FEATURE:
ESTATE PLANNING & TAXATION

By **Robert J. Kolasa**

Problems in Springing the Delaware Tax Trap

Trusts in perpetual jurisdictions may be precluded from using this strategy

Taking into account the stratospheric $11.18 million federal estate tax exclusion enacted by the Tax Cuts and Jobs Act,[1] most decedents are no longer subject to federal estate taxes. This means that many existing credit shelter trusts (and other irrevocable trusts) will no longer generate estate tax savings. Worse yet, these trusts have suddenly become counterproductive from an income tax point of view, because their assets generally don't receive stepped-up basis treatment at the death of the surviving spouse.

An increasingly popular way to achieve basis step-up for credit shelter trusts involves springing the Delaware tax trap (the Trap)[2] under Internal Revenue Code Section 2041(a)(3).[3] But, can the Trap be sprung in jurisdictions where local law permits trusts to last in perpetuity or for a very long stated period? Depending on one's interpretation of the law, trusts in perpetual (or near-perpetual) jurisdictions may be precluded from using this strategy.

RAP and Powers of Alienation

The Trap deals with successive powers of appointment (a "first power," which creates a "second power"). Understanding the Trap in the context of successive powers can be difficult because the statute is intertwined with local property rules relating to restraints on property dispositions imposed by the rule against perpetuities (RAP) and the rule against the suspension of the power of alienation (alienation rule). The former rule voids property interests vesting too remotely, while the latter rule voids property interests in which the power of alienation (sale) is suspended beyond a permissible period. The distinction between general powers of appointment (GPAs)[4] and special powers of appointment (SPAs)[5] also becomes important in the analysis.

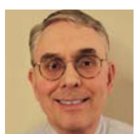
The common law RAP is that "no interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest."[6] Based on the facts existing at the time the interest was created, the rule voids future interests vesting later than 21 years after the death of a living person (the validating life). For successive powers, the perpetuity period for testing the exercise of the second power (for SPAs and testamentary GPAs) is generally measured from the date the first power was created. This is an application of the relation-back doctrine that provides the appointive property is viewed as passing directly from the donor to the appointee (as if the powerholder were "filling in blanks" in the donor's instrument).[7]

The alienation rule voids remote interests if the power of sale is suspended longer than a period prescribed by statute (a life in being plus 21 years, a two-life limitation, 30 years or another applicable period).[8] The evolving law in some jurisdictions created a critical exception for property in trust: If the trustee is given the power to sell corpus, the power of alienation isn't considered suspended.[9] For alienation rule states adopting the sale exception, trusts can last for an unlimited duration if the trustee has the power of sale.

The Trap

Congress enacted the Trap in 1951 as an anti-abuse rule (it's now a planning opportunity). The statutory language of IRC Section 2041(a)(3) includes in the gross estate all property:

> To the extent of any property with respect to which the decedent—(A) by will, or (B) by a



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> disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as *to postpone the vesting* of any estate or interest in such property, or *suspend the absolute ownership or power of alienation* of such property, for a period ascertainable without regard to the date of the creation of the first power. (Emphasis added.)

The Trap was a legislative response to Delaware's former 1933 RAP, which ingeniously voided the relation-back theory for purposes of testing the perpetuity period relating to the exercise of the second power. This allowed trusts with successive powers to last forever without estate taxation.[10]

> **Example:** G's will devises property to A for life, remainder to A's descendants as A shall by will appoint (first power). A through his will exercises the first power by appointing to his child B for life, remainder to B's descendants as B shall appoint by will (second power). At his death, B exercises the second power by appointing to his child C for life, remainder to C's children. Presume A and B were living at G's death. Thereafter, C was born. A later died, survived by B and C. B then died survived by C.[11]
>
> **Analysis:** Under the common law RAP, the validity of the exercise of the second power relates back to G's death, as if G had devised the appointive property under his will. The exercise of the second power to benefit C is valid because C's interest is vested at the death of B, with B constituting a validating life alive at G's death. The exercise of the second power granting the remainder interest to C's children is void because there's no validating life (C, who wasn't alive at G's death, might have additional children born more than 21 years after the deaths of A and B and any other individual alive at G's death).[12]

The Delaware statute ignored the relation-back rule and deemed that the perpetuity period for the second power is reckoned at the date of the exercise of such power (which is B's death, not G's death). This is significant because it makes the remainder interest to C's children valid. C, alive at B's death, is the validating life because no interest of C's children will vest more than

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21 years after C's death. If B had appointed to C for life, remainder to C's descendants as C shall appoint by will, then C could exercise the power in the same way for his children and so on ad infinitum without violating the RAP (each powerholder would constitute a validating life) or incurring estate taxation (SPAs aren't taxed as part of the gross estate).

The Trap attacked the Delaware statute by essentially codifying the relation-back rule. Section 2041(a)(3) is sprung if the second power postpones vesting or suspends the power of alienation for "a period ascertainable without regard to the date of the creation of the first power." The latter requirement (referred to herein as the "matching rule") means that to avoid estate tax inclusion, the perpetuity period for the second power must be the same as the perpetuity period for the first power. This spoiled the fun by springing the Trap for SPAs under the Delaware scheme that were second powers. The matching rule is violated because the perpetuity period of the second power (B's death), isn't the same as the perpetuity period of the first power (G's death).

From a tax viewpoint, Section 2041(a)(3) can be seen as converting first powers that are SPAs into GPAs (triggering estate tax inclusion) if enumerated

conditions are met regarding the nature of the second power. If planners desire to intentionally spring the Trap (for basis or generation-skipping transfer tax planning purposes), the traditional way is for the second power to constitute a so-called "PEG power" (an inter vivos GPA presently exercisable without restrictions). Under the laws of most states, the perpetuity validity of the exercise of a PEG power that constitutes a second power is measured from the date such power is exercised, not when the first power is created (a logical result because a PEG power is an ownership-equivalent power).[13] The Trap appears sprung in such circumstance because the perpetuity periods for the successive powers aren't the same. Yet, is this enough to trigger the Trap in perpetual trust jurisdictions?

> In states that retain their RAP but allow an opting out in the trust instrument, planners must exercise caution in determining whether to opt out.

Murphy

The only reported case on the Trap is *Murphy v. Commissioner*.[14] In that case, a 1972 Wisconsin decedent held an SPA (first power) over trust assets, which she exercised at death to create an appointive trust granting a testamentary SPA (second power) to her husband. Wisconsin had repealed its RAP and enacted a statutory alienation rule providing that the power of alienation wasn't suspended for a trustee having the power of sale (which was present in the trust).

The Tax Court held that the Trap didn't apply because Wisconsin law provided that the matching rule was satisfied (the perpetuity periods for the first and second powers in the context of the alienation rule were both measured from the date the first power was created). At first blush, it's hard to see why the government even contested the case, because if the matching rule is met, the Trap can't apply.

The Internal Revenue Service was attacking the idea of a Wisconsin trust lasting forever. This was grounded in the Trap's legislative history referencing congressional concerns with tax avoidance by perpetual trusts.[15] The IRS' argument transmuted the words of Section 2041(a)(3) into a federal RAP independent of local law that sprung the Trap for perpetual trusts operating under states that had repealed their RAP. The Tax Court unsurprisingly didn't accept this convoluted argument, especially in light of the IRS' own regulations,[16] which expressly agreed that the alienation rule and the RAP are creatures of local law.

The IRS decided not to appeal and acquiesced to the Tax Court's holding.[17] The government agreed with the court's conclusion that the Trap wasn't sprung because the perpetuity periods for both powers were the same. The IRS also proposed an alternate theory that Section 2041(a)(3) was inapplicable because the trustee's power of sale meant the power of alienation couldn't be suspended. This latter reasoning becomes important in analyzing whether the Trap can be sprung for trusts in perpetual trust jurisdictions.

Perpetual Trust Reforms

The IRS argued in *Murphy* that if the government lost, this would open the floodgates for states to enact perpetual trust rules similar to the Wisconsin law.[18] The IRS was prescient in its fears. Thirty-one states and the District of Columbia now permit perpetual (or near perpetual) trusts. Most jurisdictions have changed their common law perpetuities, alienation and relation-back rules in varying degrees to abolish or modify the RAP, extend the length of the perpetuity period to fixed years, add the alternate Uniform Statutory Rule Against Perpetuities vesting schedule, allow drafters to opt out of the RAP or adopt an alienation rule that clones the Wisconsin law in *Murphy* (the latter approach is a purported safe harbor and is referred to as the "*Murphy* approach"[19]).

Commentators suggest that states that have repealed their RAP without maintaining an alienation rule have stumbled into springing the Trap on the grant of all second powers (including SPAs), even if these powers relate back to the original granting first power. The reasoning is that for second powers in these unfortunate jurisdictions, there's no fixed ending period for

property to vest or alienation to suspend. The Trap is thus sprung because vesting is postponed or alienation suspended for the statutory requirement of "a period ascertainable without regard to the date of the creation of the first power."[20]

The above theory convinced some states to set a long fixed perpetuity period (ranging from 360 years to 1,000 years). Opponents question the premise of whether avoiding the Trap requires a fixed period, as all that's required is a period of time that's met by an infinite period (or that if infinity isn't a period, the statute literally doesn't apply).[21] Supporting the rebuttal is the empirical observation that the IRS has never adopted this theory. The argument also loses merit if the Trap can't be sprung in the first place for trusts in perpetual trust jurisdictions.

Trap Construction Problems

In analyzing whether the Trap applies, planners often try to prove or disprove the matching rule inquiry of whether the perpetuity periods for the first and second powers are the same. There's usually little scrutiny of the second requirement of Section 2041(a)(3) that the second power postpone vesting or suspend the power of alienation. Does this latter rule preclude the Trap from being sprung for trusts in perpetual trust jurisdictions? Perhaps.

For states that have neither a RAP nor an alienation rule, the analysis is that there can be no postponement of the vesting date of perpetual trusts because there's no initial limitation on vesting. That is, all competent future interests should vest in the perpetual perpetuity period set by the first power, as such period of infinity isn't changed or postponed by the second power. The Trap can't be sprung in such jurisdictions as the postpone requirement won't be satisfied.[22]

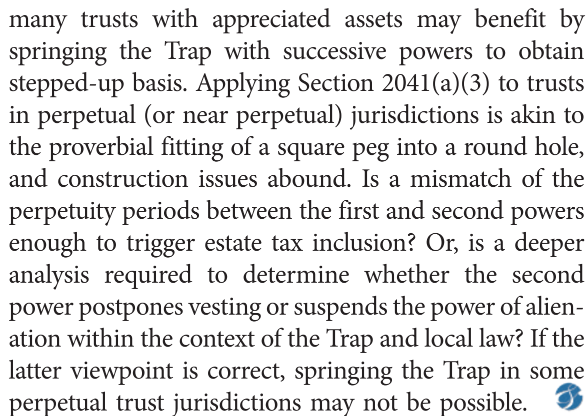
For jurisdictions adopting an alienation rule under the *Murphy* approach, the parallel contention is that the Trap can't be sprung because there's no suspension of the power of alienation. The IRS embraced this position in its *Murphy* acquiescence, by concluding that the Trap couldn't be sprung because the trustee's power of sale meant the power of alienation wasn't suspended. Because most trusts in these jurisdictions grant the trustee a power of sale, the alienation rule becomes meaningless. The Trap can't be sprung in such cases as the suspend requirement won't be satisfied.

If a long fixed durational period is weaved into a state's RAP, an interesting logical challenge is posed. In these states, a PEG power as the second power indisputably does shift the vesting period to a longer perpetuity period than that established by the first power and postpones vesting (in our example, the perpetuity period of a PEG power is measured from the point of exercise during B's lifetime, not the death of G who's the original donor). The twin requirements needed to spring the Trap appear to be facially met. But, if the perpetuity period is extended to a long duration, such as 360 years, from a practical viewpoint all proximate nonvested interests should eventually vest. Vesting can be postponed for 14 generations[23] after the original donor's lifetime before the RAP voids any future interest. For purposes of analyzing the second power, a near perpetual period is the functional equivalent of a perpetual period, and it seems wrong to treat it as anything else within the context of the Trap. Under this construction, the Trap can't be sprung as the postpone requirement won't be satisfied.

> With the historically high federal estate tax exclusion, many trusts with appreciated assets may benefit by springing the Trap with successive powers to obtain stepped-up basis.

Finally, in states that retain their RAP but allow an opting out in the trust instrument, planners must exercise caution in determining whether to opt out. If the approach opted into is based on the *Murphy* approach or a perpetual (or near perpetual) durational regimen, the Trap becomes difficult to spring for the reasons listed above.[24] By opting out, one may be forfeiting the ability to spring the Trap.

With the historically high federal estate tax exclusion,



many trusts with appreciated assets may benefit by springing the Trap with successive powers to obtain stepped-up basis. Applying Section 2041(a)(3) to trusts in perpetual (or near perpetual) jurisdictions is akin to the proverbial fitting of a square peg into a round hole, and construction issues abound. Is a mismatch of the perpetuity periods between the first and second powers enough to trigger estate tax inclusion? Or, is a deeper analysis required to determine whether the second power postpones vesting or suspends the power of alienation within the context of the Trap and local law? If the latter viewpoint is correct, springing the Trap in some perpetual trust jurisdictions may not be possible.

Endnotes

1. Pub. L. No. 115-97.
2. The colloquial name "Delaware tax trap" (the Trap) derives from legislative efforts to combat Delaware's 1933 perpetuities statute. *See* Ira Mark Bloom, "Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation," 45 *Alb. L. Rev.* 261 (Winter 1981); Jonathan G. Blattmachr and Jeffrey N. Pennell, "Adventures in Generation Skipping, or How We Learned to Love the 'Delaware Tax Trap,'" 24 *Real Prop. Prob. & Tr. & Est. L.J.*, 75, 83-84 (1989-1990).
3. The Trap can also be sprung by the inter vivos exercise of a first power under Internal Revenue Code Section 2514(d). No basis step-up is allowed, other than an increase for gift taxes paid, but the powerholder as the new transferor is enabled to allocate generation-skipping transfer (GST) tax exemption to trust property.
4. A general power of appointment (GPA) is defined under IRC Section 2041(b)(1) as a power of appointment that's exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate. Property subject to a GPA is includible in the decedent's gross estate.
5. A special power of appointment (SPA) is a power of appointment that's not a GPA and permits appointment to a designated class other than the decedent, his estate, his creditors or the creditors of his estate. Except for SPAs snared by the Trap, property subject to an SPA isn't includible in the decedent's gross estate.
6. Barton Leach, "Perpetuities in a Nutshell," 51 *Harv. L. Rev.* 638, 639 (1938).
7. *Ibid.*, at p. 653; Bloom, *supra* note 2, at pp. 277-278; Uniform Probate Code (2010) (UPC) Section 2-902(a) and comments, at pp. 253-254; *Restatement (Third) of Property: Wills and Other Donative Transfers (Restatement Third)* (Am. Law Inst. 2011), Section 27.1, comments, d(1), j, j(1) and j(3); Section 19.19, comment g; Section 17.4, comments f, f(1) and f(2); Helene S. Shapo, George Gleason Bogert and George Taylor Bogert, *The Law of Trusts and Trustees,* Section 213, at pp. 202-207 (Thomson/West, 3rd ed. 2007).
8. Bloom, *supra* note 2, at pp. 268-270.
9. In *In re Walker's Will*, 45 N.W.2d 94 (1950), the Wisconsin Supreme Court held that the power of alienation wasn't suspended if the trustee retained the power of sale (versus trust beneficiaries holding such power). This approach was later codified in 1969. Bloom, *supra* note 2, at pp. 271-276. With the embrace of the *Murphy* approach as a safe harbor by other jurisdictions, the sale exception is widely adopted.
10. Leach, *supra* note 6, at p. 653; Bloom, *supra* note 2, at pp. 278-279.
11. Uniform Statutory Rule Against Perpetuities (1990) (USRAP), based on Example (20) at 31-32.
12. Under the USRAP, the interest to C's children would be valid if C dies within 90 years after G's death. *Ibid.*, at p. 32.
13. *See* Leach, *supra* note 6, at p. 654; Blattmachr and Pennell, *supra* note 2, at pp. 83-84; Howard M. Zaritsky, "The Rule Against Perpetuities: A Survey of State (and D.C.) Law," *www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf*, at p. 9; Shapo, Bogert, Bogert, UPC and *Restatement Third*, *supra* note 7.
14. *Murphy v. Commissioner*, 71 T.C. 671 (1979).
15. *Ibid.* at footnote 21; Bloom, *supra* note 2, at pp. 286-287. To stop perpetual trusts, Congress should impose durational limits on GST tax-exempt trusts in lieu of the current reliance on state perpetuity laws. *See* Lawrence W. Waggoner, "Congress Promotes Perpetual Trusts: Why?" *Law & Economics Working Papers*, Paper 80, at pp. 9-12 (2014).
16. Treasury Regulations Section 20.2041-3(e).
17. Action on Decision 1979-87, acq. recommended (May 30, 1979).
18. *Supra* note 14, at p. 682.
19. Daniel G. Worthington and Mark Merric, "Which Trust Situs is Best in 2018?" *Trusts & Estates* (January 2018), at pp. 76-77; Garrett Moritz, "Dynasty Trusts and the Rule Against Perpetuities," 116 *Harv. L. Rev.* 8 (June 8, 2003).
20. James P. Spica, "A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute is Too Clever by Half (of Infinity)," 43 *Real Prop. Tr. & Est. L.J.* 673 (Winter 2009); Stephen E. Greer, "The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities," 28 *Est. Plan.* 68 (February 2001).
21. Richard W. Nenno, "Getting a Stepped-Up Income-Tax Basis and More by Springing-or Not Springing-The Delaware Tax Trap the Old-Fashioned Way," 40 *Tax Management Estates, Gifts, and Tr. J.*, No. 5, 215 (Sept. 10, 2015).
22. *In accord,* Jerold I. Horn, *Flexible Trusts and Estates for Uncertain Times*, at p. 559 (ABA, 6th ed. 2017).
23. Three hundred and sixty years divided by the 25-year GST generational assignment of IRC Section 2651(d)(3).
24. Some "opt out" states require that the trustee or beneficiaries have a power of sale, typically for the period after interests vest under the rule against perpetuities (RAP) (*see* 765 ILCS 305/3(a-5)). This is an attempt to create an alienation rule "period" to avoid the aforesaid argument that the Trap is sprung for all successive powers if the RAP is repealed without a backup alienation rule. But, the stated requirement doesn't appear to be a traditional alienation rule in the first place (no future interests are voided for noncompliance). If so, the Trap doesn't apply for the same reasons faced by states that have neither a RAP nor an alienation rule. Even if somehow this approach constitutes an alienation rule, the Trap is further inapplicable because the required power of sale means the power of alienation isn't suspended.