Date: 30-Mar-15
From: Steve Leimberg's Estate Planning Newsletter
Subject: **James M. Kane: Income Tax Planning Using the Delaware Tax Trap**

"This newsletter centers on income tax planning using the Delaware Tax Trap. Without having to grant anyone [e.g., grandmother] a general power of appointment, this newsletter proposes giving a third-party [e.g., grandmother] an alternative Delaware Tax Trap power to obtain a stepped-basis for trust assets to the extent of the third-party's [grandmother's] otherwise unused estate and DSUE exemptions. This planning is gift, estate, and GST neutral to all parties other than grandmother who is the trapped party.

Tax practitioner discussion about using the Delaware Tax Trap is currently very popular, more so than during my previous 20-plus years of lawyering. Professor Jeff Pennell at Emory University Law School first introduced us law students to the Delaware Tax Trap. I have maintained (and updated) since law school a three-ring binder of Tax Trap articles. The time is now ripe for Delaware Tax Trap planning for income tax purposes. As a backdrop against the alternative planning I propose in this newsletter, I include below a helpful primer on the Delaware Tax Trap."

James Kane provides members with commentary that focuses on using a third party's otherwise unused estate and DSUE exemptions (for example, grandmother) with Delaware Tax Trap planning to obtain a stepped-up cost basis for trust assets, without immediate gift tax consequences to the grantor of the power (for example, the grandmother's son).

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Here is his commentary:

EXECUTIVE SUMMARY:

This newsletter centers on income tax planning using the Delaware Tax Trap. *Without having to grant anyone [e.g., grandmother] a general power of appointment*, this newsletter proposes giving a third-party [e.g., grandmother] an alternative Delaware Tax Trap power to obtain a stepped-basis for trust assets to the extent of the third-party's [grandmother's] otherwise unused estate and DSUE exemptions. This planning is gift, estate, and GST neutral to all parties other than grandmother who is the trapped party.

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FACTS:

Is the Heightened Interest in the Delaware Tax Trap Warranted?

Yes, for the following reason. The now-generous, inflation-adjusted $5.43 million federal estate exemption opens up potential income tax planning options centering on the Delaware Tax Trap. This focus is on clients whose parents, or divorced spouses, for example, will lose the benefit of the $5.43 million exemption (and in some cases the DSUE) by not having large enough estates at death. The unique feature I propose for this Delaware Tax Trap planning is that *no general power of appointment is required*. This absence of a general power of appointment is essential to preserve asset protection for the trust property.

Does the Trust's State Law Allow a Tax Trap Result?

This is an essential threshold question. I do not address here any particular state law other than to comment that a state's case law or statutes may possibly not allow the exercise of a power of appointment that has the effect of extending the rule of perpetuities. Or, this planning likely will not work as I propose further below for the states that have abolished the rule of perpetuities applicable to trusts, without otherwise purposely defining a stated vesting period within the trust document.

Delaware Tax Trap Complexity

The following sample excerpt of the "donor / donee" complexity of Delaware Tax Trap planning is from a 2001 article discussing the Tax Trap as affected by the abolition of the rule of perpetuities in some states. I have no doubt the writer is well-versed on the subject. But, for many years I generally found these illustrations daunting for actual application in practice. Particularly, it was not always clear to me as to who among the parties triggers gift or estate tax, if any, and when. Here is the 2001 excerpt:

> The non-skip donee could exercise the nongeneral power (first power) by giving a presently exercisable general power of appointment (second power) to a new donee. The creation of the presently exercisable general power of appointment (second power) commences a new perpetuity period, which is "without regard to the date of the creation of the first power." Depending on when the first power was exercised to create the second power, the donee of the first power (who was the donor of the second

> power) would expose the appointive property to gift or estate tax. The appointive property would again be subject to either gift or estate tax, depending on when the second power was subsequently exercised, lapsed, or released by the donee of the second power. [ii] [Parentheticals in the original.]

My Primer on the Delaware Tax Trap

Below in my introductory primer I discuss key points that help lay the foundation for the Delaware Tax Trap planning I propose in this newsletter. I start with a longstanding, more typical Person A / Person B example that uses the grant of an *inter-vivos* general power of appointment to spring the Tax Trap.

In this more typical example the Delaware Tax Trap triggers gift or estate tax to Person A if Person A exercises a limited power of appointment that gives another person [Person B] a presently exercisable *inter-vivos* general power of appointment.

By contrast, the Delaware Tax Trap planning I propose further below results from a purposeful extension of the rule of perpetuities period for the trust by a third party (e.g., grandmother), but includes *no general power of appointment*:

> Here is this primer example. Assume Person A is a daughter-beneficiary under her parents' 1994 GST irrevocable trust. Assume Person A has significant third-party claims against her for a failed business venture. Giving Person A a general power was not an option in this case. Under the terms of her parents' 1994 trust Person A (daughter) holds an *inter-vivos* and testamentary limited power of appointment in favor of her children (the grandchildren of the parents) and their descendants.
>
> Person A has a nominally small estate and at her death wants to use her $5.43 million exemption against this 1994 GST trust so as to give the trust assets a stepped-up basis for income tax purposes. Person A's children are adults and have accumulated significantly large estates. Person A also can allocate (at death) her otherwise

unused GST exemption to extend the GST exempt status as to this Tax Trap triggering.

Person A exercises her testamentary limited power of appointment at her death in a manner that gives Person B (one of her children) a presently exercisable *inter-vivos* general power of appointment.

The Delaware Tax Trap triggering occurs at Person A's death (daughter) because of her testamentary grant of the general power of appointment to Person B (the child). This Tax Trap triggering occurs as to Person A *whether or not* Person B exercises the general power.

This estate tax trigger as to Person A is under Internal Revenue Code Section 2041(a)(3).[iii] This is because Person B's general power is a testamentary grant from Person A. There is no Tax Trap triggering as to the settlor or Person B in this example.

My Earlier Hurdles for the Delaware Tax Trap

Here was one of my earlier hurdles with the Delaware Tax Trap. If Person A were simply to exercise her limited power of appointment to move the trust property outright to Person B there would be no Tax Trap triggering to Person A. [iv] We practitioners experience frequently a power holder not being subject to gift or estate tax for merely exercising limited powers of appointment that give the trust property outright to an appointee.

But, on the other hand, I had difficulty reconciling how this outright distribution of the trust property to Person B creates no Tax Trap result for Person A; but, alternatively, if Person A gives Person B an *inter-vivos* general power of appointment the Tax Trap is triggered as to Person A.

I finally overcame this hurdle. An outright distribution to Person B removes the property from the trust. The property is now outright in the hands of Person B, with Person B thereafter subject to whatever, *if any*, gift or estate tax consequences might apply thereafter to Person B as to his outright ownership of the property.

By contrast to this outright ownership, the following state law point in this primer is the essence of the Delaware Tax Trap. When Person A gives Person B the *inter-vivos* general power of appointment, rather than outright to Person B, *the trust continues* in existence and the trust property remains in the trust.

State trust law has provided historically that Person A giving Person B the *inter-vivos* general power of appointment results in a restart of the rule of perpetuities for the trust. That same trust thereafter continues without terminating and without otherwise having to drop the trust property outright into the beneficiaries' hands.

This restarting of the trust's perpetuities period can occur repeatedly over and over downstream with Person B giving Person C [then from Person C to Person D, to Person E, etc.] an *inter-vivos* general power of appointment. I thought (*incorrectly*) 'Why all the fuss about these extensions of the trust's duration?' 'Isn't each person downstream with these general powers of appointment subject to gift or estate tax?'

No. And, here was my '*aha*' moment. What I failed to comprehend is that Person B's *inter-vivos* general power of appointment can also, for example, include a lapsing five or five power that given Person B's age and life expectancy can effectively cleanse or reduce Person B's gift / estate tax exposure. [v] Ideally the beneficiary getting the *inter-vivos* general power of appointment is among the youngest beneficiaries of the trust.

The use of five or five lapsing powers coupled each with Person C, Person D, Person E down the line purposely making repeated extensions of the duration of the trust provided ample opportunity to eliminate or greatly reduce exposure to gift or estate tax, virtually indefinitely.

The statutory Delaware Tax Trap provisions under Internal Revenue Code Sections 2514(d) and 2014(a)(3) put an end to this repeated trust extension opportunity by (again, as I stated above) triggering Tax Trap gift or estate tax as to Person A at the time she gives Person B an *inter-vivos* general power of appointment or (ii) causes an extension of the rule of perpetuities period for the trust.

The Crucial Question: "Who Gets Trapped?"

The mere fact the settlor gives Person A the limited power of appointment that Person A can choose thereafter to use or not use to give someone else an *inter-vivos* general power of appointment does not trigger the Tax Trap as to the settlor.

Why? What if Person A never uses the limited power to give anyone else a general power of appointment? It makes practical sense that the settlor should not be trapped with gift or estate tax simply by giving Person A a limited power of appointment. Also in the example above, when (and if) Person A chooses to use her limited power to give someone else (Person B) a general power of appointment, this is solely in the discretion of Person A. Person A is the appropriately trapped person under the Delaware Tax Trap in this instance. And, *only if* Person A uses her limited power to give another person an *inter-vivos* general power.

Person A is what we lawyers call the "*but-for*" cause. But for Person A's grant of the general power of appointment to Person B, there would have been no extension of the trust's perpetuities period. The settlor had nothing to do with, nor possessed control over, this triggering effect. This Tax Trap result is solely within the control of Person A.

This but-for cause is crucial to my proposal immediately below. In my proposal it is grandmother's action alone in choosing to exercise her (grandmother's) limited power that triggers the Tax Trap as to grandmother herself.

A Preamble to My Tax Trap Proposal

My proposal is directed at a settlor of an incomplete-gift irrevocable trust with the trust holding low-basis assets. This planning purposely springs the Delaware Tax Trap as to another third party (*e.g.*, *grandmother*) at that third-party's death. Grandmother <u>does not</u> get a general power of appointment. As an aside, my Tax Trap proposal can also be used for an older existing completed-gift trust (*e.g.*, the 1994 GST trust above), but requires additional aspects of the planning I do not cover in this newsletter.

Also, I recommend at the end of this newsletter using a ripened, existing incomplete-gift irrevocable trust in reviewing whether this third-party Tax Trap planning is an option. This existing trust element means grandmother (or any other third party) who might be a candidate for this Tax Trap planning *is not* named in the trust document. Otherwise to name grandmother in the trust document raises a possibility of an IRS challenge of substance-over-form resulting in the settlor arguably being the person trapped and the settlor instead being the person deemed to have substantively directed grandmother under the existing trust document to spring the power. See also my important "Finally, the Step-Transaction Doctrine" discussion at the end of this newsletter.

A Potential Stumbling Block for Readers

The ability in my Delaware Tax Trap proposal of the settlor giving grandmother a limited power of appointment when grandmother is not named within the class of appointees in the trust document may be a potential stumbling block for many readers of this newsletter. The question becomes: *'How can grandmother get a limited power of appointment when she is not named within the class of appointees under the trust document?'* My response to this question is two-fold.

First, as to grandmother's power, grandmother cannot change the beneficiaries or any other aspect of the trust other than extending the perpetuities period by reference to her (grandmother's) date of death. Grandmother, therefore, is not an appointee class member in the sense of the more-typical view of an appointee who receives a trust distribution in response to a power holder's use of a limited power, etc.

Second. The settlor's retention in my proposal of a limited power of appointment as to the incomplete-gift irrevocable trust gives the settlor the power virtually to do anything with the trust property as long as the settlor's power is exercised relative only to any one or more of the class of appointees (in my proposal above the settlor's spouse and descendants are the appointees). Thus, for example, the settlor can distribute all of the property to one appointee. Or, can make distributions in further trust as long as the trust benefits one or more of the class of appointees.

Here is the important technical point. Against the backdrop of the settlor being able to exercise his retained limited power of appointment as to any one or more of the class of appointees, the settlor arguably can give a third party (grandmother) a power essentially to decant the same trust with grandmother's power defined so as to maintain the same trust terms and beneficiaries, other than grandmother's decision whether or not to exercise her power to extend the perpetuities period for the trust.

I do not discuss the above concept more fully for purposes of this newsletter. The *Third Restatement*, as an illustrative reference to this concept, expressly provides that the holder of a special power of appointment (in our case grandmother) may exercise the power by appointing property to a trust solely for the benefit of permissible appointees of the power. [vi]

COMMENT:

The Nuts and Bolts of My Proposal

The how-to and mechanics of how one actually drafts the necessary documents and powers giving rise to my Delaware Tax Trap proposal is beyond the scope of this newsletter. However, I am confident a practitioner well-versed on the Delaware Tax Trap, income tax, and his or her state law on trusts can back into and formulate the necessary components to put this proposal into actual practice.

My Delaware Tax Trap Planning Proposal

The settlor gives grandmother a limited power of appointment that effectively allows grandmother – *if grandmother alone chooses to exercise the power* – to do nothing more than decant the existing trust in a manner that extends the trust's perpetuities period commencing with reference to grandmother's death. This result has to fit with the applicable state law so that grandmother's power is treated under the state law as created when grandmother irrevocably exercises her power.[vii] This irrevocability occurs by reason of grandmother's death at which time her testamentary exercise takes place. This planning triggers the Tax Trap as to grandmother at her death under the estate tax provisions of Section 2041(a)(3).

The third party (e.g., grandmother) is ideally an older family member or former divorced spouse who will not likely have a sufficient estate to use his or her estate and DSUE exemptions. Again, this targeted income tax planning is to get a stepped-up basis for the trust assets at grandmother's death to the extent of her unused estate and DSUE exemptions.

Also again, the trust is an incomplete gift by reason of the settlor's retained limited power of appointment to make distributions outright or in trust as to the class consisting of the settlor's spouse and descendants. [viii] If grandmother exercises this substantive decanting power, it is grandmother, and grandmother alone, who chooses whether to trigger the above Delaware Tax Trap. That is, it is only grandmother who "produces the substantive effect of extending the rule of perpetuities period for the trust" under the element (ii) Tax Trap trigger I mentioned above [e.g., extending the rule of perpetuities *without* a general power of appointment]. It is not the settlor who chooses to produce this extension of the trust.

An initial contrary reaction to my proposal might be that the settlor grants the limited power of appointment to grandmother ostensibly similar to Person A's grant of the power to Person B. Therefore, isn't the settlor trapped? No. My proposal essentially reverses the perspective as follows. <u>Person A</u> is the grantor of the triggering operative general power and is trapped for Delaware Tax Trap purposes as to herself (<u>Person A</u>). By contrast, the settlor is the grantor of grandmother's limited power of appointment, but it is grandmother alone who chooses whether to trigger the operative power extending the duration of the trust and trigger the Tax Trap to herself.

I am purposely repeating this next point. <u>Person A</u> is the but-for cause of the Tax Trap in the above more-typical general power of appointment situation; grandmother is the but-for cause of the Tax Trap in my proposal without using a general power of appointment.

The last point of my proposal is that the settlor stands neutral as to a gift, estate, or GST tax result due to the incomplete gift design of the trust. It is only grandmother who is trapped for Delaware Tax Trap purposes and who controls whether she will or will not extend the duration of the trust by choosing to exercise her narrowly-defined limited power of appointment.

Finally, the Step-Transaction Doctrine

I mentioned above avoiding a substance-over-form issue where the IRS asserts the settlor is substantively the trapped party, rather than grandmother. If this were to occur, my view is the incomplete gift status of the settlor's irrevocable trust arguably will still prevent a gift tax trapping as to the settlor. This is because grandmother's exercise of her limited power to extend the duration of the trust keeps all provisions of the trust intact including the settlor's continuing limited power of appointment as to the trust. The only change is the perpetuities period of the trust. The threat under this substance-over-form is that there will be no stepped-up cost basis at grandmother's death if she no longer is treated as the person who triggers the Tax Trap power (instead, the IRS will be arguing the settlor substantively triggering the power).

Also, as with any proposed planning involving desired tax savings, being aware of the step-transaction doctrine is essential for practitioners. The step-transaction doctrine may potentially result in a court or the IRS ignoring one or more of the intermediate separate steps included in a transaction or collapsing all of the steps into one single transaction.[ix] Furthermore, the binding commitment test is another substantive concern where the court of IRS concludes the parties were already committed to forming a desired result at the onset of the planning. [x]

So as to avoid creating these step-transaction or binding commitment test issues, for my above Delaware Tax Trap proposal I recommend using a ripened, existing incomplete-gift irrevocable trust if one wishes at this time to review whether this third-party Tax Trap planning is a feasible option.

Final Thoughts

This Delaware Tax Trap proposal is a realistic, practical option for income tax planning coupled with today's generous inflation-adjusted estate and DSUE exemptions. It also demonstrates the essential need for income tax planning as part of estate planning.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

James M. Kane

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CITATIONS:

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[i] There is only one reported federal tax case that addresses the Delaware Tax Trap statute under I.R.C. Code Section 2014(a)(3). This is *Estate of Mary Margaret Murphy*, 71 T.C. 671 (1979), in which the Tax Court concluded Section 2014(a)(3) was not triggered as a result of the perpetuities period limiting effect of Wisconsin state law.

[ii] Stephen E. Greer, The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities, 28 EST. PLAN. 68, 69-70 (2001).

[iii] Far removed from a topic of cocktail party chatter is Code Section 2041(a)(3) that reads, in part:

[The Delaware Tax Trap occurs if a person] 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.

From Internal Revenue Code §2041(a)(3) [emphasis added].

[iv] A power holder's exercise of a limited power of appointment constitutes a transfer from the donor of the power, not from the done. *See, for example, In re Wylie*, 342 So.2d 996, 998 (Fla. 4th DCA 1977) (quoting Restatement (First) of Property §318 comment (b) (1940)).

[v] Internal Revenue Code Section 2041(b)(2).

[vi] Restatement (Third) of Prop.: Wills & Other Donative Transfers §

19.14 (2011).

[vii] For example, contrast IRS Letter Ruling 200607015 that concludes a trustee's limited power of appointment to decant a grandfather's GST exempt trust into separate trusts did not extend the perpetuities period. The distinction in this ruling is the decanting itself expressly included language precluding the extension of the perpetuities period. The IRS concluded the decanting, in view of the express limiting language, did not extend the time for vesting of any beneficial interest held in the trusts.

[viii] Treasury Regulations §25.2511-2(c) reads: "A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves . . ."; IRS Chief Counsel Memorandum 201208026 (February 24, 2012) takes the position a testamentary limited power of appointment is not sufficient alone for incomplete gift treatment.

[ix] This doctrine originates from the U.S. Supreme Court opinion in *Gregory v. Helvering*, 293 U.S. 465 (1935).

[x] *See, for example, Penrod v. Commissioner*, 88 T.C. 1415 (1987)(IRS successfully collapsed a cash-out step to negate an otherwise Code Section 368 tax-free reorganization).