FINDING BASIS – IT'S NOT ALWAYS WHERE YOU THOUGHT IT WAS

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I. INTRODUCTION

The dramatic increase in the applicable exclusion amount and GST exemption by the 2017 Tax Act[2] has caused income tax planning to surge past wealth transfer tax planning for a great many clients. Clients with an estate significantly below the $11,400,000 applicable exclusion amount and GST exemption for 2019 ($22,800,000 for a married couple) now means that a great many clients have little to worry about with respect to the estate tax. Leaving the entire estate to a surviving spouse or a QTIP trust and relying on portability will be adequate estate tax planning for many clients. It also has the advantage of assuring that the entire estate passing to the surviving spouse will receive an estate tax value basis under Section 1014 at the surviving spouse's death.

Some clients, however, are surviving spouses with a nonmarital trust already in existence. Others have created irrevocable trusts that are not expected to be included in their gross estates, wasting potential basis increases.

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[1] Large portions of this outline are taken from *Basis After the 2017 Tax Act -- Important Before, Crucial Now*, written by Howard M. Zaritsky, Esq. and Lester B. Law and originally presented at the 53rd Annual Heckerling Institute on Estate Planning sponsored by the University of Miami School of Law.

[2] Pub. L. 115-97, 115th Cong., 1st Sess. (2017), 131 Stat. 2054. The Senate Parliamentarian required that the short title of "The Tax Cuts and Jobs Act" be deleted from the final act, because it had no revenue effect and, as the bill was being passed under the budget reconciliation procedures (avoiding the Senate filibuster rules), it had to contain only revenue-related provisions. The technical name of the bill is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." We shall refer to it as the 2017 Tax Act. So be it.

Still other clients will be looking for ways to get a full basis adjustment in the certain assets whenever the first spouse dies, whichever it may be, or even better, assets of both spouses when the first spouse dies.

II. OBTAINING A BASIS ADJUSTMENT IN A NON-MARITAL TRUST AT THE SURVIVING SPOUSE'S DEATH[3]

A. Generally

One may draft a nonmarital trust expecting to desire that the assets all be excluded from the surviving spouse's gross estate, but discover that the surviving spouse's estate is significantly smaller than his or her available applicable exclusion amount. Whether initially drafting a nonmarital trust or deciding whether to modify an existing trust by decanting, judicial modification, or nonjudicial modification, the estate planner should include in the trust instrument a device by which all or some of the trust's appreciated assets may be rendered includible in the surviving spouse's gross estate.

There are four potential mechanisms to achieve the basis step-up:

- Independent trustee power of distribution;
- Contingent general power of appointment;
- Trust protector with the ability to create a general power of appointment; and
- Delaware Tax Trap.

B. Independent Trustee Power of Distribution

1. Generally

The first alternative to achieve a basis step-up is to grant an independent trustee broad authority to make distributions to the surviving spouse (i.e., not limited to an ascertainable standard, as defined in the regulations under Section 2041).

[3] Part of this section was taken from Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Est. Pl. Inst. (2014). Richard Franklin, Esq., was the primary contributor to that portion of *Clinical Trials in Portability* which discussed basis adjustment, any mistakes in this section are those of the authors; Mr. Franklin does not make mistakes herein.

Using such power, the independent trustee could make distributions to the surviving spouse of appreciated by-pass trust property. If the amount distributed does not exceed the surviving spouse's excess exclusion, federal estate taxes are not triggered. Once the asset is distributed, the asset will be part of the surviving spouse's gross estate for federal estate tax purposes. Section 2033. The asset will be considered to have been acquired from the decedent (i.e., who is the second spouse to die) so that it is subject to the general basis adjustment rule. IRC § 1014(b)(1).

2. Advantages

a) Selection of Appreciated Assets

This method allows the independent trustee to pick and choose the appreciated assets to be distributed.

b) Retention of Depreciated Assets

Depreciated assets can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

This is a relatively simple arrangement, not based on a formula or involving complicated power of appointment issues. It is likely that clients, accountants, and financial representatives could all understand this approach.

Explaining formula or springing general powers of appointment or the Delaware Tax Trap will be more challenging. Therefore, the simplicity of this approach should not be dismissed lightly.

3. Disadvantages

a) Requires a Bold Independent Trustee and they Are Rare

Of course, an independent trustee may be reluctant to exercise this authority and the surviving spouse's death may occur unexpectedly, so that the distributions might not be made and the basis opportunity may be lost.

b) Timing Problems

The ideal time for distributing appreciated property is close to the death of the surviving spouse, so that any estimation of his or her potential taxable estate is more likely to be correct. This means that the independent trustee needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish to share this information.

c) Diversion Creditors

Another risk is that any distributed assets might be given by the spouse to persons other than those intended by the first spouse, such as a new spouse or the family of a new spouse or a charity with which the first spouse was not comfortable. Similarly, the assets could be diverted to other persons by exposing them to the surviving spouse's creditors.

d) Irrevocability of Distribution

Once you distribute assets to the surviving spouse, they belong to the spouse. There is no means of correcting this if the independent trustee later determines that the assets should not be held by the spouse, because of the possibility of diversion or creditor claims, or because the spouse's estate grows faster than anticipated, cannot be remedied.

C. Contingent Formula General Power of Appointment

1. Generally

An alternative to the independent trustee's distribution power is for the by-pass trust to grant a contingent general power of appointment to the surviving spouse. As explained below, this strategy has some gaps in the legal analysis, and is thus not without its risks.

If the surviving spouse is granted a general power of appointment over all, or a portion, of the by-pass trust the general power of appointment will cause inclusion in the estate of the surviving spouse for Federal estate tax purposes. IRC § 2041.

If the surviving spouse exercises a testamentary general power of appointment, the property passing, without full and adequate consideration, as a result of the exercise is considered to have been acquired from or to have passed from the now deceased surviving spouse, and thereby the general basis adjustment rule will apply. IRC § 1014(b)(4).

If the surviving spouse does not exercise the general power of appointment, the property required to be included in determining the value of the surviving spouse's gross estate is considered to have been acquired, or to have passed, from the now deceased surviving spouse, and thereby the general basis adjustment rule will also apply. IRC § 1014(b)(9).

Granting the surviving spouse a general power of appointment over all, or a portion, of the by-pass trust is not abusive for purposes of the general basis adjustment rule. The by-pass trust is funded upon the death of the deceased spouse. The surviving spouse is granted a testamentary general power of appointment over that trust. Even if the surviving spouse dies within one year of the deceased donor spouse's death, the by-pass trust cannot ever pass assets back to the deceased donor spouse. Therefore, Section 1014(e) (i.e., the one-year rule) is inapplicable.

2. Is it Possible to Create a Contingent General Power of Appointment?

a) Generally

This section of the paper addresses whether it is possible to create a formula general power of appointment that is (i) contingent on the surviving spouse having any unused applicable exclusion amount, and (ii) structured to be applicable to particular assets in the by-pass trust that, without an automatic basis adjustment under Section 1014, upon the surviving spouse's death would have the potential of triggering an income tax liability upon disposition as a result of appreciation in value or for other reasons such as having been depreciated for income tax purposes.

Also addressed is whether it is possible to structure the general power of appointment over the assets or classes of assets that (i) have the most significant appreciation, (ii) will be taxed at the highest rates (e.g., collectables at higher capital gains rates or depreciated assets subject to recapture at ordinary rates), or (iii) will be subject to disposition at the earliest point in time.

b) Limiting a Formula General Power of Appointment Based on the Surviving Spouse's Unused Applicable Exclusion Amount

(1) Private Rulings

The Service has approved of formula general powers of appointment based on the remaining estate tax exclusion of the decedent spouse. In PLRs 200403094 and 200604028, the decedent spouse was granted a formula general power of appointment over a share of the surviving spouse's revocable trust based on the amount of the decedent spouse's applicable exclusion amount that would otherwise be unused. The power of appointment in PLR 200403094 is quoted in the ruling as follows:

> *"At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will."*

The power of appointment in PLR 200604028 is described as follows:

> *"Trust 1 provides that if Wife is living at the time of Husband's death, Husband shall have a testamentary general power of appointment equal to the amount of Husband's remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code ("Code") minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power)."*

The strategy of the planning outlined in these PLRs allowed for the use of the lesser moneyed spouse's applicable exclusion amount if he or she died first by granting the lesser moneyed spouse a general power of appointment over the moneyed spouse's revocable trust but only to the extent the lesser moneyed spouse had exclusion that would otherwise be unused. This structure enables the moneyed spouse to retain control over his or her assets to be used for this purpose, unless and until the lesser moneyed spouse died first.

These rulings raise many interesting tax questions that are not of concern for purposes of this discussion. Importantly, however, no one questioned the scope of the formula general power of appointment being defined by reference to the deceased spouse's remaining unused applicable exclusion amount, which by definition would not be determined until the deceased spouse died.

(2) Regulations

Similar formula structures are sanctioned in the contexts of disclaimers and partial QTIP elections. For example, Reg. § 25.2518-3(d), Ex. 20, allows a fractional formula disclaimer by reference to the smallest amount which would allow the decedent's estate to pass free of Federal estate tax.

Additionally, Reg. § 25.2523(f)-1(b)(3) provides that the taxpayer may make the gift tax QTIP election by means of a formula that relates to a fraction or percentage of the QTIP trust, but the gift tax regulations provide no examples of such an election.

The estate tax QTIP regulations, however, are helpful in illustrating such formula elections. See, Examples 7 and 8 of Reg. § 20.2056(b)-7(h).

The type of contingent general power of appointment contemplated as a basis increase mechanism upon the surviving spouse's death must be fixed and determinable upon the surviving spouse's date of death. A power of appointment is considered to exist even when the time for the exercise of the power is determined by the date of the donee's death.

While the assets of the by-pass trust may fluctuate during the surviving spouse's lifetime, the rights of the surviving spouse should not be considered a mere expectancy. For example, the Eighth Circuit Court of Appeals, in *Estate of Margrave v. Comm'r*, 618 F.2d 34 (8th Cir. 1980), *aff'g* 71 T.C. 13 (1978), considered a situation in which the wife owned a life insurance policy made payable by revocable beneficiary designation to trust over which the husband held an *inter vivos* general power of appointment. The court found that the husband had a mere expectancy in the policy because the designation could be revoked; additionally, it held that the policy was not includible under Sections 2041 or 2042 in husband's estate. This is distinguishable from a funded by-pass trust subject to a testamentary general power of appointment. The surviving spouse's beneficial interests in and the testamentary general power of appointment over the by-pass trust are generally considered vested. Perhaps the testamentary general power of appointment could be vested subject to divestment based on the trustee's exercise of fiduciary discretion to make distributions.

3. Advantages

a) Power Only Over Appreciated Assets

The regulations under Section 2041 do not directly address situations in which the power holder has a power over particular assets. The term power of appointment is defined as follows:

> *"The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. Treas. Reg. § 20.2041-1(b)(1)."*

The regulations refer to powers over "part" of a trust or an interest in a trust:

> *"If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 applies only to the value of the remainder interest excluding W's life estate. If A dies after W, section 2041 would apply to the value of the entire*

property. If the power were only over one-half the remainder interest, section 2041 would apply only to one-half the value of the amounts described above. Treas. Reg. § 20.2041-1(b)(3)."

The following examples illuminate the issues presented in the regulations:

Example II-1

The assets of Trust A consist of a tract of land and shares of a family company. B, a beneficiary, is granted a power to appoint the land to the creditors of B's estate. There appear to be neither rulings nor cases in which a power was defined in terms of specific assets rather than a fraction or share of the trust, but the power should, by logic and the plain meaning of the regulations, be a general power of appointment.

Example II-2

Assume the same facts as in Example II-1, except that B's power to appoint the land is contingent on whether an increase in basis would be possible if the land were considered to have passed from the surviving spouse as contemplated by Section 1014(b).
There appears to be no impediment to this contingency or means of classification of assets over which the general power of appointment should be granted.

b) Retention of Depreciated Assets

The power need not extend to depreciated assets, which can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) Complexity

This is a far more complex strategy than an outright distribution of assets, but it is self-effectuating and, therefore, the surviving spouse need not understand it quite as well as he or she does an outright distribution.

d) Self-Adjusting Power Removes Need for Data on Spouse's Health and Finances

Unlike an outright distribution, the formula general power of appointment automatically adjusts to a change in the spouse's estate. Furthermore, there is no need for the trustee to monitor the spouse's health and finances, because the grant of the power adjusts itself.

e) No Bold Independent Trustee Required

The trustee does nothing to make this grant of a general power occur. It is automatic, so the trustee need not be particularly bold or even attentive.

4. Disadvantages

a) Spouse's Creditors

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

b) Disclaimer Funded Nonmarital Trusts

Reg. § 25.2518-2(e)(1) states:

> *"(1) In general. A disclaimer is not a qualified disclaimer unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant . . . . If there is an express or implied agreement that the disclaimed interest in property is to be given or bequeathed to a person specified by the disclaimant, the disclaimant shall be treated as directing the transfer of the property interest. The requirements of a qualified disclaimer under section 2518 are not satisfied if— (i) The disclaimant, either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard); or (ii) The disclaimed property or interest in property passes to or*

> *for the benefit of the disclaimant as a result of the disclaimer . . . ."*

This appears to preclude a spouse who funds a nonmarital trust by disclaimer of all or part of the marital share, from retaining any form of power of appointment (other than a right to invade the trust limited by an ascertainable standard).

5. The *Kurz* Dilemma -- General Powers of Appointment Conditioned on Acts of Independent Significance

a) Facts

In *Kurz v. Comm'r*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995), the Tax Court and the Seventh Circuit decided whether the decedent's 5% withdrawal right over a family trust would be included in her gross estate, when its exercise was subject to a precondition of the exhaustion of the marital trust, and the decedent had a unilateral right to withdraw all of the assets of the marital trust.

The unremarkable facts are as follows: The decedent, a surviving spouse, had a 5% withdrawal right over the family trust, but only after the marital trust was exhausted. The surviving spouse was entitled to withdraw as much of the principal of the marital trust as she wished; she had only to notify the trustee in writing.

When the decedent died, the marital trust was worth about $3.5 million and the family trust was worth about $3.4 million.

The estate argued that, because the marital trust was not exhausted on the date of death, the contingency on the 5% withdrawal power was not satisfied and none of the family trust was includible in the decedent's gross estate. The Service argued that a power of appointment (or withdrawal) is exercisable even if there is an unsatisfied condition, if the holder of the power has the power to remove the condition.

(1) Tax Court

The Tax Court held for the government. The court examined the legislative history of Section 2041, and concluded that:

> *This legislative history clearly indicates that Congress intended to eliminate what it considered an abusive technique for avoiding the*

application of certain taxes; i.e., by the use of minor restrictions that did not affect the decedent's "practical, if not technical, ownership" of the property. However, we can find nothing in the legislative history, or the language of the statute, that would indicate that Congress equated this precedent-notice or period-of-delay language with a broad proscription against all conditions precedent within the control of a decedent.

101 T.C. at 55.

With respect to the nature of a precondition to the exercise of a general power of appointment that will suffice to prevent its taxation, if the precondition is not met on the date of death. The court added that:

. . . the condition does not have to be beyond the decedent's control, [but] it must have some significant non-tax consequence independent of the decedent's power to appoint the property. [Taxpayer] has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent's power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the Reg. § 20.2041-3(b).

101 T.C. at 55. The court noted that Section 2038 is rendered inapplicable if the transferor retains a power that is subject to a precondition that is not beyond the power of the transferor to satisfy. The rule for powers of appointment, however, is different, focusing instead on whether the contingency has a significant non-tax consequence.

(2) Seventh Circuit

The Seventh Circuit affirmed, noting that:

The Tax Court was troubled by an implication of the Commissioner's argument. Suppose the Family Trust had provided that Kurz

> *could reach 5% of the principal if and only if she lost 20 pounds, or achieved a chess rating of 1600, or survived all of her children. She could have gone on a crash diet, or studied the games of Gary Kasparov, or even murdered her children. These are not financial decisions, however, and it would be absurd to have taxes measured by one's ability to lose weight, or lack of moral scruples. . . . The Tax Court accordingly rejected the Commissioner's principal argument, ruling that raw ability to satisfy a condition is insufficient to make a power of appointment "exercisable". . . .*
>
> * * *
>
> *No matter how the second sentence of § 20.2041–3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have withdrawn all of the Marital Trust and 5% of the Family Trust by notifying the Trustee of her wish to do so.*

68 F.3d 1028, 1030.

(3) Analysis

The import of *Kurz* is that a precondition must have some real economic effect independent of taxes in order for it to prevent the taxation of a general power of appointment.

With respect to a formula contingent general power of appointment for basis adjustment purposes, several issues arise. First, if the holder of the power is also the trustee, he or she would have discretion over investments. The trustee could sell appreciated assets or retain them. Retaining the appreciated asset would potentially subject the asset to the surviving spouse's formula general power of appointment.

Arguably, the surviving spouse as trustee has a duty to invest the trust assets fairly and prudently for the benefit of all trust beneficiaries. The principles governing the trustee's fiduciary obligations for investment are not illusory and should have independent significance. Thus, perhaps the surviving spouse could be trustee.

Second, one must consider the extent to which the holder of the formula conditional general power of appointment has the power to alter the size of his or her potential taxable estate and, thereby, the amount of the power of appointment, by acts that lack independent significance. For example, a surviving spouse could enlarge the scope of the general power of appointment by making testamentary transfers that qualify for the unlimited estate tax marital or charitable deduction or by incurring deductible debts.

Giving assets to a surviving spouse or to charity seems and incurring debt seem best characterized as acts of independent significance. There are, however, few precedents regarding the meaning of an act of independent significance with respect to estate tax inclusion provisions. See, *e.g.*, Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of independent significance, whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); Rev. Rul. 72-307, 1972-1 C.B. 307 (power to cancel group term life insurance policy by terminating employment is not an incident of ownership, because it is exercisable only by performing an act of great independent significance); *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."); *Ellis v. Comm'r*, 51 T.C. 182 (1968), *aff'd*, 437 F.2d 442 (9th Cir. 1971) ("For petitioner to cause a situation to occur which would compel the trustee to distribute the trust's income to Viola, petitioner would have to create a major domestic crisis."

One may, therefore, wish to use a formula that determines the powerholder's taxable estate without considering any transfers by the surviving spouse that qualify for the estate tax charitable or marital deduction or any deductions for indebtedness. This provides a safer formula, though if there are debts or dispositions to a surviving spouse or charity, it may create a general power of appointment that is much smaller than an optimal power.

One may also give a nonadverse third-party, such as a trust protector, the power to increase the amount of property to which the formula power applies, thereby obtaining an automatic modest amount of appointive property and a possible correct full amount of appointive property.

6. Planning: Requiring Consent of a Non-Adverse Party

If the donor of the power is concerned with the surviving spouse actually exercising the power or exercising it in an undesirable manner, the contingent general power of appointment could be designed with the requirement that the donee obtain the consent of a nonadverse person. Caution is warranted, however, because under Section 2041(b)(1)(C)(ii), a person is not treated as holding a general power of appointment if the power is not exercisable except in conjunction with a person having a substantial interest, in the property subject to the power, which interest is adverse to exercise of the power in favor of the person who holds the power. A taker in default of the power's exercise is adverse.

7. Drafting

a) Simple Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax

Consider the following sample language in drafting a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse's estate to the maximum amount that will not cause an estate tax liability.

"[By-Pass Trust - Spousal Testamentary General Power of Appointment]

I give to my spouse[4] *a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:*

A. Fractional Share. *The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.*

B. How Exercised. *My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

b) Detailed Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax

The language that one would have to consider is how to draft a clause that, on the one hand, will minimize and eliminate any federal (and possibly state) estate tax, and on the other hand provide the largest basis to an asset, which when sold would minimize income taxes. This is perhaps the most difficult part of using this basis-adjustment planning tool.

To simply allocate basis across the board to all assets may not maximize the tax benefits. One of the issues is some assets may not be sold in the foreseeable future (e.g., it may be a family heirloom or family business that will pass from generation to generation, accordingly, the likelihood of triggering income tax is little or none). Another issue is that of the assets may be taxed at higher rates than other assets (e.g., sale of bullion is taxed at a different rate than stock

[4] Drafting note: In the 21st century, a marriage is not necessarily between a man and a woman. Each spouse will usually want to be referred to in some specific way ("husband," "wife," "spouse"). Ask the client for their preference and adjust the clause accordingly.

and bonds). But, grouping the assets based on tax rates (when sold) may not be the best result, because they may have high enough basis, so that the tax liability when sold may be minimal, and you would have wasted the use of exemption on those assets. Another issue is to segregate the assets with the largest difference between basis and fair market value at the date of death. This again may not be beneficial, since some assets may not be sold in the foreseeable future and some may have higher income tax rates. It appears that the better way to draft a clause may be to have a general power of appointment granted over those assets that would yield the lowest income tax burden when sold. The problem with this is that when the asset will be sold is generally unknown to the drafter at the time of drafting. For a more detailed explanation of the issues and for sample language that may be possible, see, Franklin and Law, *Clinical Trials with Portability*, 48th U. Miami Heckerling Inst. on Est. Plan. ___ (2014).

c) Sample Language

(1) Formula Automatic General Power of Appointment

The following is sample language for a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse's estate to the maximum amount that will not cause an estate tax liability. It does not assure the avoidance of the *Kurz* arguments.

"***Spousal Testamentary General Power of Appointment.***

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

A. Fractional Share*. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal* *estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.*

B. How Exercised. *My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

(2) Granting Power Over Appreciated Assets

(a) Generally

One could also attempt to grant this general power of appointment over specific trust assets that have most substantially appreciated. There is no direct authority for the ability to so direct a power of appointment, but the regulations do appear to acknowledge that a power of appointment may be limited to specific assets within a trust. See Reg. § 20.2041-1(b)(3).

(b) Sample Language

"***Spousal Testamentary General Power of Appointment****.*

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated Assets (as such term is defined hereunder). The fractional share and other terms applicable to the power are as follows:

A. Fractional Share*. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for* *this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse's death.*

***B. Appreciated Assets**. The Appreciated Assets shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a), if such assets passed from my spouse within the meaning of Code § 1014(b).*

***C. How Exercised**. My spouse may exercise the power by appointing the said fractional share of the Appreciated Assets of the By-Pass Trust free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.*"

(3) Tiered Formula General Powers of Appointment

(a) Generally

As discussed above, not all gains are taxed alike. Ideally, one would like to include in the powerholder's estate only those assets likely to produce the highest tax on sale or exchange. One approach would be to have a tiered formula. This tiered formula would be a series of sequential contingent general powers of appointment.

(b) Tiered Classes of Assets

(i) General

One approach is to establish tiers by class of assets. The first general power of appointment would be over a fractional share of the appreciated assets that would be exposed to the highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse's death. The second power would be over a fractional share of the appreciated assets that would be exposed to the second highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse's death, and so on.

(ii) Sample Language

"Spousal Testamentary General Power of Appointment.

A. General Power of Appointment Over Class #1 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of Class #1 as of my spouse's death. Class #1 shall mean those Appreciated Assets (as such term is defined below), if any, that would be subject to the highest aggregate rate of federal and state income tax if sold by* *the By-Pass Trust immediately prior to my spouse's death.*

B. General Power of Appointment Over Class #2 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the denominator of the fraction in Paragraph A above. The denominator of the fraction shall be the value of Class #2 as of my spouse's death. Class #2 shall mean those Appreciated Assets, if any, that would be subject to the second highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death.*

C. General Power of Appointment Over Class #3 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my* *spouse's death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Class #3 as of my spouse's death. Class #3 shall mean those Appreciated Assets, if any, that would be subject to the third highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death.*

D. Additional General Powers of Appointment Over Additional Classes of Appreciated Assets*. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional Classes of Appreciated Assets, with each successive Class of Appreciated Assets being those assets of the By-Pass Trust subject to the next highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.*

E. Last General Power of Appointment*. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.*

__F. Appreciated Assets of the By-Pass Trust__. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a) if such assets passed from my spouse within the meaning Code § 1014(b).

__G. How Exercised__. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular Class of Appreciated Assets free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.".

d) Tiered Individual Assets

(1) Generally

This formula may not achieve the best results, because grouping the assets by classes having the highest to lowest rate of income tax applicable to a sale will not necessarily increase the basis of the assets that have the most potential gain subject to tax.

Example II-3

Trust owns asset A, worth $1 million and with an adjusted basis of $900,000, and asset B, worth $1 million and with an adjusted basis of $500,000. The surviving spouse has $1 million of available applicable exclusion amount. If sold immediately prior to the surviving spouse's death, the assume rate of tax applicable to asset A is 30% and asset B is 25%. The formula recited above would grant a general power of appointment first over asset A, which would achieve a less favorable result than if it were granted over asset B, because granting it over asset B would save more total taxes, even though the rate of tax applicable to asset B is less than the rate that would be applicable to asset A.

(2) A Better Approach

A better result might be achieved by restructuring the formula to be based on each asset, such that the general power of appointment is first subject to the individual asset that would produce the most income tax liability if sold by the by-pass trust immediately prior to the surviving spouse's death. This approach will consider both the by-pass trust's adjusted basis in each asset, as well as the rate of tax that would be applicable on a sale by the by-pass trust.

(3) Sample Language

"Spousal Testamentary General Power of Appointment*.*

A. General Power of Appointment Over Asset #1 of the Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax][5] payable by reason of my spouse's death. The denominator of the fraction shall be the value of Asset #1 as of my spouse's death. Asset #1 shall mean that asset from among the Appreciated Assets (defined below), if any, that if sold by the By-Pass Trust immediately prior to my*

[5] This clause may be desirable if the testator resides or owns substantial tangible property in a jurisdiction that imposes a significant state estate tax.

spouse's death would generate the greatest aggregate amount of federal and state income tax.

***B. General Power of Appointment Over Asset #2 of the Appreciated Assets**. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the denominator of the fraction in Paragraph A above. The denominator of the fraction shall be the value of Asset #2 as of my spouse's death. Asset #2 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the second greatest aggregate amount of federal and state income tax.*

***C. General Power of Appointment Over Asset #3 of the Appreciated Assets**. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Asset #3 as of my spouse's death. The Asset*

#3 shall mean that asset from among the Appreciated Assets, if any, that, if sold by the By-Pass Trust immediately prior to my spouse's death would generate the third greatest aggregate amount of federal and state income tax.

D. Additional General Powers of Appointment Over Additional Assets of the Appreciated Assets. *I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional assets of the Appreciated Assets, with each successive asset of the Appreciated Assets being that asset of the By-Pass Trust subject to the next highest aggregate amount of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.*

E. Last General Power of Appointment*. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.*

F. Appreciated Assets of the By-Pass Trust*. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code §*

1014(a) [6] *if such assets passed from my spouse within the meaning Code § 1014(b) [OPTIONAL PROVISION: ,provided, however, that any Family Assets shall be considered last (and then classed based on greatest aggregate amount of federal and state income tax in a similar manner as provided above) For purposes of this Section the term "Family Assets" means ______ (e.g., the family farm or private family company, which is unlikely to be sold in the near future, etc.)]. For this purpose, blocks of shares of the same stock in the same company and having the same basis shall be consider as a block as one asset.*

G. How Exercised*. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular assets of Appreciated Assets free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

e) Caveat

This clause still does not take into account that some assets may be sold quickly, while others may never be sold. Increasing the basis of heirloom assets that are unlikely ever to be sold is of little value. One may consider leaving such assets to a separate non-marital trust that does not include a contingent general power of appointment.

D. Independent Power to Grant a General Power of Appointment

1. Generally

Another basis-adjustment alternative is to grant an independent trustee or trust protector broad authority to grant the surviving spouse a general power

[6] The instrument must elsewhere define "Code" to mean the Internal Revenue Code of 1986, as amended from time to time.

of appointment. For the reasons discussed above, it appears that the independent trustee or trust protector could grant the surviving spouse a general power of appointment over particular appreciated by-pass trust assets – e.g., the assets that are likely to generate the greatest aggregate income tax liability if they do not receive a basis adjustment – and/or those assets that are likely to be sold nearest in time following the surviving spouse's death.

If the value of the assets subject to the general power of appointment do not exceed the surviving spouse's excess exclusion, federal estate taxes are not triggered, and yet there will be a basis adjustment under Section 1014.

2. Advantages

a) Selection of Appreciated Assets

This method allows the grant of a general power that applies only to those appreciated assets selected by the independent trustee or trust protector.

b) Retention of Depreciated Assets

The independent trustee or trust protector need not grant a general power over depreciated assets, preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

This is a relatively simple arrangement, not based on a formula.

d) Revocability of Distribution

The independent trustee or trust protector can revoke or modify the general power after it is granted, as long as it is done before the surviving spouse's death.

3. Disadvantages

a) Requires a Bold Independent Trustee and they Are Rare

The independent trustee or trust protector may be shy in exercising the authority and that the surviving spouse's death may occur unexpectedly. The result of which is that the power might not be granted and the basis opportunity is lost.

b) Timing Problems

Again, the independent trustee or trust protector needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish freely to share this information.

c) Creditors

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

d) Disclaimer Funded Nonmarital Trusts

Reg. § 25.2518-2(e)(1), as quoted above, provides that a spouse who disclaims a portion of the marital share in order to fund the nonmarital share cannot, therefore, retain any power of appointment over the disclaimed portion, whether general or limited (other than a right to withdraw subject to an ascertainable standard). The regulations, however, are not limited to retained powers to direct the beneficial enjoyment; they simply state that the property must pass "without any direction on the part of the disclaimant to a person other than the disclaimant." While there is no case or ruling on point, it is inadvisably risky for a spouse who funds a nonmarital share by disclaimer later to be granted a general power of appointment over the disclaimed portion of the trust.

Of course, the penalty for violating the disclaimer rules would be that the spouse is deemed to have made a taxable gift of the disclaimed assets. If the surviving spouse filed a gift tax return in the year in which the disclaimer was made and if the statute of limitations on that return has expired, the spouse could accept the power of appointment with relative impunity.

e) Is the Power Really General?

One might argue that the independent person granting the power and the person to whom it would be granted can together exercise the power, which could make it a general power of appointment even if not granted. This analysis seems strained. While there appear to be no cases directly on point, see *Johnstone v. Comm'r*, 76 F.2d 55 (9th Cir. 1935), *cert. denied*, 296 U.S. 578 (1935), *aff'g* 29 B.T.A. 957 (1934); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972), *rev'g*

323 F. Supp. 1093 (N.D. Fl. 1971); and GCM 37428 (1981), which take the position that a donor's right to dispose of the property to which a power of appointment relates following the exercise of the power is not equivalent to requiring that the power be exercised jointly by the donor and donee of the power.

4. Drafting -- Clause Allowing Disinterested Trustee to Grant Surviving Spouse General Power of Appointment Over Assets in Nonmarital Trust, to Take Advantage of Increased Applicable Exclusion Amount

"ARTICLE __. Grant of a General Power of Appointment

*A "disinterested trustee" (defined below) may at any time and from time to time grant to my *husband/wife*, if *he/she* survives me, a power to appoint at *his/her* death, all or a portion of the assets of the family trust.*

A. Granting the Power. *A disinterested trustee shall grant this power of appointment by an instrument in writing delivered to my *husband/wife*, designating the specific trust assets or fractional share of the trust, which may include the entire trust, over which my *husband/wife* shall hold this power of appointment.*

B. Changing or Rescinding a Granted Power. *A disinterested trustee may revoke any prior grant of a general power of appointment under this article or change the property to which such previously granted power shall be exercisable, or the terms under which such previously granted power may be exercised.*

C. Permissible Appointees. *My *husband/wife* may exercise this power to appoint the subject trust assets to and among a class that includes the estate of my *husband/wife* and the persons who are otherwise current or potential beneficiaries of this trust.*

1. Appointment Outright or in Further Trust. *My *husband/wife* may exercise this power to appoint the trust assets outright or in further trust, and if exercised to appoint in further trust, may appoint on such terms and conditions as *he/she* shall select.*

2. Unequal Appointment. *My *husband/wife* may appoint the trust assets among this class of appointees unequally and in such proportions as *he/she* deems appropriate for any purpose whatsoever.*

3. Appointment to My *Husband/ Wife*'s Estate. *My *husband/wife* may appoint trust assets to *his/her* estate only with the express signed written consent of a "nonadverse person" (defined below) designated by the disinterested trustee in the instrument granting the power of appointment under this article. For this purpose, a "nonadverse person" is any person who has no substantial interest in the property subject to the power of appointment, which interest is adverse to the exercise of the power in favor of my *husband/wife*'s estate. Any attempted appointment to my *husband/wife*'s estate without the express signed written consent of the nonadverse party designated by the disinterested trustee who granted *him/her* this power of appointment shall be void and of no effect, and this power of appointment shall be deemed not to have been validly exercised.*

D. Exercise of This Power. *My *husband/wife* may exercise this power of appointment by express reference to this power in *his/her* last will, or by express reference to this power in another dated and notarized writing signed by *him/her*, which writing shall be revocable and ineffective during *his/her* life and effective only upon the death of my *husband/wife*.*

E. No Liability. *I recognize the difficulty attendant in the exercise of the power of the disinterested trustee to grant my *husband/wife* a general power of appointment in a manner that best reduces income taxes on the disposition of the distributed assets without also increasing the estate tax obligation of the estate of my *husband/wife*. I direct that the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for the disinterested trustee's actions under this article. Without exclusion, the disinterested trustee shall have no liability to any beneficiary or any other person for: (1) failing to grant my *husband/wife* a power of appointment; (2) granting my *husband/wife* a power of appointment that does not cause an amount of trust assets to be included in my *husband/wife*'s gross estate for Federal estate tax purposes* *that will obtain the optimal income tax benefit for the trust; (3) granting a power of appointment to my *husband/wife* under this instrument, even if such granting causes adverse income or estate tax results; (4) granting a power of appointment to my *husband/wife* that causes more property to be included in *his/her* gross estate than can be sheltered from Federal or state estate taxes by my *husband/wife*'s available exemptions and deductions; and (5) the actions of any nonadverse party in consenting or refusing to consent to the exercise of a granted power of appointed in favor of the estate of my *husband/wife*, or the action of the disinterested trustee in naming or refusing to name such a nonadverse party. A nonadverse party named by the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for consenting or refusing to consent to the exercise of any granted power of appointment in favor of the estate of my *husband/wife*.*

F. Disinterested Trustee" Defined. *A "disinterested trustee" means a trustee who is not an interested trustee. An "interested trustee" means a trustee who is also (1) a beneficiary of the trust of which he or she is the insured under a policy of insurance owned by a trust of which he or she is a trustee; (2) married to and living together with a beneficiary of the trust of which he or she is a trustee; (3) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (4) an employee of a beneficiary of the trust of which he or she is a trustee; (5) a corporation or any employee of a corporation in which the stock holdings of the trustee and the trust are significant from the viewpoint of voting control; or (6) a subordinate employee of a corporation in which the trustee is an executive."*

E. The Delaware Tax Trap

1. Generally

Perhaps the most technical of the basis adjustment mechanisms is the so-called "Delaware Tax Trap."

Section 2041(a)(3) states that a limited power of appointment is taxed as a general power, if it is exercised to create a new power of appointment and if doing so postpones the vesting or suspends the absolute ownership or power of alienation of the appointed property, for a period ascertainable without regard to the date of the creation of the first power.

The planning idea is that the surviving spouse as a beneficiary of the by-pass trust is granted a non-general power of appointment that can be exercised to create another power of appointment in a potential appointee that can extend the trust beyond the rule against perpetuities originally applicable when the trust was created at the first spouse's death. The surviving spouse then has the option of springing the trap by exercising the special power of appointment in such manner and subject assets of the by-pass trust to federal gift and estate taxes in the surviving spouse's estate, and attaining a desired basis adjustment. Thus, it is the surviving spouse who can spring the trap for the tax benefits it may provide.

The by-pass trust needs to enable the trap to operate when and if the surviving spouse decides to spring it. Some states have prophylactic statutes that are designed prevent a non-general power of appointment from operating in a manner that could postpone vesting, ownership, or alienation beyond the originally applicable rule against perpetuities. Some trust forms also have provisions designed to do the same. Thus, it may not be possible to use the trap in certain states.

2. The History

Just understanding the background of the Delaware Tax Trap – why it is called a trap – is complicated. Historically, Delaware allowed successive exercises of non-general powers of appointment in favor of non-charitable beneficiaries, which could in effect extend the life of a trust indefinitely without running afoul of the rule against perpetuities. Thus, assets that would otherwise have to be distributed and vest in a non-charitable beneficiary within the rule against perpetuities could be held in trust for a longer period of time (or indefinitely) simply by exercising the power and creating another non-general power of appointment. Historically, since donees of non-general power of appointments were not subject to gift and estate taxes at that time, not only could the assets be held in trust indefinitely, but estate and gift taxes could also be avoided indefinitely.

Note, however, that in states other than Delaware, at common law one starts a new perpetuities period by exercising a limited power in further trust and giving the beneficiary a presently exercisable general power of appointment.

Congress responded by amending Sections 2514 and 2041 so that exercises of the non-general powers of appointment in those cases would be considered the exercise of a general power of appointment and thus be subject to gift and estate taxes, respectively. Thus, if the non-general power of appointment was exercised, the exercise would be a taxable gift (if exercised during life) or included in the donee's estate (if exercised in the donee's testamentary instrument). Causing the donee of the non-general power to be taxed on the exercise (where the holder was a beneficiary and did not have the assets of the trust to pay the tax) was viewed as a tax trap – hence the "Delaware Tax Trap". Delaware amended its law to eliminate the trap.

On the Delaware tax trap generally, see Blattmachr, Kamin & Bergman, *Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Redefined, and Reexamined*, 47 Real Prop., Tr. & Est. LJ 529 (Winter 2013); Blattmachr & Pennell, *Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes*, 68 J. Tax'n 242 (1988); Blattmachr & Pennell, *Adventures in Generation-Skipping or How We Learned to Love the 'Delaware Tax Trap*, 24 Real Prop., Prob. & Tr. J. 75 (1989); Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 Albany L. Rev. 261 (1981); Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68 (Feb. 2001); Nenno, *To Bridge or Not to Bridge the Generation-Skipping Transfer Gap: Dynasty Trusts From the Client's Perspective*, 33 U. Miami Philip E. Heckerling Inst. on Est. Plan. (1999); Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets*, 41 Est. Plan. 3 (Feb. 2014); Spica, *A Practical Look at Springing the Delaware Tax Trap to Avert Generation-Skipping Transfer Tax*, 41 Real Prop., Prob. & Tr. J. 165 (Spring 2006).

3. Advantages

a) It Places the Entire Responsibility on the Surviving Spouse – It Does Not Require Action by the Fiduciary or Attorney

One does not want to assume too much responsibility for the ultimate execution of the details of an estate plan that are required to occur after the client leaves your office. This puts the onus on the surviving spouse, rather than the trustee or the attorney, to spring the trap. The attorney can in advance draft a codicil or trust amendment springing it, but it is still the spouse's responsibility for springing it.

b) The Fiduciary Need Not Obtain Personal Information About the Surviving Spouse

Unlike most of the other techniques, the fiduciary does not spring the Delaware Tax Trap – the surviving spouse does. Therefore, the fiduciary does not need personal information about the spouse's health or assets.

c) Less Diversion Risk

The surviving spouse has a more difficult time diverting assets away from he intended beneficiaries. The spouse only is given a limited power of appointment, making diversion to a new spouse or charity or other persons virtually impossible.

d) Superior Creditor Protection

As discussed in detail below, the surviving spouse's limited power of appointment means that his or her creditors are less likely to be able to access the assets.

e) Useful When There Was No Advanced Planning

The Delaware Tax Trap can be used even when there was no advanced planning for basis, as long as the surviving spouse already has or can be given a limited testamentary power of appointment. If one was not granted, in many states the trust may be modified to grant one, sometimes without a court order.

f) Jonathan Blattmachr Loves It

This is one of the favorite estate planning techniques of Jonathan G. Blattmachr, one of the nation's leading estate planners. Sometimes a testimonial helps. See Blattmachr, Kamin & Bergman, *Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Redefined, and Reexamined*, 47 Real Prop., Tr. & Est. LJ 529 (Winter 2013); Blattmachr & Pennell, *Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes*, 68 J. Tax'n 242 (1988); Blattmachr & Pennell, *Adventures in Generation-Skipping or How We Learned to Love the 'Delaware Tax Trap*, 24 Real Prop., Prob. & Tr. J. 75 (1989).

4. Disadvantages

a) It Is Really, Really Complicated

The operation of the Delaware Tax Trap is complex and almost unfathomable to anyone other than a certifiable estate tax geek. The attorney preparing the document should understand it – and how many of us can honestly say that we do? The concept will be challenging to explain to the couple when implementing the estate plan and when the surviving spouse springs the trap. Moreover, it will be challenging for rest of the estate planning team to understand, the trust officers, accountants and financial advisors. How likely is it that anyone other than the drafting attorney could spot the language and understand the potential planning possibilities?

b) It is Not Automatic

Exercising the Delaware Tax Trap requires an affirmative act by the surviving spouse. You can in advance draft the will codicil or trust amendment exercising the power, but the surviving spouse still has to execute it at an appropriate time.

c) Difficulty of Exercise in a Non-RAP State

As discussed below, it may be difficult to exercise in a state that does not have the rule against perpetuities, or that permits an election out of the rule.

d) Presently Exercisable General Power of Appointment and Creditors of the Beneficiary

You can trigger the Delaware Tax Trap by exercising a limited power of appointment in further trust and giving a beneficiary a presently-exercisable general power of invasion. (Example: I appoint the trust fund to my child's revocable trust, dated [date], to be held as part of that trust fund and subject to my child's power to revoke. This will cause that trust fund both to be included in the child's gross estate, however, and to be available to the child's creditors, in most states.

5. The Delaware Tax Trap in States That Have No Rule Against Perpetuities

a) Generally

Springing the Delaware Tax Trap is particularly complicated if the exercise of the power is governed by law of a state that has abolished the rule against perpetuities, whether for all trusts or for those for which abolition is elected. See 25 Del. Code § 503(a) (repealed for personal property interests held in trust); Ky. Rev. Stat. § 381.224; NJ Stat. §§ 46:2F-9, 46:2F-10; 20 Pa. Con. Stat. §§ 6104, 6107.1; Gen. Laws R.I. § 34-11-38; S.D. Cod. Laws §§ 43-5-1, 43-5-8, 55-

1-20. More states, including Virginia, allow an election not to have the rule against perpetuities apply to the trust: Ariz. Rev. Stat. § 14-2901(A)(3); D.C. Code § 19-904(a)(10); 765 Ill. Comp. Stat. §§ 305/3(9-5), 305/4; 33 Me. Rev. Stat. § 101-A; Md. Est. & Tr. Code § 11-102(b)(5); Mo. Ann. § 456.025; Neb. Rev. Stat. § 76-2005(9); N.H. Rev. Stat. §§ 564:24, 547:3-K; N.C. Gen. Stat. § 41-23(d); N.D. Cent. Code § 47-02-27.4; Ohio Rev. Code § 2131.09(B)(2) (this does not apply to trusts created by the exercise of a non-general power of appointment); Ohio Rev. Code § 2131.09(B)(4)); Va. Code § 55-12.4(A)(8).

It is unclear how the Delaware tax trap applies when there is no applicable rule against perpetuities. Absent a restriction on vesting, ownership, or alienation, it is unclear that a non-general power of appointment can create a second power that springs the Delaware tax trap.

One can reasonably argue that: (1) the Delaware tax trap can never be executed in such states because the date on which the first power is created is irrelevant in determining the date on which vesting, ownership, or alienation can be postponed; (2) every new power postpones the vesting, ownership, or alienation, and because the date on which the first power was created is ignored in determining when such periods must end, the new power always executes the Delaware tax trap; or (3) the Delaware tax trap should operate the same in states that lack a rule against perpetuities as it does in those that have such a rule.

The correct analysis depends on the details of the state statute, in light of the Tax Court's analysis in *Murphy v. Comm'r*, 71 T.C. 671 (1979), *acq. recommended* A.O.D. 1979-87, 1979 WL 53162 (May 30, 1979), *acq*. 1979-2 C.B. 1.

(1) Murphy v. Comm'r

(a) Facts

Mary Margaret was one of three beneficiaries of the Harris Trust, created by her late father, which provided for payment of income in equal shares to Mary, her sister, and their mother, until the death of Mary's mother. Upon the death of Mary's mother, the trust would terminate and its principal would be distributed in equal shares to the two sisters, if both were then living. A sister who predeceased their mother could appoint her share of the trust to anyone she chose, other than to her own estate, her creditors, or the creditors of her estate. Mary predeceased her mother and appointed her share of the trust to a new trust created under her will—the MMM Family Trust.

The MMM Family Trust provided for distribution of income to Mary's husband and issue, for the lifetime of Mary's husband and thereafter until her youngest child reached 35 years of age, at which time the trust fund would be distributed to Mary's children or lineal issue. Mary's will also gave her husband a non-general testamentary power of appointment.

Mary thus exercised her limited power by creating in her husband a power that he could exercise to place the appointive property in a perpetual trust. She also gave the trustee of the newly created trust a power of sale over the corpus.

Wisconsin law at that time had a statutory rule against perpetuities concerned only with the suspension of the power of alienation. Wis. Stat. § 700.16, as then in force. Under this statute, an interest was void only if it suspended the power of alienation for a period longer than a life or lives in being, plus 30 years. The Wisconsin statute also stated that there was no suspension of the power of alienation when the property interest is held in a trust and the trustee has the power to sell the assets of the trust. Thus, the unlimited postponement of vesting and ownership was permitted, as long as there was a current power of sale. *In re Walker's Will*, 258 Wis. 65, 45 N.W.2d 94 (1950).

Under the Wisconsin rule against perpetuities, the rule was not violated by Mary's exercise of her limited power of appointment to create a trust for longer than the rule against perpetuities.

(b) Estate's Argument

Mary's estate argued that, because Wisconsin law "expresses its rule against perpetuities in terms of a prohibition on the suspension of the power of alienation, and because the perpetuities period is measured from the date the first power is created, section 2041(a)(3) is not violated." *Murphy v. Comm'r*, 71 T.C. 671 at 677 (1979). Basically, because the appointed trust gave the trustee a power of sale, there was no creation of a new perpetuities period.

(c) IRS Argument

The IRS argued that Section 2041(a)(3) functioned independently of state law and that the Code states that if a power violates any one of three conditions of title (postponement of vesting, suspension of the powers of alienation, or suspension of absolute ownership), then the property subject to the power must be included in the gross estate.

(d) Tax Court Holds for Estate

The Tax Court admitted that the IRS argument was consistent with a literal reading of Section 2041(a)(3) but stated that the legislative history and the regulations showed that applicable state law dictated how and whether the trap could be triggered.

The court noted that in 1951, when the predecessor to Section 2041(a)(3) was adopted, there were two prevailing types of perpetuities statutes. The New York approach prohibited unlimited suspension of the power of alienation or absolute ownership. The other view prohibited unlimited suspension of vesting. The Code refers to a power of appointment that is exercised by creating a second power which "under the applicable local law" can be exercised so as to postpone vesting, ownership, or alienation. Thus, local law is critical in determining how this trap is applied and sprung.

If the local rule is expressed in terms of remoteness of vesting, the court stated, the IRS must determine if vesting of appointed property may be postponed for a period ascertainable without regard to the date of the creation of the first power. Similarly, if the local rule is expressed in terms of suspension of the power of alienation or absolute ownership, a determination must be made as to whether the prohibited condition may exist for longer than the permissible period.

The court noted that the regulations actually supported the estate's position. The regulations indicate that postponing of vesting and suspension of ownership or alienation are mutually exclusive conditions of includibility, and the correct test is governed by applicable state law. Reg. § 20.2041-3(e)(1)(ii).

Under Wisconsin law, one could suspend vesting and ownership with virtual impunity, as long as the trustee was given the power to sell trust assets. Therefore, the exercise of the power in this case did not extend the rule against perpetuities.

(e) Acquiescence

The IRS acquiesced, noting in its Action on Decision that "the Tax Court's holding is reasonable, and an appeal, (while possibly warranted based on the legislative history), would be inappropriate in light of the specific wording of the regulation and the last portion of section 2041(a)(3)." A.O.D. 1979-87, 1979 WL 53162 (May 30, 1979).

In light of *Murphy* and the IRS's acquiescence, one must consider carefully the operation of the state rule against perpetuities in order to determine whether the particular exercise of a power of appointment executes the Delaware tax trap. See Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68 (Feb. 2001).

(2) Planning Under *Murphy*

Where state law imposes limitations on alienation, but not on vesting or ownership, as in *Murphy*, the execution of the Delaware tax trap is based on how the grant of a new power of appointment affects the right to alienate. All but one of the states that permit a waiver of the rule against perpetuities with respect to a trust require that the trustee have the power to sell the trust assets. (Virginia does not.) Thus, in those states, as long as the trustee has a power of alienation, the trap is not sprung because the period of the rule is not extended. If, on the other hand, the trustee has no power of alienation, and the power created by the decedent can postpone the duration of the trust beyond the period of the rule, the trap can be sprung.

The IRS argument in *Murphy* that the Delaware tax trap applies to the creation of all new powers of appointment in a state that lacks a rule against perpetuities also would result in far more executions of the Delaware tax trap than the legislation appears to anticipate. This seems an unreasonable and unintended result. If the law of the state that controls the construction of a decedent's non-general power of appointment permits any fixed limit (even if a very long one) on vesting, alienation, or ownership, the Delaware tax trap should be sprung if the first power of appointment creates a presently exercisable general power of appointment.

If the state does not limit vesting or ownership, but does limit alienation (like Wisconsin in *Murphy*), the Delaware tax trap can be sprung if the first power creates an interest in trust in which the trustee lacks the power of sale within the period of the rule against perpetuities. This may also occur if a beneficiary is given a presently exercisable general power of appointment.

If state law imposes no limitation on vesting, ownership, or alienation, as when a Virginia trust elects out of the rule against perpetuities, the result is simply unclear. The best analysis in such cases is that the exercise of a non-general power of appointment to create a new presently exercisable general power of appointment cannot spring the Delaware tax trap in such cases, but it is unclear whether this position will actually be approved by the IRS and the courts.

(3) Drafting Sample Language

Below is a rule against perpetuities clause under Missouri that contemplates the possibility of springing the Trap, complements of Steven B. Gorin. It appears that, to accomplish the basis adjustment mechanism goal, the design of the bypass trust could be structured to grant the surviving spouse a non-general power of appointment that could be exercised to create in a possible appointee a presently exercisable general power of appointment. Under this structure, the second power of appointment is a general power of appointment and as such it would trigger the Trap by creating a taxable power in the object of power, and this structure should not be caught by the prophylactic statutes.

Drafting Suggestion for Provision in Will Exercising Non-General Power of Appointment to Give Appointees a Presently Exercisable General Power of Appointment and Suspending Trustee's Power of Sale, to Trigger Delaware Tax Trap

"ARTICLE ___
Exercise of Power of Appointment

*I am granted a power of appointment under Article ...., Paragraph .... of the trust created under the law will of *grantor*. I am, under that instrument, authorized to appoint the trust held for my benefit to and among the descendants of *grantor*, outright or in further trust and on such terms as I select. I hereby exercise that non-general power to appoint the said trust share as follows:*

A. Existence of Non-General Power of Appointment. *The trustee shall divide the appointed trust fund into as many separate equal shares as shall be required to provide one (1) separate equal share for each of *grantor*'s children who survives me, and one (1) separate equal share for the then-living descendants, per stirpes, of each of *grantor*'s children who does not survive me but who is survived by then-living descendants.*

B. Creation of Presently Exercisable General Power of Appointment. *The trustee shall hold the share for each child or other descendant of *grantor* in trust as follows:*

1. Until the termination date, defined below, the trustee shall distribute to *or for the benefit of each such child or descendant (1) all of the net income of the trust, not less often than annually; (2) so much of the principal of the trust as is appropriate for such child or descendant's health, education, support, or maintenance, taking into account other income available to such child or descendant from any source; and (3) so much of the trust fund (including all or none) held for such child or descendant as such child or descendant shall direct by specific exercise of this presently exercisable general power of appointment. Commencing twenty (20) years after the date of my death and continuing until the termination date, the trustee shall also have no authority to sell assets of this trust fund.*

2. Upon the termination date, the trustee shall distribute the remaining trust fund as follows:

a. The trustee shall distribute the remaining assets of a child's or descendant's separate trust under this article as such child or descendant may direct, by specific reference to this non-general power of appointment in his or her last will or in a signed, dated, and written instrument delivered to a trustee. This power may be exercised to appoint a child's or descendant's separate trust fund, either outright or in further trust, to or among any of my descendants, excluding the person holding the power of appointment, his or her creditors, his or her estate, and the creditors of his or her estate.

b. The trustee shall distribute the unappointed assets of such child's or descendant's separate trust to the child's or descendant's then-living descendants, per stirpes. If there are no such then-living descendants, the trustee shall distribute the unappointed assets of such child's or *descendant's separate trust to my then-living children and other then-living descendants, per stirpes, except that the share for any child or other descendant of mine who has not then reached the age of *Termination-Age* years shall be added to the trust for that child or descendant under this article.*

C. "Termination Date" Defined. *The termination date is the date on which the child or descendant dies.*

F. Asset Protection Concerns for Basis Adjustment Mechanisms

1. Generally

Initially, when designing the estate plans, compare the asset protection issues involved with a traditional by-pass trust to that involved with a portability plan, such as the QTIP trust portability plan. Implementing traditional by-pass trust plans frequently involve transferring assets out of tenancy by the entirety into the spouses' separate ownership to enable the by-pass trust funding. This destroys asset protection. It is important to evaluate asset protection issues in three phases: when both spouses are alive, after the first spouse's death and after both spouses' deaths. For example, with portability planning, assets may remain in tenancy by the entirety when both spouses are alive. Moreover, many assets, such as retirement accounts, homestead property and insurance policies, already offer some creditor protection features depending on applicable state and federal law.

A discretionary by-pass trust with spendthrift provisions likely offers creditor protection for its beneficiaries. The QTIP trust in the portability plan would likely provide creditor protection as to the trust principal, but creditors may be able to reach the income of the trust once distributed to the surviving spouse. Also, in a portability plan, a disclaimer by the surviving spouse to enable the funding of the back-up disclaimer by-pass trust might be problematic if the surviving spouse has creditor problems at the time of the first spouse's death. Some states require that the disclaimant be solvent or provide that a disclaimer by an insolvent person is treated as a fraudulent transfer, and a disclaimer may create a new period of ineligibility for Medicaid benefits.

The asset protection overlay to the approaches for applicable exclusion use is more complicated than it at first appears. If one of the basis adjustment mechanisms is used with the by-pass trust to soak-up any of the surviving spouse's excess applicable exclusion, the asset protection features of the mechanism should also be considered.

2. Independent Power to Distribute

If an independent trustee actually distributes appreciated assets out of the by-pass trust to the surviving spouse to soak-up any of the surviving spouse's excess applicable exclusion, then in most cases the spendthrift trust protection of the by-pass trust is lost and the distributed assets are exposed to the surviving spouse's creditors. If the surviving spouse has creditor problems, this method of achieving a basis adjustment seems unsatisfactory.

3. General Power of Appointment

The rights of the creditors of the holder of a general testamentary power of appointment to reach the subject property depends on state law.

a) Uniform Trust Code

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to *Restatement (Second) of Property: Donative Transfers* §§ 13.1 to 13.7 (1986), discussed below.

b) Restatement (Second) of Property: Donative Transfers

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder's estate. *Restatement (Second) of Property* § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

c) Restatement (Third) of Property: Donative Transfers

The more modern rule is reflected in *Restatement (Third) of Trusts* § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder's estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is subject to the claims of the powerholder's creditors to the extent the powerholder's estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder's creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the *Restatement (Third) Trusts*.

d) Uniform Power of Appointment Act

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate's other property is insufficient to meet all claims. See, e.g., V.A.M.S. 456.1105. See, however, Va. Code § 64.2-2736(B), adopting this *Restatement (Second) Trusts* position.

e) Bankruptcy Act

The U.S. Bankruptcy Code states that the trustee in bankruptcy "stands in the shoes" of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. D. Kan. 2006); Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

4. Creditors and a Presently Exercisable General Power of Appointment

Use of a Delaware Tax Trap may not cause an asset protection issue for the surviving spouse but may create an issue for the object of the power in whose favor it is exercised. If the powerholder is granted a presently exercisable general power of appointment, the assets subject to the power are likely exposed to the powerholder's creditors.

III. THE POWER OF APPOINTMENT SUPPORT TRUST ("POAST") -- TAX SHELTER LEASING OF THE ELDERLY?

A. Generally

At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase. If such an older person (an "upstream person") has an excess of applicable exclusion amount, his or her death will be a wasted opportunity to obtain additional basis increase.

B. Outright Upstream Gifts

One can, of course, give an upstream person sufficient appreciated assets to take advantage of his or her unused applicable exclusion amount. This is a relatively simple approach, but it presents several important problems.

1. Poor Use of Donor's Applicable Exclusion Amount

The donor of an upstream gift will be subject to gift tax on the fair market value of the gift, to the extent that it exceeds the donor's available gift tax annual exclusion. This can be offset by the donor's applicable exclusion amount but using the donor's applicable exclusion amount to move assets to a higher generation is contrary to most estate planning wisdom.

2. Diversion by Donee

The upstream gift allows the donee to give or leave the property to someone other than the donor or the natural objects of the donor's bounty. This may be intentional – a gift or bequest – or unintentional – an elective share, forced share, or claim of a creditor.

3. Risk of Access by Donee's Creditors and Spouse

A subset of the risk of diversion is the risk that the donee's creditors and spouse may have claims against the assets given to the donee. This risk can be reduced by only making transfers to donees who have few or no creditors and who are unmarried or married with a very well drafted premarital agreement, but this eliminates an entire category of individuals who are likely to have a significant excess of unused applicable exclusion amount. Also, creditors can be created at any time, and the elderly are susceptible to incurring large medical expenses and to making poor investments.

4. Gift Back to Donor or Donor's Spouse within One Year

Section 1014(e) states that there is no basis adjustment at a decedent's death with respect to assets given to the decedent within one year of the date of death by the person to whom the asset passes at the decedent's death. Therefore, if one makes a gift to an upstream person who dies within one year and leaves the asset back to the donor, there is no basis increase.

C. The Power of Appointment Support Trust – A Death is a Terrible Thing to Waste

The power of appointment support trust ("POAST") involves a transfer of property to an irrevocable trust for donees, who may include (or even be limited to) the donor's spouse, but which gives a general power of appointment over appreciated trust assets to one or more upstream persons. See Austin, Beaudry and Law, *The Power of Appointment Support Trust*, 154 Trusts & Est. 55 (Dec. 2015); Morrow, *Morrow and the Upstream Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2635 (April 17, 2018) at http://www.leimbergservices.com; and Morrow, *Morrow and the Optimal Basis Increase Trust (OBIT)*, LISI Estate Planning Newsletter #2080 (March 20, 2013), updated as of late 2017 and available for download at www.ssrn.com.

1. Transfer Must be a Completed Gift

If the donor or the donor's spouse is a beneficiary of the POAST, the transfer to the trust must be a completed gift; the trust must be irrevocable and the donor cannot retain the power to alter beneficial enjoyment. Otherwise, the IRS will assert that the grant of a general power of appointment is completed only upon the death of the donee of the power, and that no basis increase is available under Section 1014(e).

2. Granting a General Power of Appointment is Not Itself a Taxable Gift

The gift tax law treats the exercise or lapse of a general power of appointment as a taxable gift, but the granting of a general power is not itself a taxable gift. Section 2501(a)(1) states that the gift tax is imposed on "the transfer of property by gift." It does not apply to the grant of powers to appoint property, whether they are general or special powers. Merely granting someone a general power of appointment is not itself a taxable gift, because it does not involve the transfer of property. See also S. Rep. No. 665, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) C.B. 496, 524 ("property" for this purpose is to be construed broadly and include "the broadest and most comprehensive sense" to reach "every species of right or interest protected by law and having an exchangeable value." Nonetheless, it still does not include a power to appoint property.)

3. Holder of a General Power May be Naked (Figuratively)

a) Generally

A general power of appointment causes the subject property to be included in the holder's gross estate even if the holder has only a naked power of appointment and no beneficial interest in the trust.

The power will still be taxable for estate tax purposes and its possession will still cause the subject assets to have their basis adjusted under Section 1014. See, e.g., PLR (TAM) 200907025 ("the fact that the Decedent could receive only income at the discretion of the trustee and could not receive distributions of corpus during life, is in no way indicative of the Settlors' intent to restrict Decedent's power to appoint the property at his death. A right to receive trust income and a power of appointment are separate interests among the possible interests that a beneficiary may have in a trust. It is the province of a settlor to control the rights and interests set forth in a trust according to the settlor's own wishes.")

b) Why Give Powerholder a Beneficial Interest

One possible reason to give the upstream powerholder at least a contingent beneficial interest in the trust assets is to avoid the analysis proposed by the IRS in *Cristofani v. Comm'r*, 97 T.C. 74 (1991), *acq. in result only* 1992-1 C.B. 1, *acq. in result only* 1996-2 C.B. 1, that a naked power of appointment should be ignored for tax purposes. *Cristofani* involved the grant of *Crummey* withdrawal powers (which are themselves general powers of appointment) to persons who had little or no fixed beneficial interest in the trust. The IRS took the position that these grants were illusory; the beneficiaries would refrain from exercising these powers only if they had agreed in advance not to do so. The Tax Court disagreed and stated that no other beneficial interest was required to create a present interest. Even with this precedent, it may be practical to name the upstream person a contingent beneficiary in order to deter the IRS from disputing the validity of the grant of a general power. See also reliance on *Cristofani* in *Estate of Kohlsaat v. Comm'r*, T.C. Memo. 1997-212; and Morrow & Gassman, *Ed Morrow and Alan Gassman on Mikel v. Commissioner: Tax Court Approves the Mother of All Crummey Trusts with 60 Beneficiaries*, LISI Estate Planning Newsletter #2309 (May 14, 2015).

An important distinction between the situation in *Cristofani* and that in the upstream basis increase trust is that the IRS, in the latter situation, may not want to be recorded having argued that a general power of appointment is not taxable unless the powerholder has a beneficial interest in the trust. This argument may be utile to it in this particular context, but one can imagine many situations in which it would result in a substantial decline in estate tax revenues.

4. Introduction of the "Support" Concept

In light of the issues with giving a naked general power of appointment, consider allowing the Trustee to make discretionary distributions of income and/or principal for the benefit of the upstream beneficiary. Thus, the upstream beneficiary is given both a power of appointment and the ability to receive support; hence, the name "Power of Appointment Support Trust" or "POAST".

5. Decedent Need Not be Competent to Exercise the Power

A testamentary power to appoint the subject property to one's estate or its creditors is taxed as a general power of appointment, even if the individual is, on the date of death and at all times when he or she held the power, legally incompetent to exercise it. The law taxes a powerholder on the property subject to a general power if he or she "possessed" the power on or before the date of death, not whether he or she could legally exercise it. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970); *Estate of Alperstein v. Comm'r*, 613 F.2d 1213 (2nd Cir 1979), *cert. denied sub nom. Greenberg v. Comm'r*, 446 U.S. 918 (1980); *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981); *Boeving v. United States*, 650 F.2d. 493 (8th Cir. 1981), *rev'g* 493 F. Supp. 665 (E.D. Mo. 1980); *Estate of Gilchrist v. Comm'r*, 630 F.2d 340 (5^{th} Cir. 1980), *rev'g* 69 T.C. 5 (1977), *acq*. 1978-2 C.B. 1 (adjudication of incompetency of holder of a general power of appointment is irrelevant to estate tax treatment, unless all exercise of the power on holder's behalf, by any person or in any capacity, is barred by the adjudication under state law); *Doyle v. United States*, 358 F. Supp. 300 (E.D. Pa 1973); *Pennsylvania Bank & Trust Co. v. United States*, 451 F. Supp. 1296 (W.D. Pa. 1978), *aff'd* 597 F.2d 382 (3rd Cir. 1979); Rev. Rul. 75-350, 1975-2 C.B. 366 (marital deduction allowed for power of appointment marital trust, even though surviving spouse was mentally ill from the time of first spouse's death until time of surviving spouse's death, and under applicable state law, incapable of exercising the power); Rev. Rul.75-351, 1975-2 C.B. 368 (minor had a general testamentary power of appointment even though, under applicable state law, minor was legally incompetent to execute a will at the time of death). But, see also *Finley v. United States*, 404 F. Supp. 200 (S.D. Fla., 1975) *vacated on jurisdictional grounds*, 612 F.2d 166 (5th Cir. 1980) (decedent, from time of devise of general power of appointment until her death lacked legal capacity to exercise general testamentary power of appointment, and so did not "possess" a general power of appointment for estate tax purposes).

6. Decedent Need not Know of Power's Existence

a) Generally

There appear to be no cases directly on point, but as a decedent who lacks the legal ability to understand the power of appointment is deemed to possess it for estate tax purposes, then a competent decedent who simply is unaware of the power's existence should be deemed to possess it.

See, however, *Estate of Freeman v. Comm'r*, 67 T.C. 202 (1976), in which a general power of appointment was given to a beneficiary who never saw the trust instrument and never knew he had the power. The court stated that the beneficiary still had a general power of appointment for tax purposes, but noted that the beneficiary knew that the trust existed and that he was a beneficiary, and he could have asked the trustee for a copy of the instrument. This suggests that one cannot entirely hide the existence of the power from the powerholder.

The IRS may not want to argue that a general power of appointment is not taxable unless the powerholder knows of its existence. This argument may be useful to it in dealing with POASTs, but it could be turned against the IRS in many cases in which a holder of a power of appointment wishes not to have the subject property included in his or her gross estate; the lack of knowledge is easy to assert and often difficult to disprove.

b) Trustee's Obligation to Inform Powerholder

(1) The Uniform Trust Code

The trustee may not be required to inform a competent adult powerholder of the power's existence in a state in which the Uniform Trust Code has been adopted.

(a) Duty to Inform

Uniform Trust Code § 813(a) requires a trustee to "keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." See V.A.M.S. 456.8-813.

(b) Powerholders are Beneficiaries

Uniform Trust Code § 103(3) states that a beneficiary is any person who has either has a present or future beneficial interest in a trust, or a power of appointment over trust property. The Comments to this section explain that:

> *"While the holder of a power of appointment is not considered a trust beneficiary under the common law of trusts, holders of powers are classified as beneficiaries under the Uniform Trust Code. Holders of powers are included on the assumption that their interests are significant enough that they should be afforded the rights of beneficiaries."*

(c) Powerholders May be Qualified Beneficiaries

Qualified beneficiaries include "a distributee or permissible distributee of trust income or principal," someone who would be such a distributee "if the interests of the distributees . . . terminated on that date without causing the trust to terminate," and someone who "would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date." Uniform Trust Code § 103(13). Under the Uniform Trust Code, therefore, a powerholder who is a discretionary beneficiary is clearly a qualified beneficiary entitled to notice of the trust's terms, while one who has no beneficial interest is not a qualified beneficiary and the trustee has no obligation to give him or her notice of the trust and its terms.

(d) Waiver of Notice by the Trust Instrument

Uniform Trust Code § 105(b)(8) states that the duty of the trustee to notify qualified beneficiaries of an irrevocable trust who have reached 25 years of age of the trust's existence, the identity of the trustee, and of their right to request trustee's reports, cannot be waived by the trust instrument. See V.A.M.S. 456.8-813 and 456.1-105(2)(8) ("the duty of a trustee of an irrevocable trust to notify each permissible distributee who has attained the age of twenty-one years of the existence of the trust and of that permissible distributee's rights to request trustee's reports and other information reasonably related to the administration of the trust" cannot be waived). *Cf.* Va. Code § 64.2-703, allowing waiver of this requirement.

(2) Common Law

The trustee is less likely to be required to inform a competent adult powerholder of the power's existence in a state in which the Uniform Trust Code has not been adopted. The comments to Uniform Trust Code § 103 note that treating holders of powers of appointment as beneficiaries is a departure from the common law of trusts, but that the Uniform Trust Code changes this rule.

Restatement (Third) of Trusts § 82 (2007) provides that the trustee of an irrevocable trust, unless the instrument provides otherwise, must inform fairly representative beneficiaries of the trust's existence, their status as beneficiaries, and their right to obtain other information regarding the trust and the trustee, and under this section "[o]ccasionally . . . the trustee's duty to provide information about a trust will extend also to a donee of a power of appointment . . ." Oddly, the Restatement (Third) of Trusts does not state what those conditions might be, but the fact that a power would cause assets to be included in the gross estate of the powerholder would seem a compelling reason to require a trustee to inform the powerholder of its existence. See also George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 961 (rev. 2d ed. 1983) ("the trustee must inform the beneficiary of all material facts affecting the beneficiary's interest that the trustee knows the beneficiary does not know, but that the beneficiary needs to know to protect the beneficiary's interest in dealing with a third party.")

(3) Possible Analogy to *Crummey* Powers

(a) Rev. Rul. 81-7 Requires Notice -- Sort Of

In Rev. Rul. 81-7, 1981-1 C.B. 474, the IRS stated that a withdrawal power does not create a present interest unless the beneficiary is aware of its existence and of any gift against which it may be exercised. Absent such knowledge, the IRS views such a withdrawal power as illusory and inadequate to create a present interest. In that ruling, however, G created a trust giving to A, the beneficiary, a *Crummey* power that lapsed at the end of the year. G made a gift to the trust on December 29. No notice was given to A. The IRS stated that the gift tax annual exclusion was not available for these gifts, because

> *"[i]n failing to communicate the existence of the demand right and in narrowly restricting the time for its exercise, G did not give A a reasonable opportunity to learn of and to exercise the demand right before it lapsed. G's conduct made the demand right illusory and effectively deprived A of the power."*

The use of the conjunctive "and" in the quoted material, however, suggests that only the combination of (1) the failure to give notice and (2) the lack of a reasonable amount of time within which to exercise the withdrawal rights justified denial of the annual exclusion. This interpretation suggests that failure to give notice, alone, does not deprive the donor of the annual exclusion and, by analogy, and does not impair the effectiveness of a power of appointment to produce a basis adjustment at the powerholder's death.

(b) IRS Requires Notice; Tax Court Does Not

The Tax Court has repeatedly rejected the requirement of notice for a *Crummey* power. *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209; *Estate of Cristofani v. Comm'r, supra.* In fact, notice was not given to the beneficiary in *Crummey v. Comm'r,* 397 F.2d 82, 86–87 (9th Cir. 1968), *aff'g in part and rev'g in part* T.C. Memo. 1966-144, but in that case the beneficiary was a minor. Thus, the IRS view that notice of a power to appoint to oneself or, by extension, to others, is required in order to make the power effective for income and transfer tax purposes is without much legal support.

(4) **Practical Planning**

Nonetheless, a practical practitioner may deem it appropriate to give the powerholder notice of the power and his or her right to exercise it, to minimize the chances of a challenge to the validity of the power as a tool for increasing the basis of the subject property. Of course, this brings one back to the most difficult issue – finding an upstream powerholder who will not, either voluntarily or involuntarily, divert the funds from the natural objects of the donor's affection, and minimizing the risk that one's choice turns out to be less reliable than one hoped.

7. Avoiding Voluntary Diversion by the Exercise of the Power

One can minimize the risk of diversion of the subject property by requiring that the power be exercised only with the consent of a nonadverse party. Reg. § 20.2041-3(c).

a) "Nonadverse party" defined

(1) Generally

Reg. § 20.2041-3(c) does not refer to a "nonadverse party, but states that a power of appointment is not a general power if it is exercisable only in conjunction with the creator or "with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate." Thus, a nonadverse party is anyone who does not have a substantial interest in the subject property and whose interest in the subject property is not adverse to the exercise of the power in favor of the powerholder, his or her estate, the powerholder's creditors, or the creditors of the powerholder's estate.

(2) Substantiality of the Interest

Reg. § 20.2041-3(c) states that an interest is substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, these interests are to be valued actuarially. Unfortunately, the regulations do not define “insignificant.”

(3) Adverse Nature of the Interest

Reg. § 20.2041-3(c) states also that a taker in default has an adverse interest, but a coholder of the power does not, unless the coholder obtains the power after the holder’s death and can then exercise it in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. One example in the regulations states that a sole remainder beneficiary who is entitled to the subject property after the death of both the powerholder and another person has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 1. Another example demonstrates that a discretionary beneficiary to whom the trust principal may be distributed has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 2. On the other hand, a third example shows that a beneficiary who is entitled to trust income during his or her lifetime does not have an interest adverse to a power to appoint the trust funds at the beneficiary’s death. Reg. § 20.2041-3(c), Ex. 3.

(4) Drafting

One of the more difficult problems is finding a nonadverse party who is willing to risk being sued by the unhappy holder of a power of appointment. There are several ways to approach this.

First, one could name an independent trustee as the nonadverse party. The trustee has a fiduciary duty to protect the interests of the beneficiaries named in the instrument, and so is less likely to consent to a different exercise of the power than would be an uninvolved person. The trustee’s fiduciary duty also gives the trustee a better litigating position if the powerholder does sue. Also, the trust can provide that the cost of the defense of such a suit should be borne by the trust assets, rather than the trustee’s personal resources.

Second, one could seek out that family member who exists in most families, who never agrees with anyone on anything. Such persons are uniquely well-suited to the role as consenting nonadverse person, and they are used to having disputes with family members. Again, however, the trust should provide that the cost of defense of any such suit will be borne by the trust assets.

Third, one could require that the local court serve as the nonadverse party. A local court has no financial interest in the trust and is clearly a nonadverse party. The time required to obtain the consent of the court means that the powerholder cannot effective act rashly, and the local court is likely to require that all financially-interested persons be notified of the suit and have an opportunity to make their views known. This protects the trustee and slows down the process to minimize the risk of a rash exercise of the power of appointment.

Also, the required consent of a nonadverse party could be imposed in all cases or only where the holder attempts to exercise the power in favor of someone other than the donor or the natural objects of the donor's bounty. The latter group could be described, for example, as "the descendants of the donor's grandparents, and all charitable organizations". A key difficulty with this approach is finding a nonadverse party whom the donor trusts implicitly and who is willing to be the possible target of abuse from the holder of the power or his or her intended appointees who disagree with the decision of the nonadverse party to reject the proposed appointment.

b) Limit Appointees to Powerholder's Creditors

Some practitioners believe that allowing the powerholder to appoint only to his or her creditors will be inhibit diversion, while still creating a general power of appointment. In reality, it does not restrain the powerholder very much, because he or she can merely borrow money to spend or give away, and then appoint the trust assets to the lender in satisfaction of the debt. It does force the powerholder to take this additional step, rather than just to appoint the property to his or her estate, but it is hardly a significant restraint on diversion. Also, while the authors disagree, some practitioners are concerned that a power exercisable in favor of one's creditors (or the creditors of one's estate) could be interpreted as general only to the extent that there are actual creditors. This seems inconsistent with the point just made, that the holder of the power has the ability to borrow money and thus expand the appointive property.

8. Rights of the Powerholder's Creditors

a) Generally

Property subject to a nongeneral power of appointment is not usually subject to the claims of the donee's creditors, but property subject to a general testamentary power of appointment may be subject to the claims of the creditors of the powerholder's estate.

b) Uniform Trust Code

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to *Restatement (Second) of Property: Donative Transfers* §§ 13.1 to 13.7 (1986), discussed below.

c) Restatement (Second) of Property: Donative Transfers

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder's estate. *Restatement (Second) of Property* § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

d) Restatement (Third) of Property: Donative Transfers

The more modern rule is reflected in *Restatement (Third) of Trusts* § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder's estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is subject to the claims of the powerholder's creditors to the extent the powerholder's estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder's creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the Restatement (Third).

e) Uniform Power of Appointment Act

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate's other property is insufficient to meet all claims. This right is subject to the powerholder's right to direct the source from which liabilities are paid.

f) Bankruptcy Act

The U.S. Bankruptcy Code states that the trustee in bankruptcy "stands in the shoes" of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. D. Mass. 1999); see also Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

g) Planning Considerations

(1) Requiring Solvency

One could precondition the valid exercise of the power in favor of the powerholder's estate upon the solvency of the powerholder's estate. Reg. § 20.2041-3(b), while not expressly authorizing such conditions, seems to presume their viability, when it provides that "a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death." *Kurz v. Comm'r*, *supra*., could pose a problem, but incurring a debt seems likely to be an act of independent significance. *Kurz* was a tax case, but a state court could apply this same analysis to the rights of the powerholder's creditors, and permit creditors of an insolvent powerholder's estate to reach the power, even though it was not, by its terms, exercisable.

(2) Careful Selection of Powerholder

The best solution to the risk that the powerholder's creditors may seek to attach the trust assets that are subject to the powerholder's general power of appointment is to grant such powers only to persons who have no significant debts and who are unlikely to incur significant debts. This sounds easier than it is, of course, because the fortunes of an individual can change. One way to minimize the risk is to grant the power of appointment only to individuals who are quite elderly and, therefore, unlikely to live long enough to create substantial new debts. Unfortunately, most people do not come with a "use by" date tattooed on their forehead, so that one must rely upon an educated guess as to the donee's life expectancy.

(3) Use a Limited Power of Appointment

One could give the powerholder only a limited power of appointment, which could then be exercised to trigger the Delaware Tax Trap under Section 2041(a)(3), by appointing the property in trust for the benefit of the desired beneficiaries, giving them a currently exercisable general power of appointment. In states that permit one to trigger the Delaware Tax Trap, this should result in inclusion of the subject property in the upstream powerholder's gross estate, with the desired income tax basis adjustment, without subjecting the assets to the claims of the creditors of the powerholder. Of course, the Delaware Tax Trap does cause the assets to become subject to the claims of the appointees' beneficiaries, because a presently exercisable power to appoint trust assets to oneself is treated as equivalent to outright ownership for most state law purposes, including creditors' rights.

(4) Requiring Consent of Nonadverse Party

Generally, property subject to a general power of appointment that is exercisable only after a condition is met is not subject to the claims of the powerholder's creditors until that condition has been met, because the powerholder's creditors cannot reach assets that the powerholder cannot personally appoint. Peter Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶ 13.10 (Thomson Reuters/Tax & Accounting, 2001 & Supp. 2018-2); Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 337-338 (Fall 2010). Thus, creditors ought not to be able to reach assets that can be appointed only with the consent of a nonadverse party, unless they can prove that there was a prearrangement under which the nonadverse party would always consent to whatever appointment the powerholder made.

(5) Amount of the Power

The power granted could be tied directly to the older generation powerholder's available applicable exclusion amount, though it would be appropriate to set it at the lower of the available applicable exclusion amount and the available GST exemption, since GST exemption will need to be allocated to the transfer occurring upon the lapse or exercise of the power of appointment.

To avoid forcing the older generation powerholder to file an estate tax return, one might set the appointable amount at $10,000 or $20,000 less than the available applicable exclusion amount or GST exemption.

9. GST Tax Issues

a) Generally

An upstream general power of appointment should not cause GST tax problems, but it does effect a series of changes in the GST status of the trust and it does require that the upstream person holding the general power of appointment allocate or be deemed to have allocated GST exemption to the trust at his or her death.

b) New Transferor

If property is subject to estate tax in a decedent's estate, the decedent becomes the transferor of that property for GST tax purposes. Reg. § 26.2652-1(a)(2). Thus, the death of the upstream powerholder causes the powerholder to be substituted as the transferor of the property that was the subject of the power of appointment, whether it was exercised or lapsed. This is particularly problematic because the upstream powerholder is, by definition, likely to be assigned to an even higher generation than the original transferor, so that individuals who were previously not skip-persons may become skip-persons with respect to this portion of the trust.

c) Loss of Original GST Exemption Allocation

The change in the identity of the transferor, because the trust is subject to estate taxation in the upstream person's estate, results in a determination of a new inclusion ratio. Thus, a new transferor for a trust results in the loss of any further benefit from the GST exemption previously allocated to the trust. This is not stated directly in the statute. This result follows from the rule in Section 2631(a) that only the transferor can allocate the GST exemption to a trust or transfer. See C. Harrington, L.L. Plaine, J. Miraglia Kwon, & H. Zaritsky, *Generation-Skipping Transfer Tax* ¶ 4.06[4][g] (Thomson Reuters/Tax & Accounting, 2d ed. 2001 & 2018 Cum. Supp. No. 2).

d) New Allocation of GST Exemption Required

(1) Generally

It is easy to use up one's applicable exclusion amount without using an equal amount of GST exemption, merely by making gifts to nonskip persons. Large generation-skipping transfers, however, always utilize applicable exclusion amount. (Annual exclusion gifts, however, may require GST exemption allocation but not exhaust the donor's applicable exclusion amount.) taxable gifts Thus, the upstream person should usually have at least as much unused GST exemption as his or her unused applicable exclusion amount. The upstream person should then allocate (or be deemed to have allocated) his or her GST exemption to the trust, preserving or creating a zero inclusion ratio.

(2) Automatic Trust Division

When different persons make transfers to the same trust, the trust must recalculate its inclusion ratio, and the trust is automatically treated like two separate trusts for GST tax purposes. IRC § 2654(b); Reg. § 26.2654-1(a)(2)(i). Treatment of a single trust as separate trusts under this rule is solely for purposes of calculating the GST tax; it does not mean that the trust files two income tax returns. Reg. § 26.2654-1(a)(2)(i). Because the two trusts should both have zero inclusion ratios (one based on the allocation of GST exemption by the original transferor and the other based on the allocation of GST exemption by the upstream person).

(3) Automatic Deemed Allocations

Obviously, the estate of the upstream person can file an estate tax return and allocate GST exemption to the trust. IRC

§ 2632(a). The unused GST exemption of a deceased upstream person will be automatically allocated to the trust, after allocation to any direct skip transfers, because the upstream individual is a transferor and a taxable distribution or a taxable termination might occur from the trust at or after his or her death. IRC § 2632(e).

e) Don’t Allocate GST Exemption – Wait for Upstream Powerholder to Pass

One way to avoid the issue of wasting the original donor’s GST exemption is simply for the original donor to opt-out of being his/her GST exemption. Thus, when the upstream powerholder dies, such upstream powerholder’s GST exemption is allocated to the trust. However, care must be given when giving the upstream powerholder an unlimited general power of appointment, because if the assets to which the power is given exceeds the donee/upstream beneficiary’s unused lifetime exclusion amount or GST exemption, there could be estate or GST tax implications.

10. Limiting the Power of Appointment

If the upstream beneficiary is given a testamentary general power of appointment over the POAST, at the time of such upstream beneficiary’s death, the entire value of the POAST would be included in his/her gross estate. This could cause unintended consequences (i.e., it may cause a Federal estate tax, where one was not anticipated).

To eliminate this contingency, the upstream beneficiary’s testamentary general power of appointment should be structured as a contingent testamentary general power of appointment. Using a contingent general power of appointment is not a new concept. It has been used for over 30 years (i.e., since the inception of the 1986 version of the GST tax) to minimize the impact of such tax. The drafter should be careful in structuring the contingent general power of appointment to minimize risking the IRS raising the step transaction / implied agreement doctrine, however.

a) Limiting to the Upstream Beneficiary’s Otherwise Unused Applicable Exclusion Amount

Limiting the contingent general power of appointment to the upstream beneficiary’s otherwise unused applicable exclusion amount avoids the imposition of any estate tax when the upstream beneficiary dies. If the assets in the POAST exceed the upstream beneficiary’s otherwise unused applicable exclusion amount, and there is no limit on the general power of appointment, then the upstream beneficiary would have a taxable estate with an estate tax liability.

For example, if the upstream beneficiary, G1, never made taxable gifts in his lifetime and had a gross estate of $2.18 million, and the POAST had assets of $10 million, the basic exclusion amount at the time of death was $11.18 million, and G1 has an unlimited general power of appointment, then there would be an estate tax due on $1 million (i.e., $2.18 million + $10 million - $11.18 million = $1 million). Thus, even though there would be a basis adjustment on all of the assets, there would now be an estate tax of $400,000 (assuming a 40% estate tax rate).

Thus, the contingent general power of appointment should be limited to the upstream beneficiary's otherwise unused applicable exclusion amount.

From a planning perspective, we suggest that the contingent general power of appointment should be limited to an amount equal to the upstream beneficiary's otherwise unused applicable exclusion amount less $10,000. The reason for this is that the gross estate of the upstream beneficiary will be less than the threshold for filing an estate tax return. Thus, you get all of the benefits of a basis adjustment without having to file an estate tax return!

b) Limiting to the Upstream Beneficiary's Otherwise Unused GST Exemption

The upstream beneficiary's contingent general power of appointment should also be limited to his/her otherwise unused GST Exemption, because if it is not, then it is entirely possible that there could be a taxable termination at the upstream beneficiary's death, which would cause a GST tax to be imposed.

Example III-1

> Assume that the upstream beneficiary (G1) made significant annual exclusion gifts to GST trusts where he used $5.18 million of his GST exemption, but had never used any of his applicable exclusion amount. At the time of death G1 had a gross estate of $1.18 million and had an unlimited general power of appointment over a POAST worth $10 million at the time of his death. G1 dies in 2018 when the basic exclusion amount and GST exemption is $11.18 million. The trust was created by upstream beneficiary's son, G2, where G1

had a discretionary income interest for support and G2's children (i.e., G1's grandchildren) were also discretionary beneficiaries. And upon G1's death, the trust is for G3 (i.e., G1's grandchildren) and their descendants.

As a result of G1's death, there will be no estate tax, because the gross estate (i.e., $1.18 million + $10 million = $11.18 million) is equal to G1's applicable exclusion amount (of $11.18 million), thus, there is no estate tax. However, because G1 only had $6 million of GST Exemption remaining (having used $5.18 million of his $11.18 million during his life), $4 million of the POAST will not be GST exempt. And, because G1 becomes the 'transferor' for GST tax purposes as a result of including the POAST in G1's estate for estate tax purposes, and because the only beneficiaries are G3 and their descendants, who are skip persons as to G1, there is now a taxable termination and $1.6 million of GST tax due (assuming a 40% GST tax rate).

To avoid the unintended incursion of estate tax or GST tax liability, the upstream beneficiary should be given a contingent general power of appointment limited to the lesser of (a) the upstream beneficiary's otherwise unused applicable exclusion amount (reduced by $10,000), or (b) the upstream beneficiary's otherwise unused GST Exemption (reduced by $10,000).

By limiting the general power of appointment, you not only avoid the possibility of the imposition of the estate and/or GST tax liability, but also eliminate the need to file an estate tax return for the upstream beneficiary, while at the same time obtaining a basis adjustment for the assets. This can be accomplished by using a POAST.

11. Interaction of an Upstream General Power of Appointment and a *Crummey* Power

There is no case or ruling on point, but a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee's *Crummey* withdrawal power could disqualify the gift for the annual exclusion, because the beneficiary's withdrawal right is not absolute. Furthermore, a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee's hanging *Crummey* withdrawal rights could be deemed to cause those rights to lapse in excess of the five percent or $5,000 limitation, thereby causing a taxable gift. To avoid this, the upstream power of appointment should expressly not apply to any portion of the trust that is subject to a beneficiary's *Crummey* withdrawal right.

One astute author has noted that:

> *"Ironically, any power to appoint trust assets that can only be made to a trust which keeps the existing Crummey withdrawal right intact is not a general power as to that portion (as it cannot be appointed to the power holder, his/her creditors, estate, or creditors of estate). [citation omitted] However, because any such appointive trust would have a presently exercisable general power of appointment (a Crummey power is a presently exercisable power of appointment), the exercise of the limited power of appointment would trigger the Delaware Tax Trap under most every state law. [citation omitted] Thus, the appointment of any portion subject to Crummey rights would trigger inclusion under §2041(a)(3) and the appointment of the remaining portion would trigger inclusion under §2041(a)(2)."*

See Morrow, *Morrow and the Upstream Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2635 (April 17, 2018).

12. Death of Upstream Powerholder within One Year of Gift to Trust – Section 1014(e)

a) Generally

If the powerholder dies within one year of the gift funding the trust, a step up in basis should not be denied under Section 1014(e), even if the same assets return to the donor by appointment or in default of a valid appointment. Section 1014(e)(1) denies a basis adjustment only for "appreciated property . . . acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death. . . ." This rule requires a transfer of property, and the grant of a general power of appointment is not a transfer of property; it is a transfer of the ability to dispose of property that the transferee (powerholder) does not possess. There are no cases or rulings on this point, and the IRS may take a different position. One should caution the client that there is always a chance that this type of trust will not provide the desired basis adjustment unless the powerholder lives for at least one year.

b) **The Gift and Sale Approach**

(1) **Generally**

Some practitioners suggest that the trust be funded with cash or unappreciated assets, and that the grantor then sell appreciated property to the trust for a promissory note. The theory is that the sale is not a gift for purposes of Section 1014(e), and the original gift was not of appreciated property, so that this rule should not apply.

(2) **The Step Transaction Doctrine Rears its Ugly Head**

The problem with this analysis is that the step transaction doctrine is likely to cause the gift and sale to be treated as part of an integrated transaction, to which Section 1014(e) may apply.

(a) **Using Older Powerholders Increases Step Transaction Problems**

This is particularly true because one tends to use the upstream power of appointment with an elderly powerholder, so that there may be relatively little time between the grant of the power and its lapse or exercise. The proximity of the two steps is, admittedly, only one factor in determining the application of the step transaction doctrine, but it is one of the most important.

(b) **Planning to Avoid the Step Transaction Doctrine on a Gift and Sale Transaction**

The planner must take steps to treat the initial gift as transaction from the later sale to the trust.

(i) **Time is Not on Your Side**

This may be as simple as waiting a substantial time between the initial gift and the sale, but as noted above, one may not have a long time to wait between the transactions. Also, there is no bright line test for time. The longer the time between steps, the less likely it is that the steps will be treated as part of a single integrated transaction. *Compare, however*, *Henricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943) (transactions one-half hour apart were independent); and *Comm'r v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939) (steps six years apart were part of a single integrated transaction).

(ii) Do Not Document the Multiple Steps

The planner should not explain in writing that the gift of cash or unappreciated assets will be followed by a sale for appreciated assets. Even privileged communications have a nasty habit of turning up in IRS files. Instead, the planning memo should describe the creation of the trust and the cash or unappreciated property gift. The trustee should then invest the cash, rather than keeping it in its present form. The memo should also state that, after a reasonable time, the grantor and the trustee should meet with the planner to discuss further investment options for the trust. After that meeting, the planner can document the sale to the trust.

13. Grantor Trust Status After the Powerholder's Death

A trust is a grantor trust if the grantor retains (or a nonadverse person holds) the delineated powers and interests described in Sections 673-677. The grantor does not own any portion of the trust attributable to a transfer by someone else, unless the grantor holds a withdrawal power described in Section 678. The death of the powerholder constitutes a constructive addition to the trust for grantor trust purposes only if the powerholder exercises the power in favor of the trust; the lapse of the power does not constitute a constructive addition to the trust. See Reg. §§ 1.671-2(e)(5), 167.1-2(e)(6), Ex. 9.

This may (or may not) be tied to the clear property law in most states that allows the creditors of the holder of an exercised general power of appointment to reach the appointive assets, while denying such access to the creditors of the holder of a lapsed general power of appointment.

Thus, if the trust is a grantor trust and the grantor wants it to remain a grantor trust, the powerholder should allow the general power of appointment to lapse, rather than exercise it.

14. Exercising an Upstream General Power to Appoint Assets in Trust for the Grantor's Benefit

a) Generally

A grantor who retains beneficial enjoyment or the power to alter beneficial enjoyment of a trust fund may have the trust assets included in his or her gross estate under Sections 2036 or 2038. The law is unclear, but there is a good chance that the same result may occur if an upstream powerholder exercises his or her general power of appointment in further trust for the benefit of the grantor.

b) Does the General Power of Appointment Negate the Original Transfer by the Grantor for Estate Tax Purposes?

(1) Section 2036 – Not Usually a Problem

Section 2036(a) includes in a decedent's gross estate property transferred by the decedent during his or her lifetime (except for a *bona fide* sale for an adequate and full consideration in money or money's worth), and as to which the decedent retains a lifetime right to income or enjoyment of the property or a right to designate who shall enjoy the beneficial enjoyment of the property. The requirement that the interest or power be "retained" renders it difficult to apply Section 2036(a) to an interest that is granted the donor by the exercise of an upstream testamentary power of appointment.
Section 2036(a) could apply, however, if there is an understanding or agreement between the donor and the upstream powerholder that the latter will exercise the power in a manner that bestows an interest or power to the former. In such a situation, the interest could be deemed retained. For this reason, the upstream powerholder should have separate counsel draft the will that exercises his or her power of appointment; use of the same counsel who prepared the trust instrument could raise a suggestion that there was an understanding or agreement to benefit the donor.

(2) Section 2038, However, is Another Matter Entirely

(a) Generally

Section 2038(a)(1) includes in a decedent's gross estate property transferred by the decedent during his or her lifetime (except for a *bona fide* sale for an adequate and full consideration in money or money's worth), and the decedent possessed on the date of death a power to alter, amend, revoke, or terminate. Section 2038(a)(1) does not require that the decedent have retained this power; it requires only that it exist on the date of the decedent's death. See Rev. Rul. 70-348, 1970-2 C.B. 193 (property included in estate of decedent who became custodian of gift to minor on death of original custodian).

Therefore, on its face, Section 2038(a)(1) should apply if the upstream powerholder exercises a general power to appoint the subject assets in further trust, either for the beneficial enjoyment of the original grantor (such as a right to invade principal or income) or for the beneficial enjoyment of others in the discretion of the original grantor. See *Seasongood v. United States*, 331 F. Supp. 486 (S.D. Ohio 1971). A grantor's right to distribute trust assets subject to an external ascertainable standard, however, does not fall under Section 2038(a)(1). *Estate of Ford v. Comm'r*, 53 T.C. 114 (1969), *acq. in part, nonacq. in part recommended*, AOD, 1970 WL 22802 (May 13, 1970), 1978 WL 194691 (Dec. 31, 1978), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971).

(b) Is the Upstream Powerholder the True Transferor?

Most practitioners would treat the inclusion of the subject assets in the powerholder's gross estate under Section 2041 as rendering the powerholder the new transferor in lieu of the original grantor, for purposes of Section 2038. Unfortunately, there appears to be no authority to support this analysis and one could as easily argue that the original grantor remains a transferor for this purpose.

(i) Point Against

Section 2038(a)(1) states that it applies "without regard to when or from what source the decedent acquired such power." This would appear to undercut the argument that the upstream powerholder should supplant the original grantor for purposes of Section 2038.

(ii) Comparison with Section 2044

A contrary rule applies where property is included in the gross estate of a donee-spouse under Section 2044. In such cases, the donee-spouse is treated as the transferor for estate and GST tax purposes and can create a trust for the original grantor without the application of Sections 2036 or 2038. This, however, is because of a specific statutory direction that a deceased spouse be treated as the transferor of any property includible in his or her gross estate because of a lifetime QTIP election. IRC § 2044(c).

(iii) Comparison with Grantor Trust Rules

In determining who is the grantor of a trust for grantor trust purposes, Reg. § 1.671-2(e)(5) states that:

> *"If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then*

such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code."

This, however, is an income tax rule, and there is no authority for adopting a similar rule for estate tax purposes.

15. Combining a POAST with a Domestic Asset Protection Trust

The only reason why a general power of appointment might not be appropriately granted to an upstream person with respect to a trust created for the grantor's lifetime benefit under a domestic asset protection trust statute, would be that it could expose the trust assets to the claims of the power-holder's creditors. There appears to be no inconsistency between the rules for an upstream general power of appointment and those for a domestic asset protection trust.

16. Other Innovative Planning Opportunities with POASTs

One of the major goals of the POAST is to utilize the upstream beneficiary's otherwise unused applicable exclusion amount and GST exemption, by causing part or all of the assets in the POAST to be included in G1's gross estate. A goal, not explicitly stated before, is to try to fund the POAST with assets, but to do so without using too much of the donor's (i.e., the lower generation's) applicable exclusion amount.

For purposes of this section, we call the upstream beneficiary, G1, the donor, G2 and the donor's other beneficiaries (e.g., his descendants), G3.

Funding by using G2's annual exclusion amounts accomplishes that goal; however, it is limited to the amount of G1s and G3s. But, there are other ways to fund the POAST.

a) The Pour-Over GRAT Approach

Using zeroed-out GRATs are generally a good planning tool in low interest rate environments, because they are very little of G2's applicable exclusion amount. However, they are not good tools from a GST tax perspective (because of the so-called "ETIP" rules). With successful GRATs, assets remaining in the GRAT could pour-over into the POAST.

Remember, we do not suggest allocating G2's GST exemption to the POAST. We wait until G1 dies and uses his otherwise unused GST exemption and allocates it to the POAST. This way, you get the benefit of the GRAT (i.e., passing assets gift/estate tax free) as to G2, and the allocation of G1's GST exemption, and a basis adjustment at G1's death.

b) The Pour-Over CLAT Approach

CLATs, like GRATs, are also good, low-interest rate estate planning tools. Like GRATs, if the CLAT is successful, the remainder generally passes to non-charitable beneficiaries. And, like GRATs, the ETIP rules apply. To get the same benefits as using a "pour-over GRAT", if there is a POAST, consider leaving the remainder of the CLAT to the POAST.

c) The Convertible POAST

Consider converting an otherwise irrevocable, dynastic trust to a POAST. Many irrevocable, dynastic grantor trusts have trust protectors with the power to add a beneficiary (i.e., often to achieve grantor trust status under Section 674(c)). If the trust has such a provision, simply add G1 as a beneficiary and give G1 a contingent testamentary general power of appointment.

If there is no trust protector, consider judicial modification. For instance, the grantor, beneficiaries and trustee could petition a count to add G1 as a discretionary income and principal beneficiary, and also provide G1 with a contingent testamentary general power of appointment.

Alternatively, if the state law permits, it may be possible to accomplish the same (i.e., adding G1 as a beneficiary with a contingent testamentary general power of appointment) through non-judicial modification.

d) Insuring G1's Life

Another efficient way to leverage the POAST is to purchase life insurance on G1s life, if it is financially feasible.

e) The Sale to a POAST

To add value to the POAST, consider the "sale to the intentionally defective grantor trust" approach. Since the POAST is structured as a grantor trust for income tax purposes, consider the sale of discounted assets to the POAST, where G2 would take back a promissory note with a favorable interest rate. If the assets outperform the interest rate on the promissory note, the appreciation will increase the net value of the POAST.

17. Premature Death of the Donor

It is entirely possible that the donor (G2) predeceases the upstream beneficiary (G1). If this is the case, the basis of the transferred assets into the POAST will not get a basis adjustment at G2's premature death (i.e., the opposite result had G2 done nothing). So, one may think that the planning did not succeed. That is not accurate. Let's put things into perspective.

If G2's death was foreseeable (i.e., G2 was ill at the time of the planning), the POAST should not have been a suggested planning tool. Conversely, if death was not foreseeable, the statistical likelihood of G2 predeceasing G1 would have been small, and thus likely ignored.

Remember, premature death simply delays the income tax benefit of the basis adjustment (unless you take the position that the basis can be adjusted at G1's death).

However, because the POAST was a grantor trust, it is likely that there would be a 'swap power' under Section 675(4)(C), which could have allowed G2 to swap some higher basis assets into the POAST and lower basis assets back into G2's estate before death to reduce the impact of waiting for the lower-basis assets to be adjusted when G1 dies.

Finally, it is important to remember the income tax benefit (i.e., basis adjustment) is only one of the benefits, the other benefits include the allocation of G1's otherwise unused GST exemption, the basis adjustment when G1 dies, and the ability to care financially for G1, should the need arise.

18. The SLAT-POAST

The so-called, Spousal Lifetime Access Trust, or SLAT, became a highly-touted estate planning tool in the early 2000s. The idea behind the SLAT was to create a trust for the benefit of one's spouse and descendants, and, assuming a happy marriage (or a relatively happy marriage, or a so-so marriage, but one that will likely end with death of one spouse), the donor and spouse get to effectively use the assets for their benefit, even though the assets have been moved out of the donor's estate for estate tax purposes.

The POAST can be structured as a SLAT. In other words, if the donor is (happily, relatively happily, etc.) married, he/she could consider creating a SLAT, and adding an upstream beneficiary as a discretionary beneficiary (for support) and giving the upstream beneficiary a contingent testamentary general power of appointment.

This combines the benefits (and burdens) of the SLAT with the benefits (and burdens) of a POAST ... The "SLAT-POAST."

IV. POST-FORMATION TECHNIQUES TO CREATE BASIS IN AN IRREVOCABLE TRUST AT THE GRANTOR'S DEATH

A. The Problem Explained

The 2017 Tax Act continues a recent history of legislative significant increases in the applicable exclusion amount. Many grantors will find that they now have more applicable exclusion amount than they require, and that their prior gifts to irrevocable trusts will now provide no estate tax savings. Yet, these gifts did remove property from the grantor's gross estate and so will deprive those assets of a basis adjustment at the grantor's death. The grantor has, in essence, foregone a basis increase at death in exchange for no actual estate tax savings. Such grantors will often wish to cause their irrevocable trusts to be included in the grantor's gross estate, either entirely or in part.

B. Give the Grantor a General Power of Appointment

The regulations state that an individual cannot retain to himself or herself a general power of appointment, for estate tax purposes. Reg. § 20.2041-1(a)(2) ("For purposes of §§20.2041-1 to 20.2041-3, the term 'power of appointment' does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038.") Where such a power was not "reserved" by the decedent, however, one could arguably be granted later. Nonetheless, there is no real precedent on this issue, and one might find it useful to evaluate the addition of a power in the grantor to appoint the trust assets under Sections 2036 and 2038, rather than under Section 2041.

C. Gross Estate Inclusion under Section 2036

1. Generally

It is difficult to cause the grantor's estate to include trust assets under Section 2036, because that section applies only to interests and powers that are retained by the grantor. One could, perhaps, argue that the grantor retained this interest or power by not expressly negating the power of the trustee and beneficiaries to decant or reform the trust, though there is no authority in support of this analysis. See, *e.g.*, Va. Code §§ 64.2-729 (modification of noncharitable irrevocable trust by court order upon consent of grantor and beneficiaries, even if modification is inconsistent with a material purpose of the trust); 64.2-730 (modification of a noncharitable irrevocable trust by court order upon finding that, because of circumstances not anticipated by the grantor, modification will further the trust purposes or prevent the trust from being impracticable or wasteful or impair the trust administration); 64.2-733 (judicial modification to conform the terms of the trust to the grantor's intentions, upon proof by clear and convincing evidence that both the grantor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement); 64.2-734 (judicial modification to achieve the grantor's tax objectives in a manner that is not contrary to the grantor's probable effect); 64.2-779.8(D) (power to create and modify powers of appointment in new trust decanted under expanded distributive discretion (discretion that is not limited by an ascertainable standard or a reasonably definite standard).

2. Grantor Cannot Assert Substance Over Form

Section 2036 applies to a power or interest in a trust that is retained by an express or implied agreement or understanding, even if it is not expressed in the trust instrument. *Skinner v. United States,* 316 F.2d 517 (3d Cir. 1963); *Estate of Linderme v. Comm'r,* 52 T.C. 305 (1969); *Estate of Kerdolff v. Comm'r,* 57 T.C. 643 (1972); Rev. Rul. 70-155, 1970-1 C.B. 189; Rev. Rul. 78-409, 1978-2 CB 234.

A grantor may, therefore, assert that such an interest or power was retained by an agreement with the trustees that was not expressed in the trust instrument. For example, a grantor who creates a QPRT and outlives the reserved use term could then continue to use the residence without paying adequate rent. Such continued use of the property would normally be deemed a retained beneficial enjoyment, if it were anticipated from the creation of the trust.

The courts and the IRS, however, have held that the taxpayer cannot argue substance over form, because the taxpayer selects the form of the transaction and cannot thereafter challenge it. *City of New York v. Comm'r*, 103 T.C. 481 (1994), *aff'd*, 70 F.3d 142 (D.C. Cir. 1995) ("To freely allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the 'transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is … [more favorable]'"); *Estate of Durkin v. Comm'r*, 99 T.C. 561, 571-573 (1992); *Comm'r v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *rev'g* 44 T.C. 549 (1965); *Coleman v. Comm'r*, 87 T.C. 178 (1986), *aff'd without op.* 833 F.2d 303 (3d Cir. 1987); *Howell v. Comm'r*, T.C. Memo. 2012-303. See also, CCA 201121020; FSAs 199921002, 199909018, 200004011, and 200242004; and TAMs 9515003, 200334001, and 200418008.

The Ninth Circuit explained this in *In re Steen v. United States*, 509 F.2d 1398, 1402-1403 fn. 4 (9th Cir.1975), in which it stated:

> *"The rule [that the government may bind a taxpayer to the form in which he has factually cast a transaction] exists because to permit a taxpayer at will to challenge his own forms in favor of what he subsequently asserts to be true substance would encourage post-transactional tax planning and unwarranted litigation on the part of many taxpayers and raise a monumental administrative burden and substantial problems of proof on the part of the government."*
>
> * * *
>
> *In a case such as this one, where the documentary form of the transaction is ambiguous, the government's assertion of the rule will normally render the taxpayer's factual characterization of the transaction on his income tax return conclusive against his conflicting and subjective testimony."*

The taxpayer can overcome this rule only by "strong proof" of the original intent of the transaction. Strong proof, a uniquely tax-related standard, is similar to the clear and convincing evidence required to reform a written contract. *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 2008 WL 1733598, 101 A.F.T.R. 2d 2008-1606 (D.N.H. 2008).

D. Gross Estate Inclusion under Section 2038

1. Generally

A grantor may be able to cause trust assets to be included in his or her gross estate by obtaining a power to alter, amend, revoke, or terminate the beneficial enjoyment of those assets. Section 2038(a)(1) applies to such a power as long as it is held by the grantor on the date of his or her death (or released within three years of the date of his or her death) "without regard to when or from what source the decedent acquired such power." This suggests that gross estate inclusion should be possible by granting the grantor a power to control the beneficial enjoyment of all or specific trust assets, whether the grantor obtains this power by decanting, judicial reformation, or nonjudicial reformation. Unfortunately, the law is not quite that simple.

2. *Skifter* and the Origin of the Power

Under a line of cases, a Section 2038(a)(1) power cannot exist unless its creation was reasonably anticipated by the grantor when the trust was created.

a) *Estate of Skifter*

(1) Facts

In *Estate of Skifter v. Comm'r*, 468 F.2d 699 (2d Cir. 1972), *aff'g* 56 T.C. 1190 (1971), *nonacq. recommended* AOD (Dec. 22, 1971), *acq*. 1978-2 C.B. 1, Hector Skifter gave his wife an insurance policy he owned on his own life. Hector lived more than three years, but unfortunately, his wife predeceased him, leaving the policy to a trust of which he was trustee. As trustee, Hector had the right to change the policy beneficiaries, though he could not benefit himself by so doing.

(2) Government Argument

The IRS contended that Hector held incidents of ownership over the policy, notwithstanding that his exercise of those incidents was circumscribed by his fiduciary duties.

(3) Courts Treat Life Insurance Policy Like Other Assets are Treated Under Sections 2036 - 2038 and 2041

The Tax Court and the Second Circuit both held for Hector's estate, that he might have incidents of ownership, but that he should not be taxed on the policy proceeds under Section 2042. The courts stated that life insurance is supposed to be treated under Section 2042 like other property is treated under Sections 2036 and 2038. In this situation, the courts held, Hector had obtained the power to control the policy's beneficial enjoyment from an unexpected and uncontrolled source – his late wife's death. The Second Circuit explained:

> *"This type of power would fall under both § 2036 and § 2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of § 2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, § 2038, would apply because decedent had the power "to alter, amend . . ., or terminate" the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. [citations omitted] Therefore, he argues, this power must be an incident of ownership for § 2042 purposes also.*
>
> *But the Commissioner's reliance on § 2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies-it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and*

> *powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted. When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. [citations omitted]"*

468 F.2d 699, at 703-704.

b) Split in the Circuits

The Sixth and Eighth Circuits followed *Skifter*. See *Hunter v. United States*, 474 F. Supp. 763, 764-65 (W.D.Mo.1979), *aff'd*, 624 F.2d 833 (8th Cir. 1980); and *Estate of Fruehauf v. Comm'r,* 427 F.2d 80 (6th Cir. 1970). See also *Estate of Reed v. United States*, 36 AFTR 75-6413 (S.D. Fl. 1974), stating that Section 2038 applies only

> *"where the transferor-decedent himself sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to him."*

The Fifth Circuit, however, twice rejected the Second Circuit's analysis, because it did not believe that the legislative history of Section 2038 was relevant to analysis of life insurance policies under Section 2042. *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); and *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975).

c) IRS Fudges and then Acquiesces -- Rev. Rul. 84-179

The IRS nonacquiesced in *Skifter*, but then acquiesced and adopted its analysis in Rev. Rul. 84-179, 1984-2 C.B. 195, in which it excluded the proceeds of a life insurance policy from an insured decedent's gross estate, if the policy was held in a fiduciary capacity, the incidents could not be exercised for the decedent's personal benefit, and:

> *"the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent."*

See Folk, *Fiduciary Powers and Life Insurance: Putting Rev. Rul. 84-179 Into Perspective*, 63 Taxes 417 (1985). This, albeit indirectly, appears to accept the concept that Section 2041 and, by analogy, Section 2038, cannot apply unless the grantor initiates the transfer that results in his or her possession of a power to alter, amend, revoke, or terminate beneficial enjoyment.

a) Analysis

(1) *Skifter* Seems Correct

Skifter poses a distinct obstacle in using Section 2038 to cause an irrevocable trust to be included in a grantor's gross estate. The legislative history of various tax acts suggests that the court in *Skifter* was correct, and that Section 2038 requires that the grantor's actions ultimately produce the right to alter, amend, revoke, or terminate. See discussion in Blattmachr, Zeydel, and Gans, *The World's Greatest Gift Tax Mystery, Solved*, Tax Notes 61 (April 27, 2007). Thus, one may reasonably expect the IRS to contest the use of a trust reformation or decanting to give the grantor a Section 2038 power over an extant irrevocable trust.

(2) Level of Grantor Involvement Required

It is not clear what *Skifter* actually requires in the way of grantor initiation of the power. It ought not to require that the power be retained by the grantor, because the Code was quite clear in imposing this requirement in Section 2036(a) and the plain language that was used there is missing from Section 2038. This may be a logical inference, but it is not necessarily legally required. See *Kirtsaeng v. John Wiley & Sons, Inc.*, 568 U.S. 519 (2013) (No canon of interpretation forbids interpreting different words used in different parts of the same statute to mean roughly the same thing.)

The *Skifter* analysis appears to require that the grantor take some affirmative action to obtain the power in question, and that he or she not merely sit passively while the power is granted to him or her. Thus, a decanting by the trustee that gives the grantor a power to appoint the trust assets would not seem to satisfy the *Skifter* requirements, possibly unless if the trustee's decision to decant was prompted by a letter from the grantor stating that the grantor had unused applicable exclusion amount and that the trustee ought to take steps to cause the assets to be included in the grantor's gross estate. A trust reformation initiated by the grantor, either alone or together with the trustee, the beneficiaries, or both, to give the grantor such a power would certainly seem to satisfy the *Skifter* requirements.

Uniform Trust Code § 411(a) states, in part, that:

> *"(a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.] [If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court shall approve the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.] A settlor's power to consent to a trust's modification or termination may be exercised by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust; by the settlor's [conservator] with the approval of the court supervising the [conservatorship] if an agent is not so authorized; or by the settlor's [guardian] with the approval of the court supervising the [guardianship] if an agent is not so authorized and a conservator has not been appointed.*

See, Ar. Stat. § 28-73-411; D.C. Code § 19-1304.11; Kan. Stat. 58a-411; K.Y. Stat. § 386B.4-110; 18-B Me Stat. § 411; Mo. Stat. 456.4-411A; Minn. Stat. § 501C.0411; N.M. Stat. § 46A-4-411; N.C. Stat. § 36C-4-411; 20 Pa. C.S.A. § 7740.1; S.C. Stat. § 62-7-411; Utah Stat. § 75-7-411; Va. Code § 64.2-729; 14A Vt. Stat. § 411; Wis. Stat. 701.0411; Wy. Stat. § 4-10-412. The grantor can initiate the suit and join the beneficiaries as petitioners. This should satisfy the requirement of *Skifter*.

For those states that did not adopt UTC's version of section 411, such as Florida, perhaps using non-judicial modification provisions under UTC section 411 (Fl. Stat. § 736.0111) or using the modification to achieve the settlor's tax objectives under UTC 416 (Fl. Stat. § 736.0416) may be another way to accomplish this. Note, however, the settlor would have to be a party to the non-judicial modification under section 111 and/or join in the court proceeding under section 416.

States that permit a reformation but have not adopted the Uniform Trust Code may still permit the grantor to file the petition for reformation.

The courts have not provided details on what actions by a grantor are sufficient to cause gross estate inclusion under Section 2038 after the trust has been created, but it seems reasonable that such a suit to reform would suffice. In any event, this is the most promising avenue for causing Section 2038 to apply to an irrevocable trust in which the grantor originally retained no power to alter, amend, revoke or terminate.

E. Boxing in the IRS

The best approach may be to have a trust protector grant the grantor a general power of appointment. The regulations state that Section 2041 does not apply to a power of appointment retained by the grantor. If the IRS argues that the power is not a Section 2038 power under *Skifter*, then the grantor should be able to contend that it is a Section 2041 power, because it has not been retained. *Skifter* requires something akin to retention, and if you fail to satisfy *Skifter*, then logically, you cannot have retained the power.

V. DOUBLE BASIS INCREASE -- THE TAX BASIS REVOCABLE TRUST, THE JEST, AND THE OPT-IN COMMUNITY PROPERTY TRUST

A. The Tax Basis Revocable Trust

1. Using a General Power of Appointment to Obtain a Basis Increase

Property subject to a general power of appointment held by a decedent is included in his or her gross estate for federal estate tax purposes under Section 2041, and that property included in a decedent's gross estate for federal estate tax purposes obtains a new basis equal to its estate tax value. In a technical advice memorandum and several private letter rulings, the IRS has taken the position that the mere fact that property is subject to a deceased spouse's general power of appointment does not assure that it will receive a basis step-up, and that Section 1014(e) will avoid such a step-up if the surviving spouse who granted the power of appointment had the right to revoke the transfers to the trust during the year prior to the first deceased spouse's death. These rulings form the basic authority on so-called "tax basis revocable trusts" and "joint estate step-up trusts (JESTs)."

2. TAM 9308002 and the Tax Basis Revocable Trust

This technique, its rejection, and the possibility that the IRS is incorrect, can best be understood in the context of the various rulings on this transaction, now known as the tax basis revocable trust. The first such ruling was TAM 9308002.

a) Community Property Tax Treatment in a Common Law State?

H and W, U.S. citizens living in Oregon (a non-community property state), created a joint revocable trust that they funded with substantially all of their assets, most of which had been held as joint tenants, into the trust. The trustees were directed to distribute the net income from the trust property to or for the benefit of the grantors in quarter-annual or more frequent installments, and to distribute as much of the principal of the trust property as the trustees determined necessary for the grantors' health, education, support, and maintenance so that the grantors could continue their accustomed manner of living.

Either grantor, acting alone and without the consent of the other grantor, could revoke the trust during their joint lifetimes, in which case an undivided one-half interest in the trust property would be distributed free of the trust to each grantor. Neither grantor exercised the power to revoke the trust.

At the date of death of the first grantor to die, the decedent's one-half interest in the property would pass to the surviving grantor outright and free of trust.

Each grantor had the power to compel the trustee by an *inter vivos* instrument to pay from the trust funds the taxes, debts, and expenses of that grantor. The other grantor's right to revoke the trust was not affected during the lifetime of the grantor making the request, but if a grantor made the request and the other grantor had not elected to revoke the trust prior to the requesting grantor's death, then at the time of the requesting grantor’s death, the surviving grantor's powers to amend, revoke and withdraw would be subordinate to the trustee's duty to pay the taxes, debts, and expenses of the deceased grantor.

W died one month after the trust was funded. At W’s death, neither grantor had notified the trustee that the trustee was to pay the notifying grantor’s taxes, debts, and expenses.

W’s personal representative included the entire trust fund in her gross estate, including one-half of the trust fund under Section 2038, because of the right to revoke, and the other half under Section 2041, because of the power of appointment.

b) IRS Analysis and Conclusions

The IRS concluded that the entire trust fund was includible in W’s gross estate, as reported on the estate tax return, but that under Section 1014(e), no basis step-up was available for H’s one-half of the trust assets included in W’s gross estate under Section 2041. The IRS explained that the legislative history of Section 1014(e) expresses Congress' concern that under the pre-1982 rules, an individual could transfer appreciated property to a family member immediately prior to the family member's death, anticipating that on the family member's death the individual would receive the property back (through bequest or devise) and obtain a step-up in basis. Under such circumstances, there is little substance to the initial transfer to the decedent, because of the short period of time between the two transfers.

Further, the IRS stated, Congress recognized that the allowance of an unlimited marital deduction and the increase in the unified credit provided an even greater incentive for persons to plan such death-time transfers of appreciated property, since in many cases, the provisions eliminated any estate and gift tax consequences with respect to the transfers. See H. Rep. No. 201, 97th Cong. 1st Sess. 188 (1981), characterizing the step-up in basis in such circumstances as “unintended and inappropriate.” Section 1014(e) applies, the IRS stated, unless the deceased donor relinquished actual dominion and control over the property for a full year prior to death.

The IRS explained that

> *“In the instant case, the surviving spouse (i.e., donor) held dominion and control over the property throughout the year prior to the decedent's death, since he could revoke the trust at any time. It was only at the decedent's death that the power to revoke the trust became ineffective. Because the donor never relinquished dominion and control over the property (and the property reverted back to the donor at the spouse's death) the property was not acquired from the decedent under section 1014(a) and (e), notwithstanding that it is includible in the decedent's gross estate. Taxpayer's position in this case would produce the “unintended and inappropriate” tax benefit Congress expressly eliminated in enacting section 1014(e).”*

3. Later Private Rulings

The IRS has issued several other private rulings involving similar transactions. Each one concluded that the portion of the trust contributed by the surviving spouse was includible in the deceased spouse’s gross estate under Section 2041, but that no basis adjustment was allowed for that portion of the trust fund under Section 1014(e).

a) PLR 200101021

(1) Facts

In PLR 200101021, the grantors, a married couple, proposed to create a joint trust and fund it with assets that they owned as tenants by the entirety. The trustee would apply trust income and principal as the trustee deemed advisable for the comfort, support, maintenance, health, and general welfare of the grantors. Either grantor could terminate the trust by notice to the other grantor. The trustee would, upon termination of the trust, deliver the trust property to the grantors in their joint names as tenants in common.

Either grantor also could amend the trust while both grantors were living, by delivering to the other grantor the amendment in writing at least 90 days before the effective date of the amendment.

The trust also granted the first grantor to die a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of the trust to the deceased grantor's estate or any other person.

In default of the valid exercise of this power of appointment, the trust fund to which the power relates would be divided into marital and nonmarital shares. The marital share would be paid outright to the surviving spouse, and the nonmarital share held in a trust for the benefit of the surviving spouse, for his or her support and maintenance, and to the couple's descendants, for their maintenance, support, and education.

(2) IRS Conclusions

The IRS ruled, without significant analysis, that:

- The transfer of joint property to the trust would not be a completed gift for gift tax purposes, because each grantor would retain the power to terminate the trust by written notice to the other grantor, and upon such termination, the trustee would deliver the trust property to the grantors in both their names as tenants in common;

- Distributions of trust property to either of the grantors during their joint lives would constitute a gift by the other grantor to the extent of one half of the value of the trust assets distributed, but the gift would qualify for the gift tax marital deduction under Section 2523;

- The first grantor to die would possess a general power of appointment over the portion of the trust fund contributed by the other grantor and a power to revoke the trust over the portion of the trust he or she had personally contributed, causing the entire trust fund to be included in the deceased grantor's gross estate;

- On the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor's one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor's entire interest in the trust, and this gift will qualify for the marital deduction under Section 2523; and

- Section 1014(e) would apply to any trust property includible in the estate of the first grantor to die that is attributable to the surviving grantor's contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor's exercise, or failure to exercise, the general power of appointment.

b) Other Rulings

See also PLR 200403094 and PLR 200604028, reaffirming the same points as PLR 200101021, but not addressing Section 1014(e).

B. The Joint Estate Step-Up Trust (JEST)

An effective variation on the tax-basis revocable trust is the joint estate step-up trust, or JEST. See, Gassman, Denicolo, & Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses – Parts 1 and 2*, 40 Est. Plan. 3, 14 (Oct., Nov. 2013).

1. Structure of the JEST

A JEST is a joint revocable trust created by a married couple residing in a non-community property state. Each spouse has the power to terminate the trust during their joint lives. If the trust is so terminated, each spouse's one-half share will be distributed to him or her individually. The JEST becomes irrevocable when the first spouse dies.

The first spouse to die is given a testamentary general power to appoint the entire trust fund, including the share contributed by the surviving spouse. On the first spouse's death, the assets of his or her share of the trust are divided into a credit shelter trust A, for the benefit of the surviving spouse and descendants, and if this share exceeds the first spouse's applicable exclusion amount, a QTIP marital trust for the excess.

If the trust share of the first spouse to die is less than his or her applicable exclusion amount, then the difference between the first spouse's share and his or her applicable exclusion amount is appointed to credit shelter trust B. Credit shelter trust B is held for the benefit of other family members; the surviving spouse is not a beneficiary of credit shelter trust B.

The surviving spouse may be added as a beneficiary of credit shelter trust B by a trust protector at some later date, if the trust protector determines it desirable to do so.

2. Analysis of the JEST

The JEST has one noteworthy advantage over the tax-basis revocable trust -- the assets contributed by the surviving spouse and appointed by the first spouse to die do not pass to the surviving spouse. They are held by a trust of which the surviving spouse is not a beneficiary. This should make application of Section 1014(e) extremely difficult.

The IRS could attempt to apply Section 1014(e) is the trust protector later adds the surviving spouse, though this likely would require the IRS to prove that there was an existing agreement or understanding that the trust protector would do so. This can be made more difficult if there is no trust protector appointed until after the first spouse's death, because without the existence of a trust protector at the first spouse's death, an agreement between the trust protector and the surviving spouse seems impossible.

C. Analysis of the IRS Position on the Tax Basis Revocable Trust (and, by Extension, on the JEST)

1. Gift at Moment Before Death

a) Generally

TAM 9308002 states that Section 1014(e) applies to property acquired by the decedent by gift unless, at least one year before death, the donor relinquishes "actual dominion and control over the property." Property is "acquired from the decedent by gift" under Section 1014(a) only upon such cessation of dominion and control. This is a reasonable interpretation of the requirement of Section 1014(e) that the property be acquired by gift within one year of death.

b) **Moment Before Death and Basis**

The concept is that the surviving spouse made a revocable gift to the first spouse to die that became a completed gift at the moment before the first spouse's death. This presupposes that the completion of the gift occurs before the first spouse dies. An interpretation that the gift was completed after death would mean that no transfer was made before the first spouse's death.

c) **Moment Before Death and Marital Deduction**

PLR 200101021 states that on the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor's one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor's entire interest in the trust, and this gift will qualify for the marital deduction under Section 2523. If the gift were deemed to have been made at the moment after the spouse's death, which seems equally tenable in theory, the gift could not be made to the spouse while he or she was married to the transferor; it would be made to the beneficiaries of the deceased spouse's estate, and it would not qualify for the estate tax marital deduction. Some commentators believe that this interpretation is at least as valid as the one adopted by the IRS. See Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?*, 42 Real Prop. Prob. & Tr. J. 413 (Fall, 2007). If the IRS took this position, however, the basis adjustment would have to be allowed, because the property would not pass back to the donor spouse.

d) **What Was Transferred within One Year of Death?**

(1) **The Surviving Spouse's Contributed Property**

TAM 9308002 and the various private rulings do not actually state whether, within one year of death the surviving spouse transferred to the deceased spouse the assets contributed by the surviving spouse or the power of appointment over those assets. TAM 9308002 speaks of relinquishing dominion and control "over the property" within one year of death. PLR 200101021 refers to the release of dominion and control over "the Trust property."

(2) The Power of Appointment

Several commentators have interpreted the IRS as having treated the power of appointment as having been transferred within one year of death. See, e.g., Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?*, 42 Real Prop. Prob. & Tr. J. 413, 421 (Fall, 2007); and Fletcher, *Drafting Revocable Trusts to Facilitate a Stepped-Up Basis*, 22 Est. Plan. 100, 105 (March/April 1995). This would seem to stretch Section 1014(e) well beyond its statutory language, because the power of appointment is not itself property, but rather a power to control the disposition of property. A more careful reading of the rulings, however, shows that the IRS treated the funding of the trust as a transfer that was incomplete until the moment immediately before the first spouse's death, when the power to revoke terminated. Thus, the death of the first spouse completed the transfer and triggered the one-year period under Section 1014(e).

2. Existence of a General Power of Appointment

The use of a tax-basis revocable trust or JEST to make the surviving spouse's assets available to take advantage of the first spouse's applicable exclusion amount depends upon the existence of a general power of appointment. The IRS did not raise in the various rulings the question of whether the power of appointment was actually a general power, though it is understood that the IRS addressed this issue in the negotiations over TAM 9308002.

a) Exercise with Consent of the Creator

The IRS estate tax examiner in TAM 9308002 argued that the power of appointment was a limited power because it was exercisable solely in conjunction with its creator. The agent noted that W could exercise the power only by giving notice to the trustees (including H) and that H would then be able to revoke the trust and withdraw his share of the trust assets. This, the agent argued, had the effect of requiring W to exercise the power together with its creator. The IRS National Office determined that W's power of appointment was a general power of appointment.

This is consistent with several cases which have held that a donor's right to dispose of the property to which a power of appointment relates after the exercise of that power is not equivalent to a requirement that the power be exercised jointly with the creator. *Johnstone v. Comm'r*, 76 F.2d 55 (9th Cir. 1935), *cert. denied*, 296 U.S. 578 (1935), *aff'g* 29 B.T.A. 957 (1934); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972), *rev'g* 323 F. Supp. 1093 (N.D. Fl. 1971); GCM 37428 (1981). See discussion in Fletcher, *Drafting Revocable Trusts to Facilitate a Stepped-Up Basis*, 22 Est. Plan. 100, 105 (March/April 1995).

b) Requirement of Notice

The requirement that notice must be given to the other spouse before exercise of an *inter vivos* power of appointment is insufficient to preclude the existence of the general power of appointment even if notice must be given to the creator of the power, acting as trustee. IRC § 2041(a)(2); Reg. § 20.2041-3(b).

3. Exclusion of Property from Surviving Spouse's Gross Estate

One article suggests that the weakest element in the IRS analysis is that, any portion of the assets contributed by the surviving spouse that are included in the first spouse's gross estate under Section 2041 and that pass to a nonmarital trust of which the surviving spouse is a beneficiary, could be includible in the surviving spouse's gross estate. This article suggests that, under the step transaction doctrine, the transfer of property to the revocable trust by the surviving spouse could be combined with their passage to a nonmarital trust, to cause the nonmarital trust to be treated as self-settled by the surviving spouse for estate tax purposes. Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In the Interim?,* 42 Real Prop. Prob. & Tr. J. 413, 430-434 (Fall, 2007). This argument is very fact-sensitive; the longer the property remains in trust before the first spouse's death, and the broader the powers granted the first spouse to appoint the trust to someone other than the surviving spouse, the less appropriate it would be to apply the step transaction doctrine.

D. Alaska, South Dakota, and Tennessee Community Property Trusts

1. Generally

Alaska, South Dakota, and Tennessee currently provide that property acquired by a married couple is separate property, unless the couple elect to treat it as community property, in contrast with the general rule in most community property states that all property acquired by a married couple is presumed to be community property, unless they have clearly provided to the contrary. Alaska permits the creation of a trust to hold property as community property and treat the assets of such trusts as community property, even if the couple creating the trust do not reside within the state. AS §§ 34.77.010 to 34.77.995. South Dakota and Tennessee provide that holding property in trust is the only way in which to create community property in those states. S.D. Cent. Code §§ 55-17-1 to 55-17-14; Tenn. Code §§ 35-17-101 to 35-17-108. In effect, all three are opt-in states, because the creation of a trust constitutes an election to adopt community property. See Asher, Blattmachr & Zaritsky, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & Tr. J. 615 (Winter 1999); Shaftel & Greer, *Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents*, SD 36 ALI-ABA 1, 12–13 (1999); Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 U. Mem. L. Rev. 369 (Winter 2011); Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 5 Nev. L.J. 704 (Spring 2005).

2. Early Opt-In State

Oklahoma enacted an opt-in community property system in 1939 and Oregon enacted one in 1943. 32 Ok. Stat. of 1941, §§ 51 et seq.; Ore. Laws of 1943, ch. 440.

3. Alaska

Alaska enacted an opt-in community property system in 1998. Alas. State Laws of 1998, ch. 42.

4. Tennessee

Tennessee enacted its opt-in community property in trust system in 2010. Tenn. State Laws of 2010, ch. 658.

5. South Dakota

South Dakota enacted its opt-in community property in trust system in 2016. South Dakota Laws 2016, ch. 231 (HB 1039).

6. The Community Property Trust

Alaska, South Dakota, and Tennessee permit residents and nonresidents to create trusts with their situs in the opt-in state, and to have in-state trustees hold those assets for the grantors as community property.

a) Alaska

(1) Mandatory Requirements of an Alaska Community Property Trust

The Alaska Community Property Act states that property held in a trust is community property if:

- One or both spouses transfer property to the trust. AS § 34.77.100(a);

- The trust expressly declares that some or all the property transferred is community property under Title 34, Chapter 77 of the Alaska Statutes. AS § 34.77.100(a);

- At least one trustee is a "qualified person," defined as (a) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or absences for good cause shown, resides in Alaska, whose true and permanent home is in Alaska, who does not have a present intention of moving from Alaska, and who intends to return to Alaska when away; (b) a trust company that is organized under Alaska law and that has its principal place of business in Alaska; or (c) a bank that is organized under Alaska law or a national banking association that is organized under federal banking law, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in Alaska. AS § 34.77.100(a);

- The powers of the qualified person who is a trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. AS § 34.77.100(a);

- The trust is signed by both spouses. AS § 34.77.100(a); and

- The trust contains, at the beginning of the trust and in capital letters, the following declaration:

> *"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE."*

AS § 34.77.100(b).

(2) Optional Features of an Alaska Community Property Trust

The statute states that an Alaska community property trust may also include the following provisions:

- The rights and obligations in the property transferred to the trust, regardless of when and where the property was acquired or located. AS § 34.77.100(d)(1);

- The management and control of the property transferred to the trust. AS § 34.77.100(d)(2);

- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. AS § 34.77.100(d)(3);

- The choice of law governing the interpretation of the trust. AS § 34.77.100(d)(4);

- Any other matter affecting the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. AS § 34.77.100(d)(5);

- Provisions respecting the right to amend or revoke. AS § 34.77.100(e). An Alaska community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation, or unless amended or revoked by a later community property trust (which need not actually declare that it holds any community property). An amended trust or the revocation of a trust is enforceable without consideration. Unless a community property trust expressly provides otherwise, at any time after the death of the first spouse the surviving spouse may amend the community property trust with regard to the surviving spouse's property to be disposed of at the surviving spouse's death. In this subsection, "surviving spouse's property" means the property that consists of the surviving spouse's separate property and the surviving spouse's share of the community property determined as of the date of the first spouse's death. *Id.*

(3) Trustees

The Alaska statute also provides that either or both spouses may be trustees, but it does not require that either spouse be a trustee. AS § 34.77.100(a). Thus, the management rights of the spouses over community property owned outright can be changed by the transfer of that property to an Alaska community property trust. The trustee of a community property trust shall maintain records that identify which property held by the trust is community property and which property held by the trust is not community property. AS § 34.77.100(h).

(4) Conditions of Enforcement

An Alaska community property trust is not enforceable if the spouse against whom enforcement is sought proves that:

- The trust was unconscionable when made. AS § 34.77.100(f). Whether or not a community property trust is unconscionable is determined by a court as a matter of law. AS § 34.77.100(g);

- The spouse against whom enforcement is sought did not execute the community property trust agreement voluntarily; or

- Before execution of the community property trust agreement, the spouse against whom enforcement is sought (a) was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse; (b) did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and (c) did not have notice of the property or financial obligations of the other spouse.

b) South Dakota

(1) Mandatory Requirements of an South Dakota Special Spousal (Community Property) Trust

The South Dakota Special Spousal Trust permits the use of a trust to opt in to a community property system. S.D. Cent. Code § 55-17-1. Property held in a trust is South Dakota Special Spousal Trust if:

- One or both spouses transfer property to a trust. S.D. Cent. Code § 55-17-1;

- The trust expressly declares that some or all the property transferred is South Dakota special spousal property as provided in S.D. Cent. Code §§ 55-17-1 to 55-17-14;

- At least one trustee is a "qualified person." S.D. Cent. Code § 55-17-1. A "qualified person" means

  - □ An individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in South Dakota, whose true and permanent home is in South Dakota, who does not have a present intention of moving from South Dakota, and who has the intention of returning to South Dakota when away. S.D. Cent. Code §§ 55-3-41(1) and 55-16-3;

- ◻ A trust company that is organized under South Dakota or federal law and that has its principal place of business in South Dakota. S.D. Cent. Code §§ 55-3-41(2) and 55-16-3; or

- ◻ A bank or savings association that possesses and exercises trust powers, has its principal place of business in South Dakota, and the deposits of which are insured by the Federal Deposit Insurance Corporation. S.D. Cent. Code §§ 55-3-41(3) and 55-16-3;

- ◻ Some or all of the trust assets are deposited in South Dakota or physical evidence of such assets is held in the state and the trust is being administered by a qualified person S.D. Cent. Code §§ 55-3-39(1) and 55-16-3;

- ◻ The qualified person must be designated as a trustee under the governing instrument, a successor trusteeship, or designated by a court having jurisdiction over the trust. S.D. Cent. Code §§ 55-3-39(2) and 55-16-3;

- ◻ The administration of the trust must be wholly or partly in South Dakota. S.D. Cent. Code §§ 55-3-39(3) and 55-16-3;

- The instrument expressly declares that the property is community property. S.D. Cent. Code § 55-17-3; and

- The trust contains, at the beginning and in capital letters, the following declaration:

  "THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE,

INCLUDING YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND AT THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK INDEPENDENT LEGAL ADVICE."

S.D. Cent. Code § 55-17-2.

(2) Optional Features of an South Dakota Special Spousal (Community Property) Trust

- A South Dakota Special Spousal Trust is enforceable without consideration. S.D. Cent. Code § 55-17-1;

- The trust may be revocable or irrevocable. S.D. Cent. Code § 55-17-1;

- A South Dakota Special Spousal Trust may not be amended or revoked unless the trust agreement provides for amendment or revocation, or unless the trust agreement is amended or revoked by a later South Dakota Special Spousal Trust. S.D. Cent. Code § 55-17-4;

- To amend or revoke the trust, a later South Dakota Special Spousal Trust need not declare any property held by the trustee as special spousal property (community property). The amended trust or the revocation is enforceable without consideration. S.D. Cent. Code § 55-17-4;

- Unless a South Dakota Special Spousal Trust expressly provides otherwise, after the first spouse's death, the surviving spouse can amend the trust with regard to his or her property to be disposed of at his or her death. S.D. Cent. Code § 55-17-4;

- The spouses may also include in a South Dakota Special Spousal Trust their agreements on the following:

  - The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located;

  - The management and control of the property transferred to the trust;

  - The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event;

  - The choice of law governing the interpretation of the trust; and

  - Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. S.D. Cent. Code § 55-17-9;

- A South Dakota Special Spousal Trust can also be a self-settled spendthrift trust, which South Dakota law refers to as a qualified disposition in trust. S.D. Cent. Code § 55-17-11(1). Nonetheless, a South Dakota Special Spousal Trust may not adversely affect the right of a child to support. S.D. Cent. Code § 55-17-10;

- No provision of a revocable South Dakota Special Spousal Property Trust can adversely affect the interest of a creditor unless the creditor has actual knowledge of the trust when the obligation to the creditor is incurred. S.D. Cent. Code § 55-17-11(1);

- The South Dakota law also expressly permits the creation of community property by a transfer at death. It states that, in addition to other transfers of property to a South Dakota Special Spousal Trust, property is considered transferred to such a trust if it is subject to a nonprobate transfer on death under an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature and the South Dakota special spousal trust is designated as a beneficiary to receive the property under the transfer. The property is considered the surviving spouse's property that is not South Dakota special spousal property. S.D. Cent. Code § 55-17-7;

- A spouse is required to act in good faith with respect to the other spouse in matters involving South Dakota special spousal property. This is one of the provisions that cannot be varied by the express terms of a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-11;

- The South Dakota statute also provides protections for a bona fide purchaser who buys property from a South Dakota Special Spousal Property Trust. First, it provides that notice of the existence of a South Dakota Special Spousal Property Trust, a marriage, or the termination of a marriage does not affect the status of a purchaser as a bona fide purchaser. S.D. Cent. Code § 55-17-12(1). Second, it provides that community property bought by a bona fide purchaser from a spouse having the right to manage and control the property is acquired free of any claim of the other spouse. The effect of this subsection may not be varied by a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-12(2);

- A South Dakota Special Spousal Trust executed during marriage is not enforceable if the spouse against whom enforcement is sought proves the following:

  - The trust was unconscionable when made;

  - The spouse against whom enforcement is sought did not execute the trust agreement voluntarily; or

- □ Before execution of the trust, the spouse against whom enforcement is sought:
  - ° Was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse;
  - ° Did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and
  - ° Did not have notice of the property or financial obligations of the other spouse.

S.D. Cent. Code § 55-17-14.

c) Tennessee

Tennessee provide for the ownership of community property in Tennessee, but only if the property is held in a Tennessee Community Property Trust. Tenn. Code § 37-15-105(a).

(1) Mandatory Requirements of a Tennessee Community Property Trust

Property held in a trust is Tennessee community property is community property, if:

- One or both spouses transfer property to the trust. Tenn. Code § 37-15-103;
- At least one trustee is a "qualified trustee," defined as (a) a natural person who is a resident of Tennessee; or (b) a company authorized to act as a fiduciary in Tennessee. Tenn. Code §§ 37-15-103(2), 37-15-102(6);
- The powers of the qualified trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that

must be filed by the trust. Tenn. Code § 37-15-103(2);

- The trust is signed by both spouses. Tenn. Code § 37-15-103(2); and

- The trust contains, at the beginning of the trust and in capital letters, the following declaration:

> *"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE."*

Tenn. Code § 37-15-103(4).

(2) Optional Features of a Tennessee Community Property Trust

A Tennessee community property trust may also include the following provisions

- The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located. Tenn. Code § 37-15-104(a)(1);

- The management and control of the property transferred to the trust. Tenn. Code § 37-15-104(a)(2);

- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. Tenn. Code § 37-15-104(a)(3);

- The choice of law governing the interpretation of the trust. Tenn. Code § 37-15-104(a)(4);

- Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. Tenn. Code § 37-15-104(a)(5);

- The right to manage and control the trust property. Tenn. Code § 37-15-104(d);

- Either spouse may amend a Tennessee community property trust regarding the disposition of that spouse's one-half share of the community property in the occurrence of that spouse's death. Except as provided in such a provision, a Tennessee community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation. Tenn. Code § 37-15-104(b).

(3) Character of Property

(a) Distributed Property

Property distributed from a Tennessee community property trust ceases to be community property. Tenn. Code § 37-15-105(e).

(b) Death of First Spouse

On the death of a spouse, one-half of the property owned by a Tennessee community property trust is treated as the surviving spouse’s community property interest. Tenn. Code § 35-17-107.

(4) Distributions in Kind

Unless the trust agreement provides to the contrary, the trustee can distribute trust assets in divided or undivided interests and adjust resulting differences in valuation. A distribution in kind may be made on the basis of a non-pro rata division of the aggregate value of the trust assets, on the basis of a pro rata division of each individual asset, or by using both methods. Tenn. Code § 35-17-107.

(5) Divorce

The trust terminates upon the dissolution of the grantors' marriage. On termination, the trustee distributes one-half of the trust assets to each spouse, unless otherwise agreed to in writing by both spouses. Tenn. Code § 35-17-108.

7. Legal Efficacy of the Alaska, South Dakota, or Tennessee Community Property Trust

a) Community Property is Statutory

The interest of one spouse in the property brought to the marriage or acquired during marriage by the other spouse, absent agreement between them, is generally determined by the laws of their domicile. *Westerdahl v. Comm'r*, 82 T.C. 83, 86 (1984); *Rosenkranz v. Comm'r*, 65 T.C. 993, 996 (1976); *Zaffaroni v. Comm'r*, 65 T.C. 982, 986-987 (1976).

Community property did not exist at common law and exists in the United States solely by statute in specific states. Therefore, the status of property as community property should initially be determined the statute of the state in which the property is acquired.

b) Changing Residency

When spouses change their domicile or residency from a community property state to a non-community property state, or *vice versa*, the change of domicile or residency does not change the status of the property as separate or community; the property retains its original status in the new jurisdiction, unless thereafter modified. See, *e.g.*, *Johnson v. Comm'r*, 88 F.2d 952 (8th Cir 1937), *later app.*, 105 F.2d 454 (8th Cir. 1939), *cert. denied*, 308 U.S. 625 (1940) (husband and wife moved from Texas to Missouri; Texas community property continued to be community property in Missouri); *Commonwealth v Terjen*, 197 Va. 596, 90 S.E.2d 801 (1956) (husband bought Virginia realty and took title in name of wife, paying for it with $19,000 he had acquired as California community property; community property retained its status when the owners moved to Virginia). See also *Nationwide Resources Corp. v. Massabni*, 143 Aris. 460, 694 P.2d 290 (Ariz. App. 1984); *Ladd v Ladd*, 580 S.W.2d 696 (Ark. 1962); *Kraemer v Kraemer*, 52 Cal 302 (1877); *Paley v Bank of America Nat. Trust & Sav. Asso.*, 159 Cal.App.2d 500, 324 P2d 35 (1958); *Lane-Burslem v. Comm'r*, 659 F.2d 209 (D.C. Cir. 1981); *Quintana v Ordono* (Fla App) 195 So.2d 577 (Fla. App. 1967), *cert* *discharged*, 202 So. 2d 178 (1967) (assets acquired by husband in Florida transaction, after he and wife had moved to Florida, involving stock bought by him in Cuba with community property funds under laws of that country, were community property for purposes of administration of husband's estate in Florida; domicile of parties at time of purchase of Cuban assets being controlling factor); *Tanner v. Robert*, 5 Mart. NS 255 (La. 1826); *Mahmud v Mahmud*, (1984, La App) 444 So.2d 774 (La. App. 1984); *Hughes v. Hughes*, 91 N.M. 399, 573 P.2d 1194 (1978) (the character of property as community or separate property is determined under the law of the state in which the couple is domiciled at the time of its acquisition); *Karp v Karp*, 109 App.Div. 2d 661, 486 N.Y.S.2d 249 (1st Dept 1985); *Re Estate of Warburg*, 38 Misc. 2d 997, 237 N.Y.S.2d 557 (1963); *Re Estate of Kessler*, 177 Ohio St 136, 29 Ohio Ops 2d 348, 203 N.E.2d 221 (1964) (the character of community property, even personal property, does not change where the married couple owning it removes from a community property state to a common-law state; the converse is also true); *Bosma v. Harder*, 94 Or. 219, 185 P.741 (1919); *Parson v. United States*, 460 F.2d 228 (5th Cir. 1972); *Oliver v. Robertson*, 41 Tex. 422 (1874); *Re Gulstine's Estate*, 166 Wash 325, 6 P.2d 628 (1932); *Devine v. Devine*, 42 Wash.App. 740, 711 P.2d 1034 (1985).

c) Property Held in Trust

The cases noted above, however, do not address property held in trust. Should the community character of property owned by a trustee of a trust domiciled in one state be dictated by the law of the state of the trust's situs or that of its grantors or beneficiaries?

(1) Generally

The rules by which a state that should assume jurisdiction over various aspects of trust administration, construction, and the rights of beneficiaries, depend upon whether the trust corpus is real or personal property. Generally, the intent of the grantor determines the jurisdiction for a trust holding personal property, while the sites of the real property is determinative with respect to a trust on real property. Issues of the administration of a trust holding personal property (whether tangible or intangible) are determined under the jurisdiction in which the trust is otherwise administered, which itself is determined on the basis of the intent of the grantor, as disclosed in the governing instrument. Absent an express declaration in the instrument as to the place of administration, the grantor's intent is usually assumed to be that the trustee shall administer the trust at the trustee's principal place of business or domicile. A grantor who names two or more trustees who are domiciled in different states may manifest an intention that the trust should be administered at the domicile or place of business of one of them. Therefore, if the grantor names one or more trustees situated in Alaska or Tennessee, as is required by the two state statutes, it may be assumed that the trust should be administered in the state of the trustee and that it should be supervised by the courts of that state.

(2) Application of Choice of Law Rules to Alaska, South Dakota, and Tennessee Community Property Trusts

The requirements for an Alaska Community Property Trust, a South Dakota Special Spousal Trust, or a Tennessee Community Property Trust include the designation of at least one in-state trustee and refer repeatedly to the construction of the rights of the parties in the property under that state's law. Under the general rule, therefore, the courts of the state in which the trusts are created should have jurisdiction over matters involving the administration of the trust even though they might lack jurisdiction over some or all of the beneficiaries. See *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).

(a) Personal Property

(i) Situs for Construction

Questions relating to the construction of an *inter vivos* trust holding personal property and the rights of the various beneficiaries will be based on the law of the state designated in the instrument, or in the absence of such a designation, the law of the place of administration, if the issue relates to trust administration, or otherwise the jurisdiction that the grantor would probably have desired to apply. *Restatement (Second) Conflicts of Law* § 268. A state need have no connection with the trust in order to use its law in construing the trust instrument, if the grantor has selected that particular state's law. *Hughes v. Comm'r*, 104 F.2d 144 (9th Cir. 1939); *Noble v. Rogan*, 49 F. Supp. 370 (S.D.Cal.1943); *Application of Eyre*, 133 N.Y.S.2d 511 (1954); *Matter of Grant- Suttie*, 205 Misc. 940, 129 N.Y.S.2d 572 (1954); *Matter of Carter*, 13 Misc.2d 1040, 178 N.Y.S.2d 569 (1958).

(ii) Situs for Validity

A similar rule applies in determining the overall validity of a trust of personal property. The validity of the trust is determined under the law of the state designated by the grantor, as long as that state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship. *Restatement (Second) Conflicts of Law* § 270. A state has a substantial relation to a trust if the grantor designates that the trust is to be administered there, or if any trustee has its principal place of business or domicile in that state when the trust is created, or if the trust is administered in that state, or if it is the domicile of the beneficiaries.

(b) Real Property

(i) Generally

As to trusts of interests in land, however, the law of the situs of the land becomes more important.

(ii) Situs for Administration and Validity

The administration and validity of a trust in land is determined according to the law of the state in which the land is situated, even if the trustees are situated elsewhere. *Restatement (Second) Conflicts of Law* § 276. A court of a state other than that in which the property is situated may still exercise jurisdiction over the administration of the trust, if this does not unduly interfere with the control by the courts of the situs. *Fuller v. McKim*, 187 Mich. 667, 154 N.W. 55 (1915); *Knox v. Jones*, 47 N.Y. 389 (1872); *Matter of Osborn*, 151 Misc. 52, 270 N.Y.S. 616 (1934); *In re Sandford's Will*, 81 N.Y.S.2d 377 (1948); *In re Fagan's Estate*, 84 N.Y.S.2d 558 (1948); *In re Piazza's Estate*, 130 N.Y.S.2d 244 (1954); *In re Master's Will*, 136 N.Y.S.2d 907 (1954); *In re Warburg's Estate*, 237 N.Y.S.2d 557 (1963).

(iii) Situs for Construction

Issues of construction of the trust instrument, however, have not always been construed according to the situs. Some courts apply the law of the situs. *Bowen v. Frank*, 179 Ark. 1004, 18 S.W.2d 1037 (1929); *Veach v. Veach*, 205 Ga. 185, 53 S.E.2d 98 (1949); *Peet v. Peet*, 229 Ill. 341, 82 N.E. 376 (1907); *Scofield v. Hadden*, 206 Iowa 597, 220 N.W. 1 (1928); *Thompson v. Penn*, 149 Ky. 158, 148 S.W. 33 (1912); *In re Estate of Hencke*, 220 Minn. 414, 19 N.W.2d 718 (1945); *Minot v. Minot*, 17 App.Div. 521, 45 N.Y.S. 554 (1st Dep't 1897); *Matter of Good*, 304 N.Y. 110, 106 N.E.2d 36 (1952), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 96 N.Y.S.2d 798 (1950). A few others have applied the law designated by the grantor in construing a trust on real estate. *Greenwood v. Page*, 138 F.2d 921 (D.C.Cir.1943); *Guerard v. Guerard*, 73 Ga. 506 (1884); *Brown v. Ramsey*, 74 Ga. 210 (1884); *Keith v. Eaton*, 58 Kan. 732, 51 P. 271 (1897); *Houghton v. Hughes*, 108 Me. 233, 79 A. 909 (1911); *Martin v. Eslick*, 229 Miss. 234, 90 So.2d 635 (1956); *Zombro v. Moffett*, 329 Mo. 137, 44 S.W.2d 149 (1931); *Applegate v. Brown*, 344 S.W.2d 13 (Mo. 1961); *Cary v.*

Carman, 116 Misc. 463, 190 N.Y.S. 193 (1921). The law of the situs almost certainly controls issues of construction only in the absence of a designation in the instrument of the governing law.

(iv) Enforceability in Domicile State

Generally, the couple can select the law to govern particular property. In *Stein-Sapir v. Stein-Sapir*, 382 N.Y.S.2d 799 (N.Y. App. Div. 1976), for example, a couple domiciled in New York married in Mexico, and elected under Mexican law to have their future assets be held as community property. They later divorced in New York and the New York court held that the community property election was valid, and that the wife owned one-half of the property earned by the husband. *Restatement (Second) of Conflicts of Laws* § 258, cmt. (b) states that a couple can choose the law of a state other than their domicile to govern their property, and such a choice will apply unless it is "outweighed . . . by the intensity of the interest of another state . . . in having its own rules applied."

(c) Caveat: *Huber v. Huber*

Despite the rules set out in the Restatement (Second) Conflicts of Law and various cases, the courts sometimes look at things in a different manner. *In re Huber v. Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013), a U.S. district court applied the law of the state in which the settlor and his creditors resided and refused to apply the law of the state under whose law a domestic asset protection trust was allegedly created and permitted a trustee in bankruptcy to set aside transfers made to the trust as both actually and constructively fraudulent.

(i) Facts

Donald Huber was a real estate developer and manager and a lifelong resident of the state of

Washington. When Donald realized that many of his real estate projects were about to fail and be foreclosed upon, that he would become personally liable as guarantor on several loans, and that he would be sued, he transferred substantially all of his assets to the Donald Huber Family Trust, an irrevocable trust, for his own benefit and that of his descendants and stepchildren.

The trust was prepared by a Washington attorney, and the trust instrument stated that Alaska law would apply. An Alaska corporation was the trustee.

It was shown that Donald created the trust for both estate planning purposes and to protect at least part of his assets from the claims of his creditors.

The trust was funded with interests in an Alaska limited liability company established for that purpose, and to which Donald had transferred substantially all of his assets. These assets were all situated in Washington, except for one $10,000 certificate of deposit that was situated in Alaska.

Donald did not expressly retain the right to direct how or if distributions were made from the trust, but substantially all of his requests for distributions were granted and there was a record of only one refusal. The only party to review the requests was Donald's son, with whom he was in business.

(ii) Bankruptcy

Donald filed for Chapter 11 bankruptcy protection in 2011. The trustee in bankruptcy moved for summary judgment that the transfers to the trust were void under applicable state law and should be set aside for purposes of the bankruptcy action. The trustee contended that the trust should be invalidated under Washington state law and federal bankruptcy law, despite the trust instrument's own designation of itself as an Alaska trust.

(iii) Held: Trust Controlled by Washington Law, Not Alaska Law

(a) Generally

The bankruptcy judge (Judge Snyder) for the Western District of Washington granted a summary judgment to the trustee, finding that the trust did not protect its assets from the claims of Donald's creditors and should be set aside on three separate bases.

(b) Conflict Between Two State Laws

The court held that the trust was not protected from the claims of the settlor's creditors by the provisions of Alaska law that expressly recognize the validity of self-settled asset protection trusts, but instead were invalid under the provisions of Washington state law that reject self-settled spendthrift trusts. Compare AS § 34.40.110 and Rev. Codes of Wash. § 19.36.020. The court stated that the conflict between the laws of the two states must be settled under federal choice of law rules, rather than state choice of law rules. Citing *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 59 F.3d 942, 948 (9^{th} Cir. 1995).

(c) Ninth Circuit Applies Restatement (Second) Conflicts

The Ninth Circuit, to which the case would be appealed, applies the choice of law rules set forth in of the *Restatement (Second) of Conflict of Laws* (1971), which states at section 270, that a provision in the instrument governing an *inter vivos* trust of personal property that declares the validity of the trust will be controlled by the law of a specific state, will be followed only if:

- the state declared in the instrument as controlling has a substantial relation to the trust, and

- the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship. *Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1069 (9th Cir. 2002).

(d) Most Significant Relationship

Comment 6 to this section of the *Restatement (Second) of Conflict of Laws* also states that the state with the most significant relationship is determined by the following factors:

- the needs of the interstate and international systems;

- the relevant policies of the forum;

- the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;

- the protection of justified expectations;
- the basic policies underlying the particular field of law;
- certainty, predictability and uniformity of result; and
- ease in the determination and application of the law to be applied.

(e) Substantial State Relation to the Trust

The comment also provides that a state has a substantial relation to a trust if

- The settlor designated it as the state in which the trust is to be administered;
- It is the trustee's place of business or domicile at the time of the trust's creation;
- It is the trust assets' location at the time of the trust's creation;
- It is the settlor's domicile at the time of the trust's creation; or
- It is the beneficiaries' domicile at the time of the trust's creation.

The court stated that Alaska law would apply only if Alaska had a substantial relation to the trust. *Restatement (Second) of Conflict of Laws* § 270, cmt. b (1971).

(f) Searching for a Substantial Relationship

When Donald created his trust, neither he nor the beneficiaries were domiciled in Alaska and the trust assets were not located in Alaska. The trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska.

On the other hand, at that time, Donald and the trust beneficiaries all resided in Washington, the trust assets (other than a certificate of deposit) were transferred from Washington, Donald's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust.

(g) Strong Washington Public Policy

Washington, however, had a strong public policy against self-settled asset protection trusts; its statutes declare them void against both existing and future creditors. Revenue Codes of Wash., § 19.36.020; *Carroll v. Carroll*, 18 Wash. 2d 171, 175, 138 P.2d 653 (1943); *Rigby v. Mastro (In re Mastro)*, 465 B.R. 576, 611 (Bankr. W.D. Wash. 2011). Therefore, as the trust was a self-settled trust, Donald's transfers of assets into the trust were void, and the trustee was entitled to summary judgment voiding the transfers.

(h) **Fraudulent Transfer**

The court also held that the transfers to the trust were fraudulent under Section 548(e)(1) of the Bankruptcy Code.

(3) **Analysis**

The strongest argument appears to be that the situs of a trust determines the nature of the property interests it acquires, and where statutory rules are imposed to determine this character, particularly with respect to community property, which is itself solely statutory, this rule seems stronger.

d) **Application of Community Property Basis Rules**

The major tax advantage of creating an Alaska, South Dakota, or Tennessee community property trust is to enable residents of non-community property states to take advantage of Section 1014(b)(6), which states that, upon the death of either spouse, the basis of the entire community property asset (and not just one-half of the asset) becomes equal to the estate tax value of the asset. Section 1014(b)(6) does not distinguish between property that is held as community property under automatic (opt out) state laws or under elective (opt in) state laws. Furthermore, significant authority strongly suggests that community property under an (opt in) law, such as that adopted in Alaska, South Dakota, or Tennessee, would be eligible for the basis adjustment at death under Section 1014(b)(6), as long as the state statute created property rights that are generally the same as those created by other state community property laws.

(1) Poe v. Seaborne

In *Poe v. Seaborne*, 282 U.S. 101 (1930), the Supreme Court held that income from community property might, or might not, be taxable in equal shares to the two spouses. The Court stated that, where community property law created a vested interest in each spouse, each spouse received one-half of the income from the community property for federal income tax purposes. The Court distinguished the community property laws of Washington, Arizona, and Texas, in which the law vested an equal interest in each spouse with respect to all community property, from the law of California, which gave each spouse a mere expectancy in the income from community property. Therefore, in California, community property did not result in a valid assignment of income, but in the other three states, it did.

(2) Harmon

In *Comm'r v. Harmon*, 323 U.S. 44 (1944), the U.S. Supreme Court held that the taxpayers in an opt-in community property state could not split their community property income for U.S. income tax purposes. The case arose out of Oklahoma, which in 1939 enacted a community property system that applied only if married Oklahoma residents opted into the system. 32 Ok. Stat. of 1941 §§ 51 *et seq.* The Harmons opted into the community property system, and then each reported one-half of the community property income for federal income tax purposes.

(a) Supreme Court Recognizes Two Styles of Community Property

The Court stated that community property systems

> *"are of two sorts--consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in Lucas v. Earl, where by contract future income of the spouses was to vest in them as joint tenants. In Poe v. Seaborn, supra., the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State."*

323 U.S. 44, at 46 (1944).

(b) Opt-In Community Property Cannot Assign Incidence of Income Tax

The Court held that the Oklahoma community property "does not significantly differ in origin or nature from such a status as was in question in *Lucas v. Earl*, where by contract future income of the spouses was to vest in them as joint tenants." 323 U.S. 44, at 46 (1944)." The Court noted that, under *Lucas v. Earl*, 281 U.S. 111 (1930), the spouses could not use community property to split income, under the anticipatory assignment of income doctrine.

(c) Analysis of *Harmon*

(i) One View

Some commentators focus on this holding to conclude that the modern opt-in community property cannot qualify for the basis adjustment under Section 1014(b)(6). D. Westfall & G. P. Mair, *Estate Planning Law & Taxation*, § 4.01(1) (4th ed. 2001 & Supp. 2017) (arguing that an elective community property system such as adopted by Alaska will not be effective under *Harmon*); and Roberts, *A Cautionary Tale -- Community Property Trusts*, 47 Tenn. Bar J. 24 (July 2011).

(ii) A Better View

The Court in *Harmon* stated that it assumed "that, once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property State . . . ." 323 U.S. 44, at 47 (1944). Thus, the Court recognized that the property was community property, but determined that the spouse who earned Oklahoma consensual community property income must report it under the assignment of income doctrine. Cf. *United States v. Robbins*, 269 U.S. 315 (1926) (couple's income was community property, but wife could not report any part of it for federal income tax purposes because her interest had not vested). In discussing the history of the case, the Court stated:

> *"[The lower courts] overruled the [Commissioner's] contention that, as the [Okla-*

homa] statute permits voluntary action which effects a transfer of rights of the husband and wife, the case is governed by Lucas v. Earl and other decisions of like import. We hold that the [Commissioner's] view is the right one."

323 U.S. 44, at 45-46 (1944).

Harmon, therefore, actually says that consensual or opt-in community property is community property under the community property laws of a state, and therefore, Section 1014(b)(6) should determine the basis of the surviving spouse's one-half interest. *Harmon* predates Section 1014(b)(6), however, and thus may not be controlling.

(d) Justice Douglas' Dissent

Justice Douglas (joined by Justice Black) dissented in *Harmon*, noting that

"One dubious decision does not of course justify another. But if Texas can reduce the husband's income tax by creating in his wife a 'vested' interest in half his salary and other income, I fail to see why its neighbor, Oklahoma, may not do the same thing. The Court now concedes that once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property state. How then can Oklahoma be denied the same privilege which other community property states enjoy?

* * *

But it is said that the filing of a written election under the Oklahoma statute is an 'anticipatory arrangement' for the disposition of income under the rule of Lucas v. Earl; that a 'consensual' community will not be recognized for federal income tax purposes but that a 'legal' community will. As the Tax Court, however, pointed out (1 T.C. 40, 49) such a distinction will not stand scrutiny. Community property created by marriage is the effect of a contract. [footnote omitted] It is the result of a consensual act. The same is true where husband and wife agree to leave Oklahoma and establish their domicile in Texas so as to gain the advantages of a community property system. I can see no difference in substance whether the state puts its community property system in effect by one kind of contract or another. One is as much 'legal' as another. The agreement to marry or the agreement to move from Oklahoma to Texas is as 'consensual' as the act of filing a written election under the Oklahoma statute."

323 U.S. 44, at 51-53.

The dissent also stated that maintaining any meaningful distinction between consensual community property under a mandatory community property system and consensual community property under a consensual community property system may be impracticable.

(3) McCollum

A lower court decision in *McCollum v. United States*, 1958 WL 10206 (N.D. Okla. 1958), is also instructive. The couple in *McCollum* elected to treat their assets as community property under Oklahoma’s opt-in statute. In 1945, after *Harmon*, Oklahoma adopted a mandatory community property regime, under which all property that a husband and wife acquired after enactment of the 1945 law would be community property. See *Kane v. Comm’r*, 11 T.C. 74 (1948) (providing a brief history of Oklahoma's experiment with community property). The 1945 law also declared that assets designated by couples as community property under its 1939 opt-in law were community property. Mr. McCollum died after the predecessor to Section 1014(b)(6) became effective. His wife succeeded to his community property interest in a particular piece of land they acquired after electing the Oklahoma community property regime. Mrs. McCollum took the position that the basis of her one-half interest in the property changed upon his death under the predecessor to Section 1014(b)(6).

The U.S. District Court agreed that the predecessor to Section 1014(b)(6) applied. While Oklahoma had a mandatory community property system when Mr. McCollum died, he had acquired the property when it still had an opt-in system.

(4) Angerhofer

Angerhofer v. Comm’r, 87 T.C. 814 (1984) provides a slight twist on the classification of community property. The case involved several married couples, all of whom were German citizens and domiciliaries. All of the husbands were employed by IBM or a related corporation. All of the couples held property under one of three community property systems available in Germany at that time. The husbands claimed that they were taxable in the U.S. on only one-half of their community property income.

(a) German Law Had Three Choices for Marital Regime

German law provided for three alternative marital regimes: gutertrennung, gutergemeinschaft, and zugewinngemeinschaft. The first two were elective; in the absence of a proper election under one of the first two regimes, the third, zugewinngemeinschaft, also known as the statutory marital regime, automatically applied. None of the taxpayers elected into either of the first two regimes.

Gutertrennung. Under gutertrennung, absent a contrary marriage contract, each spouse acquires and maintains his or her own separate property, with no ownership interest in property acquired by the other spouse. A spouse may freely manage his or her income or property without restriction.

Gutergemeinschaft. Under gutergemeinschaft, there is a joint pot of marital property, known as the gesamtgut, which both spouses own equally. The management of the gesamtgut is therefore subject to restrictions intended to assure the protection of each spouse's share of the marital property. Also, under gutergemeinschaft, the property of the husband and the property of the wife become the joint (common) property of both spouses. Property which comes into the ownership of either spouse during the application of this regime is common property. Property owned by either spouse before the marriage can remain separate property, along with its appreciation. The common property is managed by both spouses jointly, in the absence of an agreement providing otherwise. Upon termination of the marriage, the common property is divided equally between the spouses. If the marriage terminates at death, the share of the deceased spouse in the common property belongs to his or her estate and thus passes to his or her beneficiaries or legal heirs.

Zugewinnegemeinschaft. Under zugewinngemeinschaft, there was ownership and maintenance of separate property by husband and wife, with an "equalization of gains" upon termination of the marriage. Equalization occurs in different ways, depending on whether the marriage terminates by death or during life. Where the marriage ends by divorce, each spouse's share of the gain is calculated and the two figures are compared. The difference is divided in half and this amount becomes a monetary claim of the spouse with the smaller share. Gifts or inheritances received by a spouse during the marriage are included in his or her beginning property. Where a spouse's beginning property has appreciated during the marriage, the appreciation is included in accrued gains; however, there is an adjustment to account for inflationary gains. The procedure for partitioning the "community of accrued gains" is thus one of valuation, computation, and payment of a monetary amount to the spouse with the smaller zugewinn.

(b) Tax Court Held that Zugewinngemeinschaft Was Not Community Property.

The Tax Court explained that Community property, as understood in the United States, involved protection of the interest of each spouse (1) by legally assuring its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse, and (2) by limiting the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized. See *Westerdahl v. Comm'r*, 82 T.C. 83, 91 (1984). The court stated that:

> *"In reviewing the statutes of the eight American community property States, we are aware of the presence or lack of presence of rules that—*
>
> *(1) Make the community property liable for the managing spouse's separate torts;*
>
> *(2) Prevent the nonmanaging spouse from obligating by contract the community property;*
>
> *(3) Require, except in extraordinary circumstances, equal division of the community property upon its partition at divorce;*
>
> *(4) Allow the managing spouse to discharge his separate debts from community; and*
>
> *(5) Require the managing spouse to make an accounting of all community property, including wages, when partitioned at the time of divorce.*

> *No one factor is determinative of the issue at hand."*

87 T.C. 814 at 826.

While zugewinngemeinschaft was similar to American community property law with respect to restrictions on management, liability of the property for debts and torts of each spouse, and division of the property upon lifetime termination of the marriage or marital regime, it lacked the essential automatic passage of a decedent-spouse's share of the community property (or, in this case, equalization claim) to his or her heirs at death. The spouses' inability to transfer or oblige their equalization claims showed that those claims are not present vested interests. To be recognized as community property, the court held, a state's law must assure its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse and limit the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized.

(5) Santiago

In *Santiago v. Comm'r*, 61 T.C. 53 (1973), *aff'd per curiam*, 510 F.2d 223 (D.C. Cir. 1975), the taxpayer was a U.S. citizen employed by the U.S. Air Force in Spain as a civilian. The taxpayer was a resident of Spain and married to a Spanish citizen who had no United States residence. The marriage ceremony took place outside Spain. Under Spanish community property law, the court held, the community property rules did not apply to couples like the taxpayers. Thus, none of the husband's earnings belonged to the wife under Spanish law.

The important feature of *Santiago* is one statement by the court, that:

> *"Petitioner was a citizen of the United States and not of Spain, and <u>there is, of course, no Federal community property law in this country</u> (nor is there any in New York State, where petitioner was born and with which he*

> *appears to have been more closely identified than with any other State)." (emphasis supplied)*

61 T.C. at 59. Therefore, when analyzing the nature of the property interests of a decedent and a surviving spouse must focus on the law of the state that governs that property, rather than on any federal definition of community property. (It is hard to reconcile this with the analysis in *Angerhofer*, which appeared to turn on just such a federal notion of what constitutes community property.)

(6) Rev. Rul. 77-359

Rev. Rul. 77-359, 1977-2 C.B. 24 also supports the notion that the basis of opt-in community property should be determined under Section 1014(b)(6). In Rev. Rul. 77-359, Husband and Wife were residents of Washington state. In 1975, the taxpayers agreed in writing that all presently-owned separate property and all thereafter acquired property would be community property.

(a) Conversion of Property Recognized

The Service stated that such an agreement changes the status of presently owned separate property and subsequently acquired separate property into community property under applicable state law, and should, therefore, be respected for federal tax purposes.

(b) State Law Allows Contractual Creation of Community Property

The Service noted that the Washington Supreme Court had held that a written agreement between spouses that property then-owned and thereafter acquired would be community property was legally effective under applicable state law. *Volz v. Zang*, 113 Wash. 378, 194 P. 409 (1920). The court held that the agreement was a valid contract and operated converted separate real property into community property, because state law gave spouses the right to deal in every possible manner with their property, and that the couple could change the status of separate property to community property. See also *Estate of Shea*, 60 Wash. 2d 810, 376 P.2d 147 (1962); *Neeley v. Lockton*, 63 Wash. 2d 929, 389 P.2d 909 (1964); *Estate of Verbeek*, 2 Wash. App. 144, 467 P.2d 178 (1970); and *Merriman v. Curl*, 8 Wash. App. 894, 509 F.2d 765 (1973).

To the extent that the agreement affects the income from separate property and not the separate property itself, the Service stated that it would not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns. Citing *Comm'r v. Harmon*, *supra.* Thus, the IRS stated that the property was community property, but that it did not split income because it was created by an election. The clear implication is that property that becomes community by election may still be community property, even if it does not, under *Harmon*, shift the incidence of taxable income.

(7) PLR 199917025

See also PLR 199917025, in which separate property that was converted into community property by an agreement between the spouses, which agreement was enforceable under applicable state law, became community property for tax purposes. See, also Randall, *Estate Planning and Community Property*, 28 Idaho L. Rev. 807, 815 (1991/1992); Rasmussen, *Divorce Provisions in Opt-In Marital Property Agreements*, 67 Wis. Law. 15 (April 1994); Smith, *The Unique Agreements: Premarital and Marital Agreements, Their Impact Upon Estate Planning, and Proposed Solutions to Problems Arising at Death*, 28 Idaho L. Rev. 833, 873-74 (1991/1992); Treacy, Jr., *Planning to Preserve the Advantages of Community Property*, 23 Est. Plan. 24, 26, 29 (1996).

(8) Rev. Rul. 66-283

In Rev. Rul. 66-283, 1966-1966-2 C.B. 297, California grantors transferred community property to a California revocable trust. Each spouse reserved a lifetime income interest in his or her share of the trust, and upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust was includible in his or her gross estate under Sections 2033, 2036(a)(1), and 2038(a)(1). The trust included language that any community property transferred to the trust would retain its status as community property, even though owned by the trustees. The IRS concluded that the property representing the surviving spouse's one-half interest in the community property held in the revocable trust was deemed to have passed from the decedent and its basis would be determined in accordance with the provisions of Section 1014(a), so that both halves of the community property received a basis adjustment at the first spouse’s death. See similar conclusions in PLRs 201852009, 2018500001, 6603075360A, 6601074700A.

(9) DING Rulings

Several rulings that involved non-grantor trusts created to shift the incidence of state income taxes from the grantor to the trust and its beneficiaries, also involved taxpayers who resided in a community property state. In these rulings, the trust had a situs in another state, and provided that all transferred property to the trust is community property or is being transmuted into community property. Upon the death of each grantor, his or her respective interest in the trust will be includible in his or her respective gross estate for federal estate tax purposes. The IRS concluded that the basis of all community property in the trust on the date of death of the first grantor will receive an adjustment in basis to the fair market value of such property at the date of death of the first grantor to die. See PLRs 201850001 – 201850006, 201852009, and 201852018.

(10) The Specific Language of Section 1014(b)(6)

Section 1014(b)(6) requires that the property be community property under the laws of any State (or possession or foreign country). If nonresident married persons transfer property to an Alaska, South Dakota, or Tennessee Community Property Trust, and there are sufficient contacts of the property with the trust such that that state’s law should control, the property should be community property under the law of that state, and so should literally fall under the basis adjustment rules of Section 1014(b)(6).

(11) Caveat: Alaska vs. Tennessee and South Dakota

The Alaska Community Property Act closely mirrors the Uniform Marital Property Act, which Wisconsin adopted and which the IRS has ruled creates valid community property. Rev. Rul. 87-13, 1987-1 CB 20. The only significant difference is that the Alaska rules are opt in, rather than default. In particular, the Uniform Marital Property Act details the rights of the parties to manage and control the property and to dispose of it at death. South Dakota's community property statute merely states that assets in a South Dakota Special Spousal Trust are community property. It does not address management, control, or disposition at death. Tennessee's statute addresses dispositions at death and some issues of rights during lifetime, but it does not address management and control. These distinctions between the Tennessee and South Dakota statutes and both the common law rules and the Uniform Marital Property Act may give the IRS a basis for denying a basis adjustment for the entire property held in such state community property trusts.

8. Drafting and Planning

a) Generally

The Alaska, South Dakota, and Tennessee community property trusts have not been tested in any court opinion, but as discussed above, at least the Alaska trusts should work well under the existing law, and the South Dakota and Tennessee trusts have a good argument for working well under existing law.

b) Situs Issues

All three states make it quite easy for a trust to adopt those states as the relevant situs, but the importance of assuring that the chosen state's laws apply suggests that practitioners should urge their clients to do more than the minimum required to create an Alaska, South Dakota, or Tennessee community property trust. In particular, it is suggested that taxpayers do the following:

- Give the situs (Alaska, South Dakota, or Tennessee) trustee actual possession and control over the trust assets, rather than over a portion of the trust assets. If securities are held in certificate form, the trustee should hold the certificate. Otherwise, the brokerage account should be opened with a brokerage that has an office in the situs state. Tangible assets should be held in the situs state or held by an LLC or corporation created under the laws of the situs state.

- The situs trustee should have all duties with respect to management and administration of the trust assets. Distribution authority may be held by a co-trustee.

- The governing instrument should not only declare that the situs law applies but should prevent the trustee from changing the trust's situs until the first spouse has died.

c) Integrating the Community Property Trust into the Estate Plan

The easiest way to integrate the community property trust into the parties' estate plan is to provide that, when the first spouse dies or, if earlier, the §share to the husband's separate revocable trust (or, if there is none, to the husband or the personal representative of his estate), and one share to the wife's separate revocable trust (or to her or the personal representative of her estate). See Zaritsky, *Tax Planning for Family Wealth Transfers at Death*, ¶¶ 4.08[11] and 4.08[12] (Thomson-Reuters/WG&L, 2014, Supp. 2018-2), for sample forms for Alaska, Tennessee, and South Dakota community property trusts.

d) Notes on the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA) and the Basis Adjustment Rules

(1) General Overview

The Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") was drafted by the National Conference of Commissioners of Uniform State Law in 1971 and sent to the American Bar Association, who approved it on February 7, 1972.

Sixteen non-community property states have adopted the statute. AS §§ 13-41-5 *et seq.*; Ark. Code Ann. §§ 28-12-101 *et seq.*; Conn. Gen. Stat. §§ 45-298a *et seq.*; Fl. Stat. §§ 732.216 *et seq.*; HRS §§ 510-23 *et seq.*; KRS §§ 391.210 *et seq.*; MCLS Ch. 557, §§ 261 *et seq.*; Minn. Stat §§ 591A.01 *et seq.*; MCA §§72-9-107 *et seq.*, N.C Gen. Stat. § 31C-1 *et seq.*, NY CLS EPTL, Art. 6, §§ 6.1 *et seq.*; ORS §§ 112.705

et seq.; Utah Code Ann. § 75-2b-101 *et seq.*; Va. Code Ann. §§ 64.2-315 *et seq.*; and Wyo. Stat. §§ 2-7-720 *et seq.*

(2) NCCUSL's Explanation of the Proposed Statute

In most cases when uniform laws are promulgated, there are prefatory notes, which generally gives the purpose and intent of the proposed law. UDCPRDA is no exception; its prefatory note states as follows:

> *"Frequently spouses, who have been domiciled in a jurisdiction which has a type of community property regime, move to a jurisdiction which has no such system of marital rights. As a matter of policy, and probably as a matter of constitutional law, the move should not be deemed (in and of itself) to deprive the spouses of any preexisting property rights. A common law state may, of course, prescribe the dispositive rights of its domiciliaries both as to personal property and real property located in the state. California's development of its "quasicommunity property" laws illustrates the distinction.*
>
> *The common law states, as contrasted to California, have not developed a statutory pattern for disposition of estates consisting of both separate property of spouses and property which was community property (or derived from community property) in which both spouses have an interest. In these states there have been relatively few reported cases (although the number has been increasing in recent years); the decisions to date show no consistent pattern and the increasing importance of the questions posed suggests the desirability of uniform legislation to minimize potential litigation and to facilitate the planning of estates.*
>
> *This Act has a very limited scope. If enacted by a common law state, it will only define the dispositive rights, at death, of a married person as to his interests at death in*

property "subject to the Act" and is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state. The purpose of the Act is to preserve the rights of each spouse in property which was community property prior to change of domicile, as well as in property substituted therefor where the spouses have not indicated an intention to sever or alter their "community" rights. It thus follows the typical pattern of community property which permits the deceased spouse to dispose of "his half" of the community property, while confirming the title of the surviving spouse in "her half."

It is intended to have no effect on the rights of creditors who became such before the death of a spouse; neither does it affect the rights of spouses or other persons prior to the death of a spouse. While problems may arise prior to the death of a spouse they are believed to be of relatively less importance than the delineation of dispositive rights (and the correlative effect on planning of estates). The prescription of uniform treatment in other contexts poses somewhat greater difficulties; thus this act is designed solely to cover dispositive rights at death, as an initial step.

The key operative section of the Act is Section 3 which sets forth the dispositive rights in that property defined in Section 1, which is subject to the Act. Section 2 follows Section 1's definition of covered property and is designed to provide aid, through a limited number of rebuttable presumptions in determining whether property is subject to the Act.

No negative implications were intended to be raised by lack of inclusion of other presumptions in Section 2; areas not *covered were simply left to the normal process of ascertainment of rights in property.*

The first three sections form the heart of the Act; the succeeding sections might almost be described as precatory and have been added to clarify situations which would probably follow from the first three sections but which might raise questions. Thus, Section 8 makes it clear that nothing in the Act prevents the spouses from severing any interest in community property or creating any other form of ownership of property during their joint lives; and, such action on their part will effectively remove any property from classification as property subject to this Act. Similarly, Section 9 makes it clear that the Act confers no rights upon a spouse where, by virtue of the property interests existing during the joint lives of the spouses, that spouse had no right to dispose of such property at death. By way of illustration, in at least one community property jurisdiction, the wife has no right to dispose of any part of the community property if she predeceases her husband. If the law of that jurisdiction is construed so as to treat this as a rule of property, then the move to the common law state should not alter the "property interest" of the spouses by conferring a right on the wife which she did not previously possess. On the other hand, if the provision is treated as simply establishing a pattern of dispositive rights on death of a wife who predeceases her husband, rather than a property right, the common law state of new domicile could prescribe an alternative pattern of dispositive rights. The Act does not resolve this question; rather it simply makes clear that it does not affect existing "property rights," leaving to the courts the interpretation of the effect of the community property state's law."

(a) Observations on NCCUSL's Comments

In reviewing the prefatory note, it is interesting that nowhere does it mention that a purpose of this provision had anything to do with income taxes, tax basis or any similar provision. Rather, the purpose of this law was to provide upon the death of the first spouse to die of a couple who once lived in a community property state and owned community property, assuming that the couple did nothing to affirmatively destroy any property rights that they may have had in their "community property", that the surviving spouse will have certain community property "rights" with respect to such property. What is more interesting is that the uniform law does not state that the property continues to be community property (the act is silent), rather the uniform act focuses on the surviving spouse's "rights" in the property. The goal of the statute is to provide certain rights to the surviving spouse in the property that such would be akin to what the survivor would have received had the property been community property. Thus, the subtlety of the statute is the focus on the survivor's rights, and not defining the property as "community property" or some other type of property.

(b) States Implementing UDCPRDA

There are sixteen common law states that have adopted UDCPRDA. Interestingly, even though Alaska has the Community Property Trust act, they have also kept their version of UDCPRDA. With respect to opt-in community property states, keeping the UDCPRDA would be relevant for those who choose not to opt into the community property system.

(3) Does the Survivor's Interest in Property Covered Under UDCPRDA obtain a Date of Death Basis Adjustment Under Section 1014(b)(6)?

(a) Careful Reading of Section1014(b)(6)

Section 1014(b)(6) states:

> *"(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939 … "*

(b) Analysis of Section 1014(b)(6)

This statue applies only to "community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country."

The question then becomes, if a decedent dies a resident of a non-community property state, can that decedent own "community property"? This situation arises where a couple live in a community property state, acquire community property assets, move to a non-community property state and one spouse dies while a resident of the non-community property state.

The key question is whether the state in which the decedent spouse was a resident at the time of death recognized the property as "community property" at the time of the decedent's death. One could initially say that those states that adopted UDCPRDA appear to categorize property as community property, but this is not necessarily the case.

The title to the statute gives the reader a key to this. The statute is called the Uniform Disposition of Community Property *Rights* at Death Act (emphasis supplied). The statute is not a uniform statute on the disposition of community property; it is a statute that is designed to address community property rights. Nowhere in the statute does it say that the property is community property, it simply provides certain presumptions, how the property will be distributed at death, how title is perfected by the surviving spouse and the decedent's fiduciary, heirs, or devisee, how to deal with purchasers for value and creditors and certain other aspects and rights with respect to the property that was once community property when the decedent lived in a community property state.