Springing the Delaware Tax Trap: Drafting Limited Powers of Appointment to Increase Asset Income Tax Basis

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Springing the Delaware Tax Trap

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Cumulative Federal Taxes

- Income tax, 10%-39.6%
- Estate tax, 40%
- Gift tax, 40%
- GST tax, 40%
Trust Ownership of Property in Trust / Inheritance via Trust

• Fulfill intentions of settlor.
• Protects property so there when needed.
• Limits impact on beneficiary’s taxable estate
Illustration – Estate/Gift/GST Tax

• Estate tax and the GST tax can apply on one event, such as possibly where grandmother dies, giving wealth to grandchildren.
• And during lifetime grandmother may have paid gift tax as well as income tax.
Illustration – Income Tax

• Federal Estate Tax law provides for a “step-up” in the income tax basis of asset included in a decedent’s estate.

• Tailoring inclusion of trust assets into the estate of future generations helps maximize income tax basis step-up without increasing overall estate/gift/GST tax burden.
Future interest

• Potentially gives holder right of possession or enjoyment in future.
Powers of appointment

• Property owner delegates creation of a future interest to another.
• Personal to donee.
• Cannot be transferred.
Donor

• Creator of power of appointment.

Donee

• Person who may exercise power.
Lifetime or Presently Exercisable Power

• You can exercise now while alive.

Testamentary Power

• You can exercise by Will.
General or Unlimited Power

• You can exercise for the benefit of yourself, your creditors, your estate, or the creditors of your estate.

• Can be a presently exercisable power or a testamentary power or both.

• If you have a general power, federal transfer tax law treats you as owner of property subject to power (IRC Sections 2041, 2514, and 2652(a)(1)).
Special or Limited or Non-General Power

• Power you may NOT exercise for the benefit of yourself, your creditors, your estate, or the creditors of your estate.

• Can be a presently exercisable power or a testamentary power or both.

• Generally, no adverse estate, gift or income tax consequences of holding a special or limited power of appointment

• Exercise of special or limited power in certain ways may trigger the “tax trap” on donees who exercise the power
Rule Against Perpetuities

• Limits postponement of ownership of property.
• In Alaska the maximum period is generally one thousand years (AS 34.27.051 et seq.).
• Ownership is known as vesting.
  – When property held in trust indefeasibly vests in you, you now own the property.
  – Then the Rule Against Perpetuities no longer applies.
• The rule applies, if at all, only when vesting has been postponed.
• To keep track of the maximum period the rule has a start date, when the postponement of vesting has begun, and an end date, when property has indefeasibly vested.
History of the Delaware Tax Trap

- Creation of “perpetual” trusts under Delaware law using successive exercises of limited/special powers of appointment – allowed asset to pass estate tax-free through the generations without future inclusion in a beneficiary’s estate

- Congress’ response was to enact the “Delaware tax trap”

- Exercise of special power at death could cause estate inclusion under IRC § 2041(a)(3)

- Exercise of special power during life could trigger a gift tax under IRC § 2514(d)
Language of Delaware Tax Trap, IRC 2041(a)(3):

- The value of [your] gross estate shall include the value of all property ... [t]o the extent of any property with respect to which [you] ... by will ... exercise ... a [special] power of appointment ...
- ... by creating another power of appointment [such as a presently exercisable general power] ...
- ... which under the applicable local law can be validly exercised so as to postpone the vesting of any ... interest in such property ...
- ... for a period ascertainable without regard to the date of the creation of the first power.

There is similar language under the federal gift tax system (IRC Section 2514(d)).
History of the Delaware Tax Trap (con’t)

• Many states have repealed the Rule Against Perpetuities so successive limited powers of appointment are no longer necessary to maintain a perpetual trust

• Conflicts in language between state laws allowing perpetual trusts and federal tax law required many states to enact “anti-tax trap” legislation
Delaware Tax Tap

• "Trap" rendering property taxable to you as if you were the owner of the property.
• Contained in IRC Secs. 2041(a)(3) and 2514(d)).
• Tool to reduce income tax by increasing tax basis.
• Tool to select the less costly transfer tax system.
  – Child-beneficiary of trust may live in a state with a significant death tax.
  – GST tax generally does not apply where the child-beneficiary has no children.
Delaware Tax Tap

• Formula clauses may be unavoidably flawed.
  – For example, a formula clause purporting to grant a child-beneficiary of a general power only when needed to minimize tax may always grant the general power.
  – We can control our taxable estates (within the meaning of IRC Section 2051) through tax deductions, such as by gifts to spouses or charities.
  – A large charitable gift can result in a zero taxable estate, and like magic you undeniably have a general power under typical formula clauses.
  – So if you are granted a possible general power, and you are in control of whether that general power comes into existence, does that control mean you always have the general power?
  – Suffice it to say formula clauses raise difficult questions

• Delaware Tax Trap advantages are simplicity and flexibility.
• State property law is determinative.
Illustration
(granting general power of appointment):

- Suppose you hold a special power of appointment.
- Here property subject to power not considered yours for federal gift or estate tax purposes.
- But you may be considered to have held a general power, which subjects you to gift and estate tax, if you appoint the property in further trust and give a trust beneficiary a presently exercisable general power of appointment.
- Creating a presently exercisable general makes the start date of your special power of appointment -- the "first power" as referenced in the Internal Revenue Code -- irrelevant.
- The individual you give the presently exercisable general power can appoint property in further trust and "postpone the vesting ... for a period ascertainable without regard to the date of the creation of the first power."
Illustration
(tailoring which transfer tax applies):

• Consider an Alaska resident who preparing Will.
• Wants to pass assets to a long-term Alaska trust for her child.
• The trust will have GST tax exposure.
• Instead of giving the child-beneficiary a general power over the trust with GST tax exposure, a better alternative is to give the child-beneficiary a special power of appointment.
• To minimize tax, the child-beneficiary may then exercise the special power any number of ways, including the following:

  – By giving a beneficiary, such as her own child, a presently exercisable general power over trust principal, thus intentionally triggering the Delaware Tax Trap (AS 34.27.051(b)).
  – Here the child may elect, in effect, to subject the property to the federal estate tax system at her generational level where such tax would be lower than any otherwise applicable GST tax.
  – By giving trust principal to her spouse, a sibling, a sibling's spouse, or a charity (see IRC Section 2651 on generation assignment under the GST tax).
  – By giving trust principal to his or her grandchildren, thus skipping estate taxation for multiple generations (cf. IRC Section 2653(a) on taxation of multiple skips).
Illustration (income tax step-up in credit shelter trust by surviving spouse):

- Wealthy spouse creates a credit shelter trust at death to use available GST tax exemption and does not want to rely upon portability.
- At surviving spouse’s death, she is given a limited power to appoint the asset of the credit shelter trust (FIRST POWER) to or among descendants (typical “be nice to mom” clause).
- At surviving spouse’s death, credit shelter trust has value of $6 million with $2 million of zero-basis assets and $4 million of assets with full FMV basis.
- Surviving spouse has only $2 million in her taxable estate.
- Surviving spouse may “trigger” the tax trap over the $2 million of zero-basis assets by appointing asset in further trust (exercise of FIRST POWER) granting her descendants a limited power of appointment (SECOND POWER) that may be exercised to postpone vesting for a period ascertainable without regard to date of creation of the FIRST POWER.
- $2 million of zero-basis credit shelter trust assets along with the $2 million of personal asset are includable in surviving spouse’s estate to receive basis step-up without incurring an estate tax.
- If “excess” estate tax exemption of survivor following application to her separate assets is insufficient, any remaining balance can be applied to the lowest tax-basis assets to maximize the value of estate inclusion/basis step-up.
Illustration (income tax basis step-up by beneficiaries with unused estate tax exemption):

• Wealthy parents create a long-term trust for descendants (3 children/5 grandchildren) using combined exemptions of $10.9 million
• Upon surviving parent’s death, trust splits into 3 equal $4 million shares (trust value had grown to $12 million)
• At Child’s death, he is married and has only $1 million of combined personal assets with his wife
• Parent’s trust for Child has value of $6 million at child’s death with $3 million of zero-basis assets and $3 million of assets with full FMV basis
• Child may “trigger” the tax trap over the $3 million of zero-basis assets by appointing asset in further trust (exercise of FIRST POWER) granting his descendants a limited power of appointment (SECOND POWER) that may be exercised to postpone vesting for a period ascertainable without regard to date of creation of the FIRST POWER
• $3 million of zero-basis assets are includable in Child’s estate to receive basis step-up but not exposed to his creditor and continue in trust in the same manner as provided under Parent’s Trust
Open Questions Regarding Delaware Tax Trap

• Do you always trigger the tax trap when exercising a special power of appointment in a “perpetual trust” jurisdiction?

• Is it possible to trigger the tax trap in a state that has done away with its rule against perpetuities?

• Impact of “anti-tax trap” laws in state where trust is administered and in “trust friendly” jurisdictions.

• Default administration in “trap friendly” jurisdiction to provide planning flexibility for beneficiaries.
Reference Documents

• For more information, visit:
• http://www.bgolaw.pro/the-delaware-tax-trap.html