: The survivor must disclaim the power to appoint the trust property to others in order for the disclaimer not to be treated as a gift by her, and wasting estate and gift tax exemption.

**6. CLAYTON TRUST**.

A decedent’s trust for the benefit of his spouse and others may provide that the spouse will have an income right, but only if the “executor” (personal representative of the decedent’s estate or trustee of the deceased spouse’s property if no probate estate) elects on the estate tax return Form 706 of the decedent estate elects to have that trust treated as a QTIP Trust. This causes the estate to be permitted to deduct the value of the trust as a marital deduction for federal estate tax purpose, thus either or both reducing estate tax or freeing up the unused estate tax deduction of the deceased spouse for portability to the surviving spouse. Reg. Section 20.2056(b)-7(d)(3). The moniker “Clayton” comes from the case approving the technique.

If the Clayton election is not made, then the spouse could have distribution rights of a typical credit shelter trust (i.e., an annual power to withdraw the greater of 5% of trust value or $5,000, and also the right to receive amounts for her “health, education, maintenance and support (so-called “HEMS rights”)). Either way, the surviving spouse could retain the power to appoint the trust property to others without adverse tax consequences. If the surviving spouse is the “executor” who has that power to elect QTIP treatment, then she will have a general power of appointment to grant herself an income right. Then she will have made a gift to the remaindermen of the trust if she fails to so elect. Therefore, there should be another independent party who can elect or require election of QTIP treatment to avoid this general power of appointment attaching to the surviving spouse, thereby not wasting estate tax exemption.

The election of QTIP status will cause inclusion of the deceased spouse’s property in the survivor’s estate for a second step up in basis at her death.

Upside: Maximum flexibility. The decedent’s unused GST exemption can be allocated to the decedent’s trust, whether or not a QTIP election is made. Also, a reverse QTIP election can be made to capture the deceased spouse’s unused GST Exemption in a QTIP Trust. The GST exemption is not “portable” as is the unused estate and gift tax exemption.

Downside: An additional party is required to make the QTIP election to avoid a deemed gift by the survivor if the election is not made.

**7. FORMULA GENERAL POWER OF APPOINTMENT IN BENEFICIARY.**

**THIS METHOD HAS POTENTIAL TAX RISK**!: The credit shelter trust (or for that matter, any irrevocable trust) could provide that, upon death of the surviving spouse (or other beneficiary), to the extent of that beneficiary’s available estate tax exemption, that person shall have a general power of appointment. The formula should provide that the power is exercisable with respect to trust property that has the highest ratio of fair market value to basis, and then the next highest, and so on.

Care must be taken to avoid the beneficiary being able to manipulate her taxable estate in order to have a greater value of assets of which she has a general power of appointment. For example, if the beneficiary leaves a greater share of her estate to charity, that reduces the taxable estate and would increase the value of the property that would be includable in her estate. The issue is whether the action by the beneficiary is an act of independent significance other that just increasing the property to be under a general power of appointment. If not then the beneficiary has an arbitrary ability to have a GPA over all of the trust property. The consequence would be to cause inclusion of all of the trust property in her federal gross estate, whether or not she acts to have that result. See *Estate of Kurz v. Comm’r*, 101 T.C. 44 (1993), aff’d 68 F.3d 1027 (1995).

Further Downside: It is rigid, and is not changeable without **third party involvement** **prior to** the death of the beneficiary.

**IRREVOCABLE TRUSTS WITH LOW BASIS ASSETS:**

First a quick trust income tax sidebar: The income tax rules applicable to trusts are detailed and confusing. However to simplify things, we will assume that there are two types of trusts. The normal trust that is directly subject to income tax. Another type is the “grantor trust.” Due to certain provisions of the Internal Revenue, the settlor of the trust is deemed to own the assets and includes in his taxable income the taxable income items of the trust if the trust has certain provisions. Typically the Form 1040 for the settlor includes all income items of the grantor trust and the settlor. (There are other situations where a beneficiary of a trust could be treated as the grantor instead, and for income tax purposes would be treated as owning the trust assets and report its taxable income or loss.)

**8. IRREVOCABLE TRUST – APPOINTING OUTRIGHT OR GRANTING A PERSON A GENERAL POWER OF APPOINTMENT.**

If a trust beneficiary, who is not the settlor, has a general power of appoint the trust property at death, then regardless of whether or not the power is exercised, then, generally, property in the trust will be includable in the gross estate and the basis of the property will be re-set to FMV at the date of death of the trust beneficiary.

If the power is a special power of appointment, then generally the property of the trust will not be includable in the powerholder’s gross estate, whether or not the power is exercised (disregarding the Delaware Tax Trap (the “DTT”), discussed below). However, if authorized, the powerholder could appoint selected trust property outright to a volunteer, or in trust granting the volunteer a general power of appointment (“GPA”).

Care must be taken not to inadvertently spring the DTT in the case of appointing in further trust and granting one a GPA. This can be done by specifying the rule against perpetuities (“RAP”) saving clause in the new trust that will require vesting of interest within the original RAP period applicable to the trust. The GPA will cause the property in the trust subject to the GPA to be included in the gross estate of the volunteer at his death.

**9. SPRING THE DELAWARE TAX TRAP – CODE SECTION 2041(a)(3).**

We can still gift the asset in a trust to be included in Mom’s gross estate, but without risk of a creditor reaching the property. This discussion is technical, so hang on.

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.[[2]](#footnote-2)

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 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 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 Generation-Skipping Transfer Tax (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”), also called a limited power of appointment. 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 nongeneral power of appointment (an SPA) remains the date of initial funding of the irrevocable trust.[[3]](#footnote-3) 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 presently exercisable GPA. In that case, under the common law and in all states, the date of creation of the new GPA is date of exercise of the initial power creating the new GPA.[[4]](#footnote-4) 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.[[5]](#footnote-5) 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 possible exposure of the assets to the 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.[[6]](#footnote-6)

**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[[7]](#footnote-7) 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.[[8]](#footnote-8)

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 power.[[9]](#footnote-9) Idaho also comes within this category, unless there is an unlimited power to terminate the trust “in one or more persons in being.”[[10]](#footnote-10)

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 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.

**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 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.[[11]](#footnote-11)

**Delaware’s creation date rule leaves an uncertain result.** In 2000 Delaware changed its RAP by adding a new Section 504 in Title 25, Delaware Code. At first glance it appears to do 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. On the other hand, if there is no limitation regarding vesting under Delaware law, then there can be no “postponement” of vesting (which is a condition to application of IRC Section 20141(a)(3)), so maybe the Delaware Tax Trap cannot be triggered.[[12]](#footnote-12)

**Arizona’s creation date rule is clear.** 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. ARS Section 14-2905(C) reads:

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

**GRAPHIC OF UPSTREAM GIFTING:**



**10. IRREVOCABLE TRUST - DELAWARE TAX TRAP RECAP - EXAMPLES.**

We have already discussed this issue above in detail. This is just recap to explain the power of the Delaware Tax Trap (the “DTT”) to pry open a trust to cause selected assets of the trust to be included in the powerholder’s gross estate. This paragraph explains the DTT from another point of view. Through the DTT, if someone has a special power of appointment (“SPA”), then the assets subject to the SPA **can become includable** in the gross estate of the powerholder (for legal eagles, the “donee” of the power). This is done by the donee exercising the SPA to create another trust of which another (the second donee) is given a power of appointment, which may be exercise to postpone vesting of the asset subject to the power for a period not dependent upon the creation date of the first power. Code Section 2041(a)(3).

Let’s review a classic estate planning graphic:



Now, let’s see how the DTT can assist in the following situations:

**SITUATION 1 - BYPASS TRUST (DECEDENT’S TRUST) (spouse):**

- An irrevocable trust for benefit of Jane is settled by her HUSBAND.

- Jane has the right to amounts for her health, education and support.

- On her death it passes to her children.

- She has a power to appoint the property to anyone but herself, her estate or creditors of either.

- Since her power to appointment cannot be exercised for her benefit, it is called a special power of appointment (SPA) (a/k/a limited power of appointment). So the trust will avoid inclusion in her estate at her death, whether she exercises the power or doesn’t – unless the DTT can apply.

**SITUATION 2 – DYNASTIC (GENERATION-SKIPPING) TRUST (child):**

- An irrevocable trust for benefit of Jane is settled by her PARENTS.

- Jane has the right to amounts for her health, education and support.

- On her death it passes to her children.

- She has a power to appoint the property to anyone but herself, her estate or creditors of either.

- Since her power to appointment cannot be exercised for her benefit, it is called a special power of appointment (SPA) (a/k/a limited power of appointment). So the trust will avoid inclusion in her estate at her death, whether she exercises the power or doesn’t – unless the DTT can apply.

For both Situation 1 and Situation 2, property in the trust has appreciated, and its basis is very low, so there will be substantial TAXABLE gain if sold. If it was included in the beneficiary’s (the spouse’s or the child’s) estate (whether or not there is estate tax) its basis would be stepped up to fair market value at her death. Then there would be much less TAXABLE gain if sold.

So how to step up basis? Spring the DTT. Example:

“I appoint, effective upon my death, the trust property in further trust, which trust terms are as follows:

///

Trustee shall distribute such amounts to the beneficiary in the Trustee’s discretion.

Beneficiary has the power to appoint the trust property outright to Beneficiary at any time.

///.”

The DTT has been sprung because:

(i) the powerholder (the surviving spouse) has exercised a power of appointment (in this case a special power of appointment),

(ii) creating another power of appointment (in this case a general power of appointment) in another,

(iii) which second power of appointment (the general power of appointment) can be exercised so as to postpone vesting for a period beginning on the date of the second exercise (which maximum period is not dependent on the date of creation of the first special power of appointment). Section 2041(a)(3).

**11. IRREVOCABLE TRUST – MODIFICATION TO IMPLICATE SECTION 2038 – SETTLOR REACQUIRES POWER.**

A settlor may have gifted property in trust for descendants or others, such that the trust property is not includable in her gross estate. But now her taxable estate would be well under her remaining estate tax exemption and the FMV of assets in the trust is way under the basis the trust has in the assets and also under the remaining exemption. So inclusion of the assets in her estate would cause tax-free step up in basis.

Through various trust modification techniques, the settlor could reacquire rights or powers that would cause an Estate Tax String Section to apply. Most likely candidate is Section 2038.

The modification techniques may include nonjudicial settlement agreement (UTC Section 111), the common law, decanting (Ex: Arizona ARS Section 14-10819), action of a Trust Protector (Ex: ARS Section 14-10818), trust combination (UTC Section 417), or court ordered modification pursuant to the panoply of modification purposes (UTC Sections 411 through 416). Some of these action may create the possibility of taxable gifts occurring for one or more beneficiaries.

Specifically, a modification could grant the original settlor a power to appoint the property to others, when the settlor did not have such power previously. The power can be very narrow, perhaps limited to allocate between two descendants. This would implicate Section 2038 without creating any rights of creditor of the settlor to reach the trust property, since the power is a special power of appointment and not a general power of appointment, which permits the settlor to alter, amend or terminate a beneficiary’s enjoyment of the property. (See Section 2038(a)(1) below.) Section 2036 would not apply because the power was not “retained” by the settlor. (See Section 2036(a)(2) below.)

If the person whose estate that is intended to include trust property is not the settlor, then that person may be given a power to appoint such property to herself, her estate, or the creditors of either effective upon death. Section 2041(a)(2). The power will still be effective to cause the property to be included even if the consent of a nonadverse party is required.

**Risk**. There is a risk that providing a general power of appointment will expose the trust property to creditors of the person given such power, whether or not the power is exercised. There is also a theoretical risk that the power could be exercised to divert the assets of the trust away from the intended beneficiaries.

**Confirm with a court order to assure results.** In *Commissioner v. Estate of Herman J. Bosch*, 387 U.S. 456 (1967), Ct. D. 1915, 1967-2 C.B. 337, the Supreme Court 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 a determination by 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, 1973-1 C.B. 405, explains that the holding from *Bosch* would not apply to disregard a court order preceding a taxpayer action: “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.”

**12. IRREVOCABLE TRUST – SECTION 2036(a)(2) AND SECTION 2038 – CONTINUOUS COMMON LAW POWER OF SETTLOR.**

Under the common law, the settlor, with the consent of all beneficiaries of the trust, can modify the trust, whether or not the modification violates a material purpose of the trust.[[13]](#footnote-13)

**SECTION 2036(a) READS:**

(a) **General rule.** The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

**(2)** the right, **either alone or in conjunction with any person**, to designate the persons who shall possess or enjoy the property or the income therefrom.

**SECTION 2038(a)(1) READS:**

(a) **In general.** The value of the gross estate shall include the value of all property—

(1) … To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money’s worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent **alone or by the decedent in conjunction with any other person** (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent’s death.

There is more authority that this common law power of a settlor to modify a trust will cause inclusion under Sections 2036(a)(2) and 2038(a)(1), than not.[[14]](#footnote-14)

The application of Section 2038 can be more or less confirmed if the beneficiaries who must consent to the modification with the settlor is reduced to less than all of them. The Seventh Circuit in *Swain v US,* 147 F.3d 564 (1998), decided a plain vanilla case involving a settlor having an express power in a trust agreement to modify the trust with less than all beneficiaries. The court held the power was clearly within Section 2038(a)(1). The court reiterated its prior decision, in which it had not considered "whether Section 2038(a)(1) covers powers exercisable by the decedent in conjunction with all the beneficiaries."

**13. GRANTOR TRUST – SWAP ASSETS.**

If a trust is a grantor trust as to the settlor of the trust for income tax purposes and the trust has low basis in an asset relative to its FMV, then perhaps that person can buy back or otherwise swap assets tax-free with the trust by exchanging cash or high basis property. Since it is a grantor trust, and its assets and income are deemed to be those of the grantor, then, solely for income tax purposes, there is no taxable sale or exchange when assets are sold or exchanged. Revenue Ruling 85-13, 1985-1 CB 184. Care must be taken that the values are equal. Then, at the settlor’s death, the former trust assets’ bases are stepped up to fair market value. Handshakes all around.

**14. GIFTING OF PROPERTY WITH EYE TO RECEIVING IT BACK (RETAINED IN TRUST).**

If property is gifted to another, and that donee dies within a year and the donor (or the donor’s spouse) receives the property back, then the property’s basis in the hands of the original donor will be the original adjusted basis and not the value of the property at the time of death of the donee. Section 1014(e).

So death bed planning for the volunteer to include in the estate when the property is not intended to pass on to descendants of the original owner is problematic. Also there is a theoretical risk that the volunteer may transfer the property in an unintended manner or his creditors are able to reach it.

A technique to avoid these risks is to initially gift to property into a trust, giving the volunteer a general power of appointment that must be exercised with the consent of a nonadverse party (causing inclusion under Section 2041(a)(2). If the volunteer survives for a year after the gift, then the donor can be a beneficiary to become outright owner, and still enjoy the step up in basis. If death occurs with one year, then the trust agreement provides that the beneficiaries are descendants of the donor or others. If the donor becomes a beneficiary, then the assets would remain included in the donor’s estate. This may appear to waste the estate and gift tax exemption. However if the trust remains in existence, whether or not the underlying assets are sold, then it is possible that the original use of the gift tax exemption might be reinstated if the trust remains included in the donor’s estate. Section 2012.

**15. ALTERNATIVE TO GIFTING AND RECEIVING IT BACK.**

If property is gifted to cause inclusion in the estate of a volunteer and separately and independently the volunteer exercises a general power of appointment for the benefit of, or, if owned outright bequeaths the property to, the original donor, then there would not be any recoupment of the gift tax exemption used by the original donor. In this case the volunteer’s bequest should be viewed as independent from the original gift. Neither Section 2036 or 2038 should apply. However, if the property is given back in the form of a trust separately settled by the volunteer, then the structure could be to avoid inclusion in the estate of the original donor, although he could have substantial use and benefit of the property, which, if GST Exemption of the volunteer is applied, could remain in a multigenerational generation-skipping dynastic trust.

**Other resources:**

There is a detailed article (285 pages) about many of these ideas and other basis planning:

“*Basis After the 2017 Tax Act – Important Before, Crucial Now*,” by Howard M. Zaritsky, Esq. and Lester B. Law, which was originally presented at the 49th Annual Heckerling Institute on Estate Planning sponsored by the University of Miami School of Law.

I have written two articles concerning the Delaware Tax Trap:

“‘*Delaware Tax Trap’ Opens Door to Higher Basis for Trust Assets*,” by Les Raatz, *Estate Planning* (February 2014 - Volume 41 Number 2), Tax & Accounting business of Thomson Reuters as Publisher.

“*USRAP Surprise Trigger of Delaware Tax Trap*,” by Les Raatz, *Estate Planning* (May 2016 - Volume 43 Number 5), Tax & Accounting business of Thomson Reuters as Publisher.

1. References to Sections are to the Internal Revenue Code unless otherwise indicated. [↑](#footnote-ref-1)
2. 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 GST Exemption, the GST Exemption allocation may make the Inclusion Ratio of the trust 0.0, thereby eliminating the potential for the GSTT. [↑](#footnote-ref-2)
3. The creation date of a trust is when it is irrevocably funded. The Restatement (Second) of Property (Donative Transfers), Section 1.2, and its comment b and Illustration 11. [↑](#footnote-ref-3)
4. 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. [↑](#footnote-ref-4)
5. 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. [↑](#footnote-ref-5)
6. 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. [↑](#footnote-ref-6)
7. Restatement of Property, Section 392; Comment d., and its Illustration 11, to Restatement (Second) of Property (Donative Transfers), Section 1.2. [↑](#footnote-ref-7)
8. Va. Code 55-12.4(a)(8). [↑](#footnote-ref-8)
9. 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). [↑](#footnote-ref-9)
10. Idaho Code Section 55-111A. [↑](#footnote-ref-10)
11. 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 confirm 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. [↑](#footnote-ref-11)
12. 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). [↑](#footnote-ref-12)
13. Restatement (Second) of Trusts, Section 338; Restatement (Third) of Trusts, Section 65. See Uniform Trust Code Section 411(a) and NCCUSL’s comments added in 2004 amendments to Section 411(a) of the Uniform Trust Code. [↑](#footnote-ref-13)
14. See Les Raatz, *Including all Trusts in the Settlor's Estate –**The Skinny on* Helmholz*and Sections 2036 and 2038 Recalling the Tale: The Emperor's New Clothes*, 11 Est. Plan. & Community Prop. L.J. (forthcoming Spring 2019). [↑](#footnote-ref-14)