HOW TO STEP UP BASIS IN IRREVOCABLE TRUST ASSETS

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Assets are retained in long term trusts for many good reasons. One is asset protection. Another is to avoid inclusion in taxable estates of one or more beneficiaries or generations (so called “generation-skipping” or “dynastic trusts”). All indications are that the aggregate value of such trusts is growing significantly and continuously. Long hold assets in these trusts are not run periodically through the estate tax ringer as would be the case if they were held individually, and the basis in those assets is not reset (“stepped up”) to fair market value free of income tax. So, the long term consequence is for much greater taxable gain when these assets are sold. Also the combined state and federal marginal income tax rates are now higher than at any time in the last twenty years.

There is a way to step up the basis of selected assets tax-free in certain of those trusts to reduce the income tax when the assets are sold. It is a newly considered technique because it is founded on the high federal estate tax exemption made permanent this year. It generally requires that a trustee or another have a discretionary power to distribute or appoint assets from the trust.

One appointment method to step up basis is to appoint the assets directly to a not so wealthy elderly but loyal family member who then is trusted to bequest the property back into trust for the benefit of desired persons. The other method is to spring the **Delaware Tax Trap**. With each method, the plan is to intentionally cause selected assets of an irrevocable trust to become subject to the estate tax of a decedent whose taxable estate is under $5,000,000, and whose estate could absorb the trust assets in his or her taxable estate without creating an estate tax liability. By including the asset in the taxable estate, tax-free step up in basis could occur. The method is not available in all situations. **There must be a power of appointment or trustee discretionary power over the assets desired to be stepped up.**

Overview to Step Up Basis.

The estate tax exemption is now at an unprecedented $5,250,000 permanently, and has never been so high. It is also annually adjusted upward for inflation, and is estimated be be increased to $5,340,000 in 2014. Opportunity exists now that never existed before. That opportunity is to gratuitously cause low basis property in a trust to be included in the gross estate of a volunteer who is less than very wealthy. If the property is included in the volunteer’s estate, then generally the basis the trust has in the property is stepped up to fair market value. For example, if a person has a taxable estate of $2,000,000, and has or can be given a special power of appointment over some or all of the trust property, his or her gross estate could soak up over $3,000,000 in additional assets by causing trust property to be treated as part of the estate pursuant to Code Section 2041(a)(3) (the "Delaware Tax Trap") without incurring an estate tax liability.

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

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

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

The technique is discussed at length below.

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

If the decedent died domiciled in Washington State and not in a state that has no estate tax, the additional marginal estate tax rate could be 19% higher.[1] Presently, lost basis may cost about 28.8% in many circumstances (20% federal capital gain rate and assumed state income tax rate of 5%, plus possibly the Obamacare Tax of 3.8%) of the portion of the property attributable to the appreciation. In less common circumstances ordinary income tax rates may apply (e.g., involving depreciation subject to IRC Sections 1245 and 1250 recapture). Therefore presently the income tax rate may be as high as 48.4% (39.6% federal rate and assumed state income tax rate of 5%, plus possibly the Obamacare tax of 3.8%). The federal estate tax rate is now 40%. But that is applied to <u>all</u> property subjected to such tax (both represented by basis and appreciation as well).

As was discussed, the estate tax exemption, the generation-skipping transfer tax exemption, and the gift tax exemption has been permanently increased to $5,250,000, (and will be further increased for inflation). The increases have made the estate tax less of a concern. Correspondingly, the income tax rates have significantly increased. Therefore planning to avoid or reduce income tax is increased in importance, both in absolute terms and relative to transfer taxes. The importance of tax basis of assets is significantly increased. Planning to increase basis now has greater value.

CRITICAL POINT: Trusts that are Candidates.

The trusts that are ripe for this step up procedure would have certain characteristics:

1. Irrevocable trusts which assets have value in excess of basis,

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

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

> **<u>Example:</u>** Assume Joe and Mary set up a standard A-B trust arrangement in 2001 when the estate tax exemption was $1,000,000 and Joe dies in 2008, and their total net estate then is $4,000,000, equally owned, whether or not community property. All of Joe's property is allocated to the Bypass Trust (a/k/a the Credit Shelter Trust or the Decedent's Trust). And all of Mary's property ends up in the Survivor's Trust. Mary is not doing well in 2013. The Bypass Trust is now worth $3,500,000 - and Mary's estate is $1,000,000, because it had the house

[1] Truth be told, there is a deduction of the state death tax in computing the federal estate tax. So the effective highest Washington marginal rate may be about 11.4% today, and with the current 40% federal rate yields a 51.4% marginal rate.

and she has spent down the Survivor's Trust and did not deplete the Bypass Trust. Much of the Bypass Trust has appreciated assets – value materially in excess of its basis. The survivor, Mary, has a general power of appointment over her assets, but she also has a special power to appoint the assets of the Bypass Trust to anyone but her, her creditors, and the creditors of either. The design was to give maximum flexibility, but avoid inclusion of the Bypass Trust in the estate of the Mary.

General Discussion.

The Federal Estate Tax Exemption increased to a much larger $5,250,000 in 2013. There is opportunity to use the Delaware Tax Trap to select the assets of the Bypass Trust to be subject to estate tax upon the death of Mary to the extent that there is no tax, so as to permit the basis of the selected estate to be reset to fair market value to reduce future taxable gain or increased depreciation write-offs. However, the opportunity can only be exploited if the spouse, or child beneficiary, or even a poor relative who is not a beneficiary of the trust has a right in the trust agreement (or as decanted) to change the beneficiaries of the trust or the method a beneficiary enjoys the property held by the trust.

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

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

Such a trust was intended to shelter funds from estate tax of the surviving spouse when the Estate Tax Exemption was $1,000,000 or even when it was higher. But with the current Federal Estate Tax Exemption at $5,250,000, subject to inflation adjustment, all or a significant portion of the Bypass Trust now may not need to be sheltered from the Estate Tax. For example, if the assets owned by the survivor total $2,000,000, and the amount in the Bypass Trust also totals $2,000,000, then even if the assets were all owned by the survivor, there would still be no Estate Tax upon the survivor's death since the total estate would be $4,000,000 and the Estate Tax Exemption is well over that, at $5,250,000 in 2013.

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

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

<u>Bypass Trusts</u>. However, if the property was funded into the Bypass Trust of the deceased spouse so as not to be included in the estate of the surviving spouse's estate, then no step up will occur, even if it turns out that there would have been no Estate Tax if there had been no Bypass Trust and the assets had been entirely owned by the survivor.

<u>Generation-Skipping Trusts</u>. The same low basis problem exists with so-called "dynasty trusts" or "generation-skipping trusts" that were set up by parents for their children designed to be available to them, but designed to both protect the assets from the creditors of the children and also to avoid being estate taxed on their death. The assets in those trusts may have value today far greater than the basis that the trust has in them. Because the assets are not included in the child's estate at his or her death, the basis of those assets is not increased to fair market value at the child's death. This lost opportunity is true even if the child's estate is much less than $5,250,000 exemption today and it would be an advantage to have the asset included in the child's estate for the tax free step up in basis.

Technique to be Used: Delaware Tax Trap: **Overview.**

If assets in the Bypass Trust for a spouse or Generation-Skipping Trust for a child are appointed at that person's death to another trust for others, then the Federal Estate Tax Code can cause the basis in the selected assets to be "stepped up" to fair market value. Not all trusts can be successfully modified, but many can. One important point to remember: The step up in basis technique cannot be applied AFTER the death of the spouse or child. It must be set up while the party is living. Another important point: it may be possible to select and aggregate one or more elderly family members to elect to be the ones whose respective $5,250,000 Estate Tax Exemption are all used to include assets to be stepped up.

How can one get a step up in basis of assets in irrevocable generation-skipping trusts that will not realize a step up in basis for a long time? The answer is: Find some way to include those assets in the taxable estate of someone. Not just anyone - someone whose estate will be able to absorb the trust assets and not incur a federal estate tax or state estate or inheritance tax. Filling the bill nicely is a poor person's estate: it can soak up its weight in estate tax exemption. But up until 2001 that soaking up ability was limited to less than $1,000,000, then slowly ramping up to $3,500,000, and now $5,250,000 in 2013. So now, many more people are expected to have taxable estates way under the current exemption. For example, under the current exemption of $5,250,0000, many, if not most, spousal Bypass Trusts created when the first spouse passed away years ago do not need to be in place today to save estate taxes when the survivor passes away. The surviving spouse could own the property in that trust and still not incur an estate tax. If property in the Bypass Trust, or even just specific property in the Bypass Trust, has a fair market value significantly greater than the trust's basis in the assets then it would be great if that asset could become includable in the surviving spouse's estate to obtain that step up in basis pursuant to Section 1014(b). If only it could.

There is a way.

Understanding the Delaware Tax Trap.

Few people, even among the estate planning community, understand it. It is generally thought of as something just plain bad. The Delaware Tax Trap is the nickname for Code Section 2041(a)(3) and its little brother Section 2514(d).

In a way the Delaware Tax Trap is like the Grantor Trust Rules of Code Section 671, et.seq., where a creator of a trust may remain taxed on its income even though he cannot benefit from it. The legislation was desired by the taxing authority to prevent abuse by perceived aggressive taxpayers, and then embraced to obtain beneficial tax results by the next generation of tax planners.

Internal Revenue Code Section 2041(a)(3) provides:

> **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**.

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 Section 2514(d) causes an intervivos exercise of similar effect to be treated as a gift by the powerholder.

These sections are called the Delaware Tax Trap because when the sections were enacted Delaware's Rule Against Perpetuities Statute ("RAP") was different than other states in an important regard. Delaware's RAP allowed a person having a special power of appointment to appoint property to another trust and give another a power to appoint in further trust such that the property did not have to vest in someone's absolute ownership within the RAP period beginning when the trust first became irrevocable. Mechanically this was accomplished because then Delaware's RAP by default caused the RAP period to begin again upon the exercise of the power, on the "creation" of the the nonvested interest or new power. Congress perceived this as abusive because it permitted avoidance of federal estate taxes by "floating" the ownership out for potentially hundreds of years. It was a "trap" because someone could exercise the 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 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. So for GSTT purposes, from that time forward are the beneficiaries deemed two or more generations down from the decedent are "skip persons."

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

To spring the Delaware Tax Trap, it is necessary to exercise a special power of appointment to create another power of appointment. Is there a preferable kind of power of appointment to create? There are two fundamental types of powers of appointment that can be granted to spring the trap to step up trust assets bases: a general power of appointment ("GPA") and a special power of appointment ("SPA"). A GPA permits the powerholder to appoint the trust assets to any one or more persons, including the pwerholder. An SPA permits the powerholder to appoint to any one or more persons, outright or in trust, by 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 two reasons: (1) it continues to permit protection of trust property from the creditors of all beneficiaries and (2) trust property does not have to be made available for the immediate taking by any beneficiary or other person, and 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 most states there is no choice, and the Delaware Tax Trap can only be sprung by creation of a presently exercisable GPA. Under the common law and the law of most states the creation date for purposes of measuring the RAP period when an SPA is exercised creating another power of appointment remains the date of funding of the irrevocable trust. So, the exercise of the power 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. Therefore such exercise will spring the trap, the appointed assets will be subjected to estate tax, and the basis of the assets will be stepped up. However the price paid for basis step up is exposure of the assets to the sole control of the person granted the power, and to his creditors, as well as inclusion in his estate upon his death for estate tax purposes.[2]

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

Fortunately, in a few states, the Delaware Tax Trap can be sprung and the bases of assets can be stepped up when the new power created is an SPA. In other words, the creation date of the new power is the date of the exercise of the power creating the power. Arizona and, it appears, Idaho, Rhode Island, Pennsylvania and Virginia are such states. In such states the trap can be sprung by exercising the initial SPA to create a second SPA, 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 nor the rule elsewhere. Arizona is one state in which one can select whether or not to spring the trap by exercise of an SPA and do it by either giving another person an SPA or a presently exercisable GPA.

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 two, both for asset protection from creditors of the beneficiary and, if desired, from the beneficiary's control and to avoid estate tax

[2] 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 those states where date of creation of the new power for RAP purpose is the date of exercise of the first power.

inclusion in the beneficiary's taxable estate. Having said that, the creation of an SPA means that, in addition to the powerholder's having sufficient estate tax exemption, there must be allocation of sufficient GST Exemption by the powerholder's estate so distributions to skip persons from that new trust do not trigger the GSTT. Obviously, if there is no GST Exemption available, then an unvested interest with SPA should be avoided if a skip person (of the powerholder, not the settlor) could receive distributions before the Delaware Tax Trap is sprung by a nonskip person. Even if the powerholder has no GST Exemption, skip persons of the trust after exercise of the power are determined from the powerholder's generation and not the settlor's generation.

The exercise should be able to be made in the form of a formula clause to exactly soak up the remaining Estate Tax Exemption (or GST Exemption, if desired) of the powerholder, like a marital deduction clause or charitable deduction clause. The exercise could be to appoint specific property having low basis in further trust with an SPA. Only then would the property be included in the estate of the powerholder in order to achieve basis step up.

See Specimen Exercise Of Power Of Appointment below.

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[3] for trusts becoming irrevocable in 1995 and thereafter,[4] and with

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[3]Arizona may be one of a handful of states to have this Delaware Tax Trap potential. Interestingly, Arizona's statute may be one of the few that can be controlled. Other flexible states may be Idaho, Rhode Island, Pennsylvania and Virginia. There is a decent argument that Delaware's 2000 changes in its RAP by adding a new Section 504 in Title 25, Delaware Code does nothing to prevent the Delaware Tax Trap from to applying on every exercise of any power of appointment of a trust governed under Delaware law. This is because in the Delaware RAP there is no limitation on the length of time interests in property other than realty can remain unvested or powers to appoint such exercisable. Therefore, even though the creation date of a second power over a GST exempt trust is deemed (pursuant to Section 504) to be the date the first power arose, all subsequent powers of appointment created are validly exercisable under "applicable local law" for periods that can be determined "without regard to the date of the creation of the first power," since they are always valid, regardless of when created. Therefore the trap is always tripped 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). But see Topic below: "Designing Future Irrevocable Trust Agreements to Permit Basis Step Up" and fn.12 for a possible solution. But at least one commentator (ACTEC Fellow Jerry Horn) believes the opposite, since the Delaware tax trap statutory language requires that the appointment must

respect to creation of new powers of appointment resulting from exercises of power under pre-1995 trusts.[5] But to really see it, ARS Section 14-2901, Section 14-2902, and Section 14-2905 have to be read together:

> **ARS Sec. 14-2901. Nonvested property interest; general power of appointment; validity; exception**
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>
> **C. A nongeneral power of appointment or a general testamentary power of appointment is invalid unless at least one of the following is true:**
>
> **1. At the time the power is created it is certain to be irrevocably exercised or otherwise to terminate not later than twenty-one years after the death of a person who is then alive.**
>
> **2. The power is irrevocably exercised or otherwise terminates within five hundred years after its creation.**
>
> **3. The power is with respect to an interest under a trust whose trustee has the expressed or implied power to sell the trust assets and at one or more times after the creation of the interest one or more persons who are living when the trust is created have an unlimited power to terminate the interest.**
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"postpone" the vesting date, and that literally cannot be done under the Delaware RAP, since 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 p.23, expanded from Chapter 13 of *Flexible Trusts and Estate for Uncertain Times*, 4th Edition (ALI-ABA 2010).

[4] ARS Section 14-2902(A) provides: "Except as provided in subsections B and C of this section and section 14-2905, subsection C, the time of creation of a nonvested property interest or a power of appointment is determined under general principles of property law." (See fn. 6). ARS Section 14-2905(A) provides: "Except as otherwise provided, this *article* applies to a nonvested property interest or a power of appointment that is created on or after December 31, 1994." [emphasis added] Together ARS Section 14-2902(A) and ARS Section 14-2905(C) have the effect of applying the Delaware "exercise is creation date" rule to post 1994 trusts. Furthermore, those provisions also have the effect of applying the Delaware "exercise is creation date" rule to exercises of pre-1994 trust powers creating new powers. In addition, the Arizona decanting statute, ARS Section 14-10819, permits modification of trusts to have a different RAP than the original trust so long as the recipient trust "[d]oes not violate the limitations on validity under sections 14-2901 and 14-2905." There is no mention of any requirement or limitation upon decanting that would require the recipient trust to comply with the pre-1994 Arizona rule against perpetuities, which was the common law rule.

[5] Both the Model Uniform Statutory Rule Against Perpetuities ("USRAP," now Part 9, Subpart 1 of the Uniform Probate Code) Section 2-905(a) and ARS Section 14-2901(C) cause application of the USRAP statutory regime to powers created after the effective date of the USRAP. Arizona's modified USRAP ("AZRAP") was changed as part of Arizona's 2008 enactment of the Arizona Trust Code (HB 2806) to provide that date of exercise of a special power under a trust to create another power became the creation date of the new power for all purposes of AZRAP, and not just to apply AZRAP to pre-1995 trusts. The result was to create the Delaware Tax Trap potential in Arizona for all such exercises after 1994, regardless of when the trust became irrevocable.

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

A. Except as provided in subsections B and C of this section and section 14-2905, subsection C,[6] the time of creation of a nonvested property interest or a power of appointment is determined under general principles of property law.

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

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

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

C. For the purposes of this article, if the person who exercises a power of appointment so provides in the exercise, a nonvested 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.[7]

An important fact to note is that the powerholder holding a personal nonfiduciary power who can attract estate inclusion or incur a taxable gift might not have a connection with, right in, power over, or significant beneficial interest in the trust other than the power to appoint into another trust.[8]

Under Arizona's RAP, specifically ARS Section 14-2905(C), when read with either Section 2901(B) or (C), the exercise of a special power of appointment to either:

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

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

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

[8] However, *see* S. Rep't 382, 82d Cong., 1st Sess., 1951 U.S. Code Cong. & Ad. Serv., Vol. 2 Legislative History, p. 1535, discussing trustee powers not coupled with an interest as not intending to cause the springing of the trap.

(i) create either a general or special power of appointment or (ii) postpone vesting (e.g., creating a series of life estates, generation to generation), can reset the RAP period, thereby Springing the Trap. This can be easily avoided by either not referencing ARS Section 14-2905(C) or specifying in the exercise that the RAP period will be measured from the date of the creation of the first power.[9]

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

If there is no SPA held by anyone in a low basis high value trust or in a 1.0 Inclusion Ratio Trust that will eventually distribute to skip persons, then how can a Delaware Tax Trap be sprung to either step up basis or bless a trust with GST Exemption or otherwise mitigate a GST Tax? Answer: DECANT – unless you can't.

For example, in Arizona, an irrevocable trust can be decanted by the trustee **if the trustee has the discretion under its terms to make distributions**. See ARS Section 14-10819 below. If the trust is "decantable," the trustee can now restate the trust so long as the conditions of Section 14-10819(A) are met: (i) fixed income, annuity or unitrust payments must continue to be made, (ii) the beneficiaries cannot be changed, (iii) the Arizona RAP must be followed, (iv) there is no adverse tax effect to the trust, trustee, settlor or beneficiaries, and (v) if the trustee is an beneficiary, he cannot liberalize the standards for distribution to him. Otherwise, the statute provides no other limits to the changes that can be made. One of the requirements to decant is that there be no adverse tax effect to a trustee, settlor, or beneficiary. The granting of a Delaware Tax Trap power does not adversely affect anyone. It is the exercise thereafter that could do so. So it appears to be within the parameters of ARS Section 14-10819(A)5 to create such a power.

If the trust is "decantable" it can be changed to apply the Arizona RAP, if that does not by itself cause adverse tax results to the beneficiaries, such as loss of GST grandfathering or GST Exemption 0.0 Inclusion Ratio. Having an Arizona RAP using 500 years suggested above would permit a Delaware Tax Trap exercise if there is held a power of appointment or trustee discretion.

Examples for Decanting to Create an SPA:

Ex.1. If the trustee may make distributions to a beneficiary in the trustee's discretion, logic would dictate that it can be decanted to grant the beneficiary a special power to appoint trust assets under whatever conditions trustee determines, since that is within a subset of the powers and rights the trustee could grant to the beneficiary.

Ex.2. The trust agreement provides that the trustee is to distribute to the beneficiary amounts for the health, education, maintenance and support of the beneficiary, and after death to trust for the beneficiary's descendants under the same provision for generation after generation. The trustee decanted the trust to restate the

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

trust with identical provisions, EXCEPT that beneficiary is given an SPA exercisable at death to appoint the trust property to an identical trust, with the unvested interest duration for Arizona 500 year RAP purposes to be measured from the exercise date. Then the beneficiary so exercises the power of appointment. Substantively there is no material change of beneficial interests. Technically the trap is tripped as the condition described in Code Section 2041(a)(3) has occurred.

Ex.3 Same as Ex. 2, EXCEPT Grandma having no net worth, instead of beneficiary, is given the SPA exercisable at death. She is intended to attract the estate tax inclusion.[10]

What if the Trust does not Qualify for Decanting?

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

> SECTION 411. Modification Or Termination Of Noncharitable Irrevocable Trust By Consent.
> SECTION 412. Modification Or Termination Because Of Unanticipated Circumstances Or Inability To Administer Trust Effectively.
> SECTION 415. Reformation To Correct Mistakes.
> SECTION 416. Modification To Achieve Settlor's Tax Objectives

The most appropriate of the above may be Section 416.

Decanting an Out of State Trust.

A trust's beneficiaries cannot benefit from Arizona law, including its RAP, unless the trust law applicable and the RAP is that of Arizona. If a trust has transferred its governing jurisdiction to Arizona, then the trustee can decant a "decantable" trust under the ATC. ARS Section 14-10819(B). A trust is subject to the jurisdiction of the state as specified by ARS Section 14-10202. One of the ways a trustee, and therefore a trust, becomes subject to the jurisdiction of Arizona courts is declaring that the trust is subject to the jurisdiction of the courts of this state. ARS Section 14-10202(A). Since this is a minimal connection, other connections should be established with Arizona, if practicable, such as possible co-trusteeship, administration, or assets or beneficiaries located or domiciled in Arizona.[11] Similarly, compliance with another state's law to attract its jurisdiction must occur.

[10] But see S. Rep't 382, *op.cit.,* p.1535.

[11] Arizona income taxation attaches to a trust if a trustee is resident in Arizona. ARS Section 43-1301(5).

Designing Future Irrevocable Trust Agreements to Permit Basis Step Up.

In states where the applicable Rule Against Perpetuities does not permit appointment creating another SPA to spring the trap, it should be possible to fashion new trusts to be able to do so. For example, assume that Florida has a general 360 year required vesting period RAP and no ability to appoint granting another SPA to spring the trap. A trust agreement of a trust governed under Florida law could provide that the required vesting period is 175 years, but otherwise the applicable Florida rule against perpetuities savings provisions are set forth in the trust agreement. In addition, the trust agreement provides that, if the powerholder elects, the creation date of either a new SPA starting a new 175 year special RAP period with respect to a trust asset will be the date of first exercise of the initial SPA set forth in the trust agreement. Literally, this should permit the springing of the trap and re-setting of basis. [12] The loss of a potential 175 years of suspended vesting (requiring vesting and estate taxation by the year 2188, instead of 2363) might be a little less onerous than foregoing an opportunity to step up trust asset basis anticipating a taxable sale or future deductible re-deprecation.

Summary.

The value of the utilization of the Delaware Tax Trap is primarily due to the huge increase in the Estate Tax Exemption, and, when important, the GST Exemption, both now $5,250,000. Not all trusts can be included in gross estates using the methods

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[12] Treas. Reg. Section 20.2041-3(e)(ii) (the "Regulation"), text produced below in this outline, provides that if the second power's permissible period of exercise can be ascertained without regard to the date of the creation of the first power under the terms of the trust, the terms of the exercise, and applicable local law, then the Delaware Tax Trap will apply. The statute (text produced above in this outline) just referred to local law. Assume that the trust instrument stated that an SPA has to be exercised in 1 year from its creation or it lapses, but exercise to create a new SPA will result in that SPA creation date to be the beginning point for its year of validity. If the second power was created 6 months after the trust was created, would that trip the Delaware Tax Trap? Literally it appears so since the regulation implicates both the local law AND the operative instruments in the analysis to determine if the period of vesting of the second power may be ascertained without regard to the creation of the first power, even though Code Section 2041(c)(3) only mentions local law. In other words, will Code Section 2041(c)(3) be applied taking into account the rules of required vesting be made by the instruments of trust and exercise, if of shorter duration than the applicable state law RAP? The private letter rulings referenced in fn.5 all involved the exercise of the first power appointing to a trust that required vesting within the state RAP period measured from the time of creation of the first power, even though state law permitted the RAP period of the second power to commence at its exercise. Such rulings are consistent with the reading that the Regulation permits vesting limitation periods to be determined by the operative documents. The rulings establish that "the terms of the instruments creating and exercising the first power and applicable local law" [the exact language in the Regulation] may provide a different date used to determine the beginning of the vesting period the state law creation date, for purposes of Code Section 2041(c)(3). Those same instruments, so long as not violative of the applicable state law RAP, logically may provide a different duration of the vesting period than the default state law duration, and should be controlling for purposes of Code Section 2041(c)(3). In *Murphy v Comm'r*, 71 TC 671 (1971), the Tax Court held that same clause (ii) of the Regulation, although varying in wording in a significant way from the statute with respect to which it was promulgated, controlled to interpret the same Code Section 2041(c)(3) and caused the court to find for the taxpayer.

described in this discussion. A few states permit trustees and beneficiaries to dial in the Delaware Tax Trap and maintain the highest degree of asset protection. Trustees may be able to decant or otherwise change the governing law of a trust to obtain both the benefit of basis step up and preserve asset protection. It is necessary to plan this technique carefully and well in advance, having first exercised the diligence in identifying the trust assets which bases are materially less than their current fair market value and will matter. This area will evolve.

C:\SEM\NYL\HOW TO STEP UP BASIS IN IRREVOCABLE TRUSTS

RELEVANT REGULATION AND STATUTES

TREAS. REG. SECTION 20.2041-3(e)

(e) Successive powers.

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

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

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

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

14-10202. Jurisdiction over trustee and beneficiary

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

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

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

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

B. This section applies to a trust governed by the laws of this state, including a trust whose governing jurisdiction is transferred to this state.
C. The exercise of the power to invade the principal of a trust under subsection A of this section is considered to be the exercise of a special power of appointment.
D. The trustee, in the trustee's sole discretion, before or after the exercise of the trustee's discretion under this section, may request the court to approve the exercise.
E. The trustee may exercise the discretion to appoint all of the trust estate pursuant to this section by restating the trust.

SPECIMEN EXERCISE OF POWER OF APPOINTMENT:

EXERCISE OF POWER OF APPOINTMENT (FORMULA CLAUSE)

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

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

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

Dated:____________________, 2013.

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JANE POWERHOLDER