LEMONS TO LEMONADE: Making Use of the Delaware Tax Trap

2019 ABA Section of Taxation May Meeting
May 11, 2019
Powers of Appointment

General Power of Appointment

- Defined as a power to appoint to yourself, your estate, your creditors or the creditors of your estate
- Causes estate tax inclusion

Limited Power of Appointment

- Defined as a power to appoint to anyone other than yourself, your estate, your creditors or the creditors of your estate
- The only time a limited power of appointment causes estate tax inclusion is when the Delaware tax trap applies
Section 2041(a)(3)

Section 2041(a)(3) says trust property will be includible in a powerholder’s estate to the extent he:

“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.”
History of the DE Tax Trap

• **Common law rule against perpetuities**: “No [nonvested] interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest.” J. Gray, *The Rule Against Perpetuities* § 201 (4th ed. 1942).

• **Relation back doctrine**: When you exercise a limited power of appointment or a general testamentary power of appointment the rule against perpetuities period is measured from the date the power was created (*i.e.*, the date the trust that gave you the power became irrevocable).

• Delaware got rid of the relation back doctrine in 1933.
Common Law Relation Back Doctrine v. Delaware’s 1933 Law

ORIGINAL TRUST

Jan. 1, 1940 (trust created)

Rule Against Perpetuities Period

~2030 (trust must terminate within 21 years of the death of someone alive on Jan. 1, 1940)

EXERCISE OF LPOA
(Common Law Relation-Back Doctrine Applies)

Jan. 1, 1940 (trust created)

Jan. 1, 1970 (LPOA exercised)

Rule Against Perpetuities Period

~2030 (trust must terminate within 21 years of the death of someone alive on Jan. 1, 1940)

EXERCISE OF LPOA
(Delaware’s 1933 Law Applies)

Jan. 1, 1940 (trust created)

Jan. 1, 1970 (LPOA exercised)

~2060 (trust must terminate within 21 years of the death of someone alive on Jan. 1, 1970)
Understanding § 2041(a)(3)

Trust assets will be includible in a powerholder’s taxable estate under § 2041(a)(3) if:

1. He exercises a power of appointment (the “first power”);
2. To create another power of appointment (the “second power”); and
3. The second power can be exercised in a way that re-starts the rule against perpetuities.
Understanding § 2041(a)(3) (Cont’d)

To determine whether the second power can be exercised in a way that re-starts the rule against perpetuities you must look at:

1. The instrument that created the first power;
2. The instrument that exercises the first power; and
3. Applicable local law. See Reg. § 20.2041-3(e).
Perpetuity Saving Provision: Example 1

“The trustee shall terminate and forthwith distribute any trust created hereby, or by exercise of a power of appointment hereunder, and still held twenty-one years after the death of the last to die of myself and the beneficiaries in being at my death.”

Perpetuity Saving Provision: Example 2

“All trusts hereunder shall terminate twenty-one years following the death of the last to die of my parents’ issue who were living on the date of this Agreement. The foregoing sentence shall also apply to trusts created by the exercise of a power of appointment, unless the exercise of the power of appointment commences a new rule against perpetuities.”

- Based, in part, on language from Wealth Transfer Planning™ software
Perpetuity Saving Provision: Example 3

All trusts hereunder shall terminate twenty-one years following the death of the last to die of my parents’ issue who were living on the date of this Agreement.
Deed of Exercise – Sample Saving Clause for GST Grandfathered Trust

“I further direct that any power of appointment conferred upon any person under the provisions of this instrument may not be exercised in any manner which would vest an interest in trust beyond the expiration of twenty-one (21) years after the death of the survivor of my spouse and my issue living on [date original trust became irrevocable.] If any such power is so exercised, I direct that it be declared void ab initio.”

Constructive Addition Rule

• If you exercise a LPOA over a GST grandfathered trust, it is treated as a constructive addition that causes the trust to be subject to GST tax if the LPOA is:

  "exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period)." Reg. §26.2601-1(b)(1)(v)(B)(2).

• Exercising a LPOA to avoid making a constructive addition will automatically avoid the DE tax trap.
Local Law

• Most states still follow the relation back doctrine.

• In those states, with few exceptions, you can trigger the DE tax trap only if the second power is a presently exercisable general power of appointment.

• There are few states in which you can trigger the trap by conferring a limited power of appointment.

• These states include Arizona and Delaware.
Arizona

“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.” ARS § 14-2905(C).
“Every estate or interest in property, real or personal, created through the exercise by will, deed or other instrument, of a power of appointment … shall, for the purpose of any rule of law against perpetuities … be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment.” Del. Code Ann. tit. 25, § 501.
“Notwithstanding any other provision of this chapter, and except as otherwise provided in subsection (b) of this section, in the case of a power of appointment over property held in trust (the ‘first power’), if the trust is not subject to, or has an inclusion ratio of zero for purposes of the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto and the first power may not be exercised in favor of the donee, the donee’s creditors, the donee’s estate or the creditors of the donee’s estate, then every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power … shall, for the purpose of any rule of law against perpetuities … be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power.” Del. Code Ann. tit. 25, § 504.
Triggering the DE Tax Trap

• Income Tax Benefits
  ▫ Increase basis of trust assets
  ▫ Reduce/eliminate tax on sale
  ▫ Federal capital gains (15%-20%), state capital gains (8.95% in DC), NIT (3.8%)
  ▫ Remove appreciation

• Transfer Tax Benefits
  ▫ Allocate generation-skipping transfer tax exemption
Triggering the DE Tax Trap (Cont’d)

• Other Benefits
  ▪ Avoid inheritance tax (in Pennsylvania)
  ▪ Allow aggregation of assets
  ▪ Protect insolvent powerholder’s estate from access by creditors to LPOA assets
  ▪ Continue Settlor’s plan to hold assets in trust for beneficiaries
Increasing Basis of Trust Assets

- Sufficient federal estate tax (FET) exemption left in estate
- Deceased spousal unused exemption (DSUE) available to surviving spouse
- Exchange of other assets for low-basis trust assets not feasible
- Trusts not includable in anyone’s estate (generally though . . . .)
Increasing Basis of By-Pass Trust

• Example: $3 million credit shelter trust
  □ $2 million at funding
  □ Created to use wife’s GST and FET exemptions
  □ Widower is trust beneficiary
  □ LPOA to appoint to descendants or charity

• Widower appoints in trust to grandchildren and grants second LPOA

• Widower’s remaining FET is $7 million
  □ Trust plus his estate worth $6 million
  □ Each gets stepped-up basis of $3 million
Increasing Basis of By-Pass Trust (Cont’d)

- Example: $10 million credit shelter trust
  - Same trust terms as previous example
  - Remaining FET at $7 million not sufficient
- Sever by-pass trust into two trusts
  - $4 million low-basis assets into subtrust 1
  - $6 million high-basis assets into subtrust 2
- Apply remaining FET
  - $4 million to subtrust 1
  - $3 million to widower’s other assets
Increasing Basis with Discounted Assets

• Couple’s plan with valuation discounts
  ▪ Assets owned in part by husband’s revocable trust and in part by wife’s revocable trust

• QTIP created for surviving spouse under revocable trust

• Assets in QTIP included in survivor’s estate under Section 2044
  ▪ Basis step-up for QTIP assets in survivor’s estate
  ▪ But discount reduces amount of step-up
Increasing Basis with Discounted Assets (Cont’d)

• Example: $4 million vacation home
  ▪ Deceased husband’s 50% TIC interest held in QTIP for wife’s benefit
  ▪ Wife’s 50% TIC interest in wife’s revocable trust
  ▪ Discounted value of each TIC interest is $1.7 million

• Exercise LPOA over QTIP trust
  ▪ Appoint assets to trust for children
  ▪ Give children second LPOA
  ▪ Estate inclusion under Section 2041 leads to aggregation of asset
  ▪ Overrides separate valuations
Avoiding GST Taxes by Lifetime Exercise

- Application to Non-Exempt Trust
- Possibly distributed to skip persons
- Settlor lacking sufficient GST Exemption
- Powerholder with unused exemption
- Deemed transferor to allocate exemption
Invoking Gift Tax under Section 2514

• Advantages
  ◦ Shift income and future appreciation
  ◦ Escape state estate tax
  ◦ Use annual gift tax exclusion
  ◦ Enjoy tax exclusive nature of lifetime gifts
  ◦ Allocate GST exemption now to avoid appreciation overtaking remaining exemption

• Disadvantages
  ◦ Only increases basis to extent of gift tax actually paid
Avoiding GST Taxes by Lifetime Exercise

• Example: $3.5 Million Irrevocable Trust
  ▪ Non-exempt trust for child’s lifetime
  ▪ Funding value was $750,000
  ▪ Inclusion ratio of trust is one
  ▪ Lifetime LPOA to appoint to Settlor’s descendants

• Child appoints trust to her grandchild
  ▪ Creates second LPOA under Section 2514(d)
  ▪ Child’s remaining FET is $4 million
  ▪ Allocates sufficient amount of GST Exemption
  ▪ Makes inclusion ratio zero
  ▪ No basis step-up
Avoiding GST Taxes by Lifetime Exercise (Cont’d)

- Example: $3.5 Million Irrevocable Trust
  - Same trust terms as previous example
- Child appoints trust to her grandchild
  - Child’s remaining FET is only $1.5 million
  - Child pays gift tax on other $2 million
  - Allocates sufficient amount of GST Exemption
  - Basis step-up on $2 million because gift tax paid
- Question is whether paying gift tax is worth income tax savings
Avoiding GST Taxes at Death

• Example: $4 Million Irrevocable Trust
  - Trust for child’s lifetime
  - LPOA to child to appoint to Settlor’s descendants

• Child exercises LPOA
  - Appoints to sibling and grants second power
  - GST tax deferred to sibling’s death
Avoiding GST Taxes at Death (Cont’d)

• Example: $4 Million Irrevocable Trust
  - Same trust terms as previous example

• Child exercises LPOA
  - Appoints to transferor’s great-grandchild and grants second power
  - Avoids estate tax for multiple generations
  - No additional tax at grandchild level
  - No direct skip tax
Mechanisms for Exercising Power

• Give power to third party not beneficiary of trust agreement

• Trust created by Settlor for his children
  ▪ Uncle given power to appoint
  ▪ No changes permitted to class of appointees
  ▪ Supported by Restatement (Third) of Property: Wills and Other Donative Transfers § 19.14 cmt. g (2011)
Circumventing Prohibitions

• Include trust provision stating Settlor’s intention is for LPOA to trigger trap

• Move trust situs to more favorable jurisdiction

• Add assets to existing trust
  - Invoke exception to common law relation back doctrine
  - RAP start date is date trust originally funded
Circumventing Prohibitions (Cont’d)

• Change trust agreement
  □ Decant to new trust
  □ Enter into Nonjudicial Settlement Agreement
  □ Modify trust agreement
  □ Merge existing trust with newly created trust agreement
When Not Beneficial to Trigger

• For GST Exempt Trust
  ▫ No excess GST exemption
  ▫ State estate tax applies
  ▫ Little or no built-in gain

• For Non-Exempt Trust
  ▫ State estate tax applies
  ▫ Amount of gain neutral because basis step-up at taxable termination under Section 2654(a)(2)
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