Upstream 'Basis' Planning

Take-Away: When the principal goal of an estate plan is to gain an income tax *basis* adjustment, more so than to avoid federal transfer taxes, springing the Delaware Tax Trap is often the tool of choice to gain a *basis* adjustment to an asset's fair market value, thus eliminating the heirs' exposure to future capital gains taxes.

Caveat: What follows is, admittedly, tough reading.

Background: With the applicable exemption amount hovering close to $14 million per person, which is likely to be increased to $15 million if Congress has its way, there is far less incentive for individuals to avoid federal gift, estate, and GST taxes. In turn, this shifts much of estate planning to obtain an income tax *basis* 'step-up' of assets to avoid future capital gain taxes. We have covered this topic previously of intentionally increasing the income tax *basis* of assets, which was then described (tongue-in-cheek, but aptly) as *free-basing with Grandma*. We return to this topic, and *Grandma,* in more depth.

Delaware Tax Trap: The traditional use of the Delaware Tax Trap is in the estate tax context, relying on IRC 2041(a)(3). That Tax Code Section provides that if an individual (a power holder) exercises a power of appointment in a way that creates a new power of appointment that can be validly exercised to create a new perpetuities period that is different from the original perpetuities period when the initial power of appointment was first created, that exercise will cause the appointed property to be included in the power holder's gross estate for federal estate tax purposes. That inclusion then causes an adjustment to the income tax basis of the assets that were subject to the power of appointment. [IRC 1014(a).]

Gift Tax: There exists a parallel Delaware Tax Trap rule in the federal gift tax context. IRC 2514(d) applies to lifetime limited powers of appointment. That Tax Code Section provides that the exercise of a limited power of appointment in a way that creates a new power of appointment, a/k/a *staking powers of appointment,* that can be validly exercised to create a new perpetuities period that is different from the original perpetuities period of the trust is a taxable gift. If the exercise of the power of appointment is limited to trust corpus, it becomes a gift of the income interest in that property if the power holder has an interest in the income. [*Regester v. Commissioner, 83 Tax Court 1 (1984.)*] If the holder of the power of appointment does not retain an interest in the appointed property, then the new trust that is created from the exercise could be excluded from the power holder's gross estate for federal estate tax purposes. Unlike the estate tax Delaware Tax Trap that relies on the power holder's death to trigger the *basis* adjustment, or a GST exemption allocation, the gift tax Delaware Tax Trap can be sprung immediately, which may be its major feature. However, in this gift tax context, the trust property does **not** receive a *basis* adjustment. Consequently, springing this 'trap' as a gift might be useful to allocate the power holder's available GST exemption to a non-GST exempt non-grantor trust's assets, but it will not be useful if the goal is to increase the income tax *basis* of the trust's assets.

Spring the Trap: To 'spring' the 'trap', a trust could grant an older person (*Grandma*) a limited power of appointment that she exercises in favor of a family member in a way that either (i) grants the family member a limited power of appointment that can be exercised to create a new perpetuities period, or (ii) grants the family member a presently exercisable general power of appointment.

Free-Basing: This is the *free-basing with Grandma* planning approach where an older individual (*Grandma*) with plenty of applicable exemption amount to available to her, is given a testamentary general power of appointment over a trust that benefits the settlor's children, or grandchildren, where *Grandma* is expected to die first, thus causing the value of all of the trust's assets to be included in *Grandma's* gross estate for federal estate tax purposes. This gross estate inclusion of the value of the trust assets then causes an income tax basis adjustment (or 'step-up') to all trust assets on *Grandma's* death. [IRC 1014(a),(b)(4) and (b)(9).] The Regulations clarify that this *basis* adjustment applies to property that was includible in the power holder's gross estate because of the exercise, **or the nonexercised, power of appointment.** [Regulation1.1014-2(b)(2).] Even if *Grandma* lacks legal capacity to exercise the general power of appointment, the *basis* adjustment benefits of IRC 1014 are still available. [See Revenue Ruling 75-350.] A federal appeals court has held that the mere existence of a general power of appointment is sufficient to cause gross estate inclusion for the power holder under IRC 2041. [*Fish v. United States, 432 F.2d 1278 (1970)*.] Other federal courts have reached the conclusion that IRC 2041's gross estate inclusion rule applies even if *Grandma* did not know that her power of appointment existed. [*Alperstein v. United States, 613 F.2d 1213 (1979.)*]

Relation Back Doctrine: Absent any legislative change, however, the common law, and the Uniform Rule Against Perpetuities Act apply the **relation back doctrine**, which treats the perpetuities period of a newly formed power of appointment as that of the original perpetuities period, except in the case of a presently exercisable general power of appointment. As such, the relation back limitation must be navigated to achieve the gross estate inclusion and thus gain the intended *basis* adjustment.

Free-Basing Existing Trusts: Assume that a trust already exists, like a credit-shelter trust, that benefits grandchildren, but the trust does not give an individual a general power of appointment over the trust corpus. Maybe, too, this trust is not GST-exempt. How can changes be made to this credit-shelter trust to enable another person who has a large, available, applicable exemption amount (or large GST exemption amount), to be used (probably more accurately, *exploited*) to (i) increase the *basis* of trust assets and (ii) use the powerholder's available GST exemption to shelter the trust assets from future GST taxes on distributions to the grandchildren?

It is possible to achieve some federal capital gains benefits with such a trust. The trick is to use the living to help the non-grantor trust by doing upstream planning with strategic general powers of appointment or springing the estate tax Delaware Tax Trap. The Tax Code opens the door to this free-basing. This might be achieved by granting a power of appointment through a trust director, the granting of which does not require the trust beneficiaries' consent or grant only limited powers of appointment and rely on the power holder to spring the 'trap.' Since a trust director in Michigan is a fiduciary, it may be necessary to move the trust to another jurisdiction, like Delaware, where the trust director does not have to always act in a fiduciary capacity. Or, the trust could be decanted by the trustee, or otherwise modified, to grant *Grandma* a testamentary general power of appointment that is only exercisable with the consent of an adverse person (see below.)

Drafting Powers of Appointment: Because there might be some reluctance to give *Grandma* a full-blown general power of appointment over an irrevocable trust that she did not fund, nor is she a beneficiary, there can be some controls or limitations placed on her power, and the general power more effectively employed. A formula power of appointment is normally the preferred method for upstream *basis* planning, for a variety of reasons. A few considerations or suggestions follow:

- If the fear is that *Grandma* might go rogue if she now has a general power of appointment to appoint trust assets to anyone, or she has creditors that might reach into the trust by exploiting *Grandma's* general power of appointment to attach trust assets, *Grandma's* power could be a limited *testamentary power of appointment*, which is limited solely to satisfying the creditors of *Grandma's* estate (if any.) Thus, the time that the power can be exercised is limited, and the potential appointees of the power are also limited (to her estate creditors) which despite the presence of such limitations will be sufficient to cause estate inclusion on *Grandma's* death.

- Nor does the general power of appointment held by *Grandma* need to be an open invitation to her creditors or her whims and favoritism. A general power of appointment for federal tax purposes can be structured with 'strings' attached. IRC 2041(b)(1)(C) provides that, among other types of powers, a general power of appointment includes one that is exercisable only with the consent of a person that does not have a substantial interest in the property that is adverse to the exercise of the power. Thus, an independent trustee or trust director could fill the role of that person who must consent to *Grandma's* exercise of her general power of appointment. [Regulation 20.2041-3(c)(2).]

- Merely holding a general power of appointment at death will cause federal estate tax inclusion for *Grandma,* which will cause an *indirect skip* for GST tax purposes and adjusts the income tax *basis* in the trust assets included in *Grandma's* gross estate. *Grandma's* available GST exemption can then be applied to the trust to shelter any future GST tax that might otherwise have to be paid on a GST distribution or termination.

- If the goal is to apply the power holder's GST exemption, the formula exercise of the power might be limited to the value of trust property that would not exceed *Grandma's* available GST exemption. I

- f *Grandma* lacks sufficient GST exemption to shelter the entire trust from future GST taxes, then a qualified severance of the trust could follow to ensure that trust has only fully exempt, and fully non-exempt ,GST portions. [Regulation26.2642-6.]

- To maximize the new income tax *basis* benefits, the power of appointment formula, or a condition, could use an ordering rule that prioritizes including in the power of appointment or its exercise, the property of the trust that is eligible for an increased new *basis* under IRC1014 (a) or a proportionate amount of the trust property, thus excluding assets that are not available for a new *basis,* such as income in respect of a decedent, e.g., IRAs, or property that would receive a decreased *basis* adjustment. The trust may hold property that does not qualify for a *basis* adjustment, like income in respect of a decedent, or it may have assets that have decreased in value. In these situations, it would not be wise to attempt a *basis* adjustment because it would either be ineffective (with the IRD) or it would eliminate built-in capital losses the trust may be able to use in the future to offset future capital gains. Thus, the formula that grants the general power of appointment, or the exercise of a limited power of appointment, should only be over property that would create the largest federal income tax benefit to the trust.

- If the goal was to use *Grandma's* available GST exemption to cause a non-GST exempt trust to become an exempt GST trust, then the formula should use 'ordering rules' to create a priority list that begins with the most federal income tax benefit to the trust, then reach property that would not have a federal income tax benefit if the *basis* adjustment rules apply, e.g., IRD.

Conclusion: Exploiting the Delaware Tax Trap to gain an income tax *basis* adjustment for assets that are subject to a power of appointment is fundamental to estate planning. How and when that 'trap' is 'triggered' thus becomes important. There are also several different considerations involved in working with, and/or around, the 'trap' that makes drafting the power of appointment particularly challenging. But if the goal is to increase *basis* in assets, becoming familiar with the Delaware Tax Trap is a first step.

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