

The History and Future of the Delaware Tax Trap

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I. Introduction

This paper is intended as a primer on the Delaware Tax Trap (“Trap”). Part II will begin with a history of the Rule Against Perpetuities (“Rule”); Part III will continue with the advent of the Trap following the American movement toward Rule modification; Part IV will describe the tax advantages the Trap can afford if triggered correctly; and Part V will conclude with a forecast for the future.

The Trap is enigmatic in its history and application. Throughout its tenure, the Trap has been a persistent source of anxiety for practitioners. Because of the Trap’s esoteric nature, practitioners have often viewed it as something to avoid. Understanding the Trap’s intricacies takes time, patience, and no small measure of effort. But the changing landscape of estate planning, now with an increased focus on income tax planning, demands familiarity with the Trap. This paper is intended to provide the reader with a working knowledge of the Trap, including how it can be used in the new planning environment.

II: History of the Rule Against Perpetuities

The Delaware Tax Trap (“Trap”) is predicated upon another legal concept with a richer and more complicated history: the Rule Against Perpetuities (“Rule”). To understand the intricacies of the Trap, one must first explore the history and purpose of the Rule.

The initial formulation of the modern Rule originated in the *Duke of Norfolk’s Case*.¹ The *Norfolk* decision contravened the growing popularity of executory interests.² English courts were concerned about the free alienability of land, and knew unfettered executory interests could tie up land for generations.³ One hundred fifty years after the *Norfolk* decision, *Cadell v. Palmer* determined the vesting limitations and paved the way for articulation of the modern Rule.⁴

Cadell established the common law vesting contours of the Rule, holding property could be tied up in four situations:

(i) During the life of any existing person and the minority of any person living at his death; (ii) During the life of any existing persons and for 21 years after the death of the survivor, irrespective of the minority of any particular person; (iii) During the lives of any number of existing persons and during the minority of any person living at the death of the survivor of them; and (iv) If the person who became entitled on the death of the existing person should happen to be a posthumous child, who was *en ventre sa mere* at the time of death, not being born until afterwards, the 21 years can be extended by the addition of time which elapsed between the death of the person in question and the birth of the child.⁵

Ultimately, the vesting limitations described in *Cadell* provided the framework for John Chipman Gray's modern American articulation of the Rule: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest."⁶ Gray's classic formulation put the Rule's emphasis squarely on an interest's vesting. This emphasis has persisted throughout the Rule's tenure in American jurisdictions. Put simply, the Rule restricts how long a future interest in property created by a disposition can exist before it must either vest or take effect.⁷

The common law Rule can be viewed as "a compromise permitting a property owner to control the disposition of her property for the lifetime of persons whose propensities she knows . . . and for twenty-one years thereafter, but not beyond the period during which decedent might plausibly assert some special knowledge of the propensities of one of her beneficiaries."⁸ The common law Rule ignores any events that occurred after the creation of the interest, and instead

focuses entirely on what was certain to occur or not to occur at the time the interest was created.⁹

Application of the common law Rule raises a host of questions, such as: How are the lives in being determined? Has the interest truly been vested? How does the Rule apply to any given case?¹⁰ These questions are often difficult to answer because the Rule is deceptive in its apparent simplicity. In truth, the Rule is notorious for its complexity and difficulty.¹¹ Moreover, such difficulty is compounded by “the orthodox Rule [being] remorseless in its application, and the possibilities that void an interest are often ridiculous.”¹² Given the common law Rule’s rigid application, it will come as no shock that many American jurisdictions have since reformed the common law Rule. These reformations are discussed *infra*.

III: Rule Modification and the Creation of the Trap

A. Rule Modification

Many theories exist as to why the common law Rule fell into disfavor in the United States. The versions of the story may differ, but the end result is the same: authorities in the field gradually determined the common law Rule no longer served its intended purpose. In the 1950s, for example, Barton Leach, a Harvard professor, called for an end to the common law Rule’s “reign of terror.”¹³ Ever since Leach’s assault, the Rule has been in decline.¹⁴ Interestingly, though Leach’s *Perpetuities in Perspective: Ending the Rules Reign of Terror* “is generally given credit for beginning this new movement [away from the common law Rule],” the movement “actually began five years earlier with the enactment of the Pennsylvania Estates Act of 1947.”¹⁵ The Pennsylvania Estates Act of 1947 adopted what is known as the “wait and see” principle.¹⁶ The “wait and see” principle allows courts, when determining whether a limitation is valid under the Rule, to “wait until the *actual events happen* or until it becomes apparent that the interest

cannot vest within the allowed period rather than considering the possibilities at the time the interest is created.”¹⁷ Under a “wait-and-see” rule, “a disposition is not automatically void at the outset for a possible violation of the Rule”; instead, “the disposition's validity is determined by waiting to see what actually happens, and if the interest vests or becomes certain to vest or to fail within the perpetuities period of 21 years after the death of the life in being.”¹⁸ The Pennsylvania Estates Act of 1947 and its “wait and see” principle, along with Leach’s article, started the ball rolling toward Rule reform.

The 1960s and 1970s saw increased support for reformation of the Rule. Discontent with the common law Rule grew stronger in 1979 when the Restatement (Second) of Property¹⁹ contended the common law Rule was unreasonable because it failed to address events that “had already occurred before the court or parties had to determine the validity of the interests created.”²⁰ The Restatement (Second) of Property’s reporter, Professor A. James Casner, was a colleague of Leach, and his first order of business for the second version of the Restatement was Rule reform.²¹ Chief among Casner’s criticisms of the Rule was that it ignored events occurring after the interest was created.²² Casner’s contention was met with stern rebuke by the Restatement (First) of Property’s reporter, Professor Richard R. Powell.²³ The two academics debated at the American Law Institute’s annual meeting for two consecutive years over the appropriate contours of Rule reform.²⁴ Ultimately, Casner prevailed.²⁵ After the Restatement (Second) of Property’s firm statement, Professors Jesse Dukeminier and Lawrence Waggoner joined the debate in a series of high-profile articles.²⁶ Dukeminier supported “wait-and-see” as the appropriate vehicle for Rule reform,²⁷ while Waggoner proposed a future interest should be upheld, even if it violated the common law Rule,²⁸ so long as the interest actually vested within a period of ninety years from the date of the interest's creation.²⁹

But the rumblings of Rule reform became shouts of open rebellion after the passage of the “new” federal generation-skipping transfer tax (“GST tax”) in 1986.³⁰ The 1986 version of the GST tax was actually Congress’ second attempt at the taxation of generation-skipping transfers. Prior to 1986, “wealthy property owners could skip a generation (or sometimes two generations) of tax by making transfers--generally in trust--to grandchildren or even more remote descendants.”³¹ The 1986 GST tax “closed that loophole by subjecting these transfers to a separate tax.”³² Congress simultaneously introduced a GST tax exemption (which, at the time, was \$1,000,000 per transferor).³³ This exemption proved most valuable when applied to trusts that would last for as long as possible. Such a trust is commonly known as a “perpetual trust” or “dynasty trust.” After the 1986 GST tax became effective, state legislatures “rushed to authorize perpetual trusts” to compete for and encourage trust creation and funding.³⁴ But a major barricade stood in the way of this perpetual trust bonanza: the Rule. The Rule was the “principal doctrinal obstacle” to perpetual trusts, and, following the 1986 GST tax, states began to plot the common law Rule’s demise.³⁵

The axe truly began to fall on the common law Rule with the promulgation of the Uniform Statutory Rule Against Perpetuities (“USRAP”).³⁶ Released the same year as the 1986 GST tax, the USRAP instituted a 90-year “wait and see” rule “as an alternative to the common law [R]ule and authorized judicial reformation of interests that failed to vest within the 90-year period.”³⁷ Seeking to reinvigorate the Rule, the Uniform Law Commission (“ULC”) marketed the USRAP as a simplified version of the common law Rule.³⁸ Ironically, by supporting the adoption of a 90-year “wait and see” Rule, the ULC “implicitly endorsed the creation of 90-year trusts, which Dukeminier predicted would cause the [R]ule to fall into disuse and eventually lead to its formal abolition.”³⁹ This implicit endorsement by the ULC of the “wait and see” principle

played a significant role in the downfall of the common law Rule. By actively permitting any trust to last for at least ninety years, “the drafters of USRAP signaled that ninety-year trusts would do no significant harm to the social fabric.”⁴⁰ Instead of reinvigorating the common law Rule, the USRAP added fuel to the Rule reformation movement fire by adopting the “wait and see” approach, “adding an alternate 90-year period (measured from the creation of the interest or power) for the [R]ule,” and authorizing the use of *cy pres* to resolve Rule violations.⁴¹ The unraveling of the common law Rule was in full force.

Faced with pressure to abolish the Rule, and with the prospect that states like Delaware and Alaska would attract trust dollars from local banks and trust companies, other states quickly began to respond by modifying their own Rule.⁴² Many state legislatures adopted the USRAP (either alone or as part of the Uniform Probate Code).⁴³ With some variation, the USRAP was eventually adopted in twenty-five states and the District of Columbia (Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Florida, Georgia, Hawaii, Indiana, Kansas, Massachusetts, Michigan, Minnesota, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Utah, Virginia, and West Virginia).⁴⁴ The common law Rule was on its last legs.

At its “high water mark,” the USRAP was “adopted by more than half the states, but several of those states subsequently joined the rush to abolish the [R]ule.”⁴⁵ Once USRAP and its “wait and see” principle became the norm, it did not take long for some of the states to further consider, “if ninety years is unobjectionable, why not 150, or 200?”⁴⁶ And many states found such an extended perpetuities period entirely acceptable. Nine states have adopted extended fixed periods for the Rule: “Alabama (100 years for property not in trust; 360 years for property in trust), Arizona (500 years), Colorado (1,000 years), Delaware (110 years for real property held

in trust); Florida (360 years), Nevada (365 years), Tennessee (360 years), Utah (1,000 years), Washington (150 years).⁴⁷

Currently, the common law Rule remains intact in only three states: Alabama, New York, and Texas.⁴⁸ Iowa, Mississippi and Oklahoma have the common law rule with the “wait-and-see” modification.⁴⁹ From the original promulgation of the USRAP until now, several of the USRAP-adopting states have made substantial modifications or added major exceptions.⁵⁰ A majority of states have eliminated the Rule, “either entirely or for certain types of trusts, or have adopted a very long fixed permissible period of the rule.”⁵¹ Eight states have repealed the Rule entirely: “Alaska (repealed the [R]ule for vesting of property interests), Delaware (repealed entirely for personal property interest held in trust; 110 year [R]ule for real property held directly in trust), Idaho, Kentucky (repealing the [R]ule interests in real or personal property), New Jersey, Pennsylvania, Rhode Island, South Dakota.”⁵² Louisiana has never had the Rule.⁵³ Seventeen states have retained the Rule, but have authorized certain trusts to continue without its application: Arizona, District of Columbia, Hawaii, Illinois, Maine, Maryland, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Virginia, and Wyoming.⁵⁴

Though a few states have elected to keep the original Rule, or modify it only to add a “wait and see” provision, the general movement has been away from the rigid common law Rule toward a more flexible, useful Rule. Why is this important? Because the Rule modification movement is a major precursor to the creation of the Delaware Tax Trap.

B. *The “Delaware Tax Trap”*

The Delaware Tax Trap (“Trap”), as it is colloquially known, is found in Internal Revenue Code (“Code”) sections 2041(a)(3) and 2514(d).⁵⁵ Code sections 2041(a)(3) and

2514(d) include assets subject to a power of appointment in the power holder's transfer tax base (either the gift tax base or the gross estate) if the power holder exercises the power "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."⁵⁶

The Trap gets its name, unsurprisingly, from the state in which it was created: Delaware.⁵⁷ Delaware's former Rule, originally enacted in 1933, stated: "the validity of an interest in trust which is created by the exercise of a power of appointment is measured from the date the power of appointment is exercised to create the appointed interest rather than from the date the power of appointment is created."⁵⁸ Therefore, in Delaware, one could create a trust that would last forever by giving a beneficiary a nongeneral power of appointment,⁵⁹ who in turn would use that power to create a successive nongeneral power of appointment.⁶⁰ This practice would allow the vesting of a noncharitable interest to be postponed beyond the Rule.⁶¹ Moreover, not only did the practice allow for a perpetual trust instrument, by using nongeneral powers of appointment it also provided substantial federal estate tax savings.⁶²

Congress viewed Delaware's double benefit as a problem. United States transfer tax laws (gift and estate taxes) assume the common law Rule that noncharitable interests cannot be deferred forever.⁶³ At some point the interest must vest in a noncharitable beneficiary.⁶⁴ Because Delaware's Rule allowed for both perpetual trusts and avoidance of the estate tax, Congress enacted the Powers of Appointment Act of 1951 ("Powers Act") to prevent successive exercise of nongeneral powers of appointment to extend the term of trusts beyond the original period of the Rule without incurring estate or gift tax.⁶⁵ The Powers Act added sections

811(f)(4) and 1000(c)(4) to the Code to “insure that, as the term of the trust was being extended in this manner [Delaware’s successive nongeneral powers of appointment], the trust property would not avoid wealth transfer tax liability.”⁶⁶ The Powers Act accomplished this goal by addressing Delaware law’s peculiar vesting determination.⁶⁷ Delaware law did not “refer back to the date the first power was created to determine the time in which the property subject to this power must vest.”⁶⁸ The Powers Act required such reference back. As a result, “a donee of the power who exercised it to create a successive power was subject to either gift tax or estate tax on all property subject to this power, depending on whether the power was exercised during life or at death.”⁶⁹

Code sections 811(f)(4) and 1000(c)(4) eventually became Code sections 2041(a)(3) and 2514(d) – which now define the Trap.⁷⁰ The “trap” aspect relates to the inadvertent consequence a beneficiary would experience if: (i) they are the beneficiary of a Delaware trust, (ii) the trust gave a beneficiary a nongeneral power of appointment, and (iii) that nongeneral power of appointment was exercised to create a successive nongeneral power of appointment.⁷¹ If the donee of a nongeneral power exercised the power in the manner proscribed by Code sections 2514(d) and 2041(a)(3), the power would be treated as a general power.⁷² Exercising this power during life would constitute a gift.⁷³ If so exercised at death, the property subject to the power would be includable in the gross estate.⁷⁴ Because the effect was to impose a gift or estate tax on a beneficiary who never actually owned the property in the trust but only possessed a nongeneral power of appointment, it is viewed as a “tax trap.”⁷⁵ “Delaware” was tacked on because the above scenario was enabled by Delaware law.⁷⁶ Thus, the Trap was born.

For much of the Trap’s tenure, it has been viewed as something to avoid. Practitioners who unintentionally trigger the Trap through imprecise drafting may be subjected to malpractice

claims. Unwitting beneficiaries exercising nongeneral powers of appointment over Delaware trusts may face unforeseen tax bills. These events are the stuff of nightmares.

The Trap was typically regarded as a peculiarity derived from the interplay between Delaware state law and Congressional statute. When Congress drafted the predecessors to Code sections 2041(a)(3) and 2514(d), it focused on a rule of local property law, namely Delaware's Rule, to resolve a tax problem believed to be unique to Delaware.⁷⁷

The problem is no longer unique to Delaware. In some states, a beneficiary of a perpetual trust with a nongeneral power of appointment who exercises that power to give a successive beneficiary a nongeneral power of appointment may create a gift or estate tax liability.⁷⁸ Conversely, the same exercise in other states will likely fail to trigger the Trap.⁷⁹ The Trap does not apply to either the grant or exercise of a general power of appointment because the possession of a general power of appointment will cause inclusion in the power holder's estate, and the exercise or lapse of a general power of appointment will start the running of a new Rule period.⁸⁰

“Although the Trap refers to postponement of vesting and suspension of absolute ownership or the power of alienation in the disjunctive,” *Estate of Murphy v. Commissioner* has interpreted the Trap's contours further.⁸¹ According to the *Murphy* court, the Trap is sprung (i.e., causes inclusion in the estate or gift transfer tax base) only “if, under the applicable local law, both the period during which vesting may be postponed by exercise” of the successive power of appointment (the power created by the original power holder's exercise of the original power) and “the period during which absolute ownership or the power of alienation may be suspended by exercise” of the successive power of appointment can be ascertained without regard to the date of the original power's creation.⁸² So even in a jurisdiction without a Rule, a similar rule

against suspension of absolute ownership or the power of alienation could still prevent the Trap's being sprung.⁸³ The converse is also true: in a jurisdiction without a rule against suspension of absolute ownership or the power of alienation, a Rule will prevent the springing of the Trap.⁸⁴ Thus, a careful examination of the applicable jurisdiction's laws is necessary.

This examination, however, is not so easy. Here the Rule reformation movement, discussed *supra*, is particularly relevant: because many states have deviated substantially from the common law Rule, practitioners must be cautious when determining what Rule applies and whether the Trap may be triggered as a result.⁸⁵

As more states modify or abolish the Rule, practitioners will need to become more familiar with the Trap to avoid unintended consequences. The Trap is of concern "whenever a beneficiary is considering exercising a power of appointment and trusts resulting from such exercise might last beyond" the common law Rule.⁸⁶ In states with a modified or abolished Rule, exposure to the Trap could become more problematic "because, in the typical case, and since a trust could now last forever, the states did not require that the exercise of a special power of appointment (created under a preceding special power) be restricted to a time period based on the creation of the original special power."⁸⁷ Some states have observed this problem, and have attempted to counteract the potential implications of the Trap. Some have adopted rules declaring that the exercise of a nongeneral power of appointment arising from the exercise of a previous nongeneral power of appointment will, by that state's law, be arbitrarily measured from the grant of the original nongeneral power of appointment.⁸⁸ In essence, some states have removed the ambiguity by deeming the original power creation to be the beginning of the time period.

As an example of the complexity, consider Delaware itself. Delaware, interestingly, is

among those states which have elected to arbitrarily declare that the exercise of a nongeneral power of appointment arising from the exercise of a previous nongeneral power of appointment will, by that state's law, be arbitrarily measured from the grant of the original nongeneral power of appointment.⁸⁹ The problem with Delaware's "anti-Delaware-tax-trap" provision, however, lies in the language itself: by deeming that the successive nongeneral power of appointment's perpetuities period relates back to the creation of the first nongeneral power of appointment, Delaware seems to have misunderstood that its own Rule doesn't include personal property held in trust.⁹⁰ Therefore, Delaware's attempt to combat the unintentional springing of its own Trap does nothing for personal property held in trust because: (i) "the successive nongeneral power of appointment can be validly exercised to postpone the vesting of interests in personal property held in trust forever," and (ii) the "period that runs forever from the date" of the successive power of appointment's exercise is ascertainable "without regard to the date of creation of the" original nongeneral power of appointment," thereby springing the Trap.⁹¹ Confusing, no doubt, and somewhat disconcerting the "anti-Delaware-tax-trap" language came from Delaware itself.⁹² The end result is Delaware's "anti-Delaware-tax-trap" provision fails because Delaware does not have a Rule to relate back to. Presumably, this failure to address the Trap's unintentional springing can be extrapolated to any other jurisdiction that is considering or has already modified or abolished its Rule (or similar rules against suspension of absolute ownership or the power of alienation).⁹³

This is the current state of the Trap: confusion and uncertainty. How the Trap affects the beneficiaries of a trust will depend on what jurisdiction's Rule (or lack thereof) will apply. As more and more jurisdictions continue to reform, modify, or abolish the Rule entirely, practitioners will have to address the Trap or suffer unintended consequences. Fortunately, an

informed understanding of the Trap, coupled with a changing estate planning landscape with a renewed focus on income tax planning, can both prepare and motivate a practitioner for the future.

IV: Tax Advantages of the Trap

A. Tax History of the Trap (and Preview of the Future)

Until recently, intimate knowledge of the Trap was probably unnecessary for most practitioners in the field. Low historic estate and gift tax exemption limits established a definitive paradigm: under most circumstances, one should keep assets outside of the estate and gift tax base whenever possible. Even in those jurisdictions where the Trap was an issue, it was simple to avoid by specifying the effective date of power creation within the structures of Code sections 2041(a)(3) and 2514(d). This paradigm is now shifting. “Permanency” has arrived with the American Taxpayer Relief Act of 2012 (“ATRA”).⁹⁴ Income and capital gain rates have increased.⁹⁵ The new 3.8% tax on net investment income has exacerbated the trend.⁹⁶ Whether some of the provisions included in ATRA will remain permanent for any significant length of time remains to be seen, but one area addressed by ATRA appears to be on more solid ground: estate and gift tax exclusions look as though they will remain relatively high for the near future.⁹⁷ These exclusion amounts (\$5,000,000 for a single taxpayer and \$10,000,000 for a married couple, both indexed yearly for inflation) present an opportunity for practitioners to investigate the intentional inclusion of assets in a decedent’s gross estate when covered by the available estate tax exemption.⁹⁸

What would be the benefit of intentional inclusion? A step-up in asset basis, if done

correctly. A basis step-up would provide beneficiaries with assets devoid of built-in taxable capital gains. The catch, of course, is that the process must be done correctly.⁹⁹ Additionally, a few specific criteria must be present for the process to be successful. These are discussed *infra*.

How would basis step-up through intentional inclusion be accomplished? There are various ways discussed at length by scholars in the field. One example requires a grantor trust, where the grantor of that trust elects to “buy back or otherwise swap assets tax-free with the trust so that at the settlor’s death the former trust assets’ bases are stepped up to fair market value.”¹⁰⁰ Another involves the creative use of partnership interests.¹⁰¹ Another intriguing method, given its history as something to avoid, is through the intentional use of the Trap.

The most seminal discussion of the tax benefits the Trap might provide was Jonathan G. Blattmachr and Jeffrey N. Pennell’s *Using ‘Delaware Tax Trap’ To Avoid Generation-Skipping Taxes*.¹⁰² Blattmachr and Pennell’s 1988 article came out shortly after the introduction of the 1986 GST tax. After the 1986 GST tax became effective, Blattmachr and Pennell identified the potential tax benefits inherent in the Trap.¹⁰³ By exercising a nongeneral power of appointment to create a *general* power of appointment, the article contended a deft practitioner could prevent application of the GST tax at a lower gift or estate tax cost.¹⁰⁴ GST tax is generally imposed only if property is transferred to a “skip-person.”¹⁰⁵ The purpose for creation of the second power of appointment, the general power, was to subject property to estate and gift tax as the property “moves down” the generations, thereby avoiding the GST tax.¹⁰⁶

The Trap operates as an alternative method to avoid GST taxation through the inclusion of property in the gross estate. The exercise of a nongeneral power of appointment to “create a new power of appointment that has the effect of postponing the period of the Rule . . . converts

the nongeneral power of appointment into a taxable power.”¹⁰⁷ The Trap forces property that would otherwise avoid estate and gift taxation to be included in the gross estate.

The two authors go further than simply restating the mechanics of the Trap, however. Blattmachr and Pennell contend that Code sections 2041(a)(3) and 2514(d) not only apply to the successive creation of nongeneral powers of appointment (the standard Trap scenario), but also to the creation of a presently exercisable general power of appointment (“PEG”) if the PEG power begins a new perpetuities period that does not refer back to the creation of the original nongeneral power of appointment.¹⁰⁸ Their argument is rooted in the history of Congress’ intent: to prevent the creation of a new perpetuities period without reference to the original perpetuities period.¹⁰⁹

Blattmachr and Pennell’s article began a trend. The Trap, once feared and misunderstood, could now be actively used to accomplish tax objectives. Blattmachr and Pennell did not intend their historic article as a discussion of basis step-up methods, presumably because of the then relatively small estate tax exemption amount of \$600,000.¹¹⁰ Intentional inclusion in the gross estate would have cut across the grain of the trend at the time. The purpose of their article was to provide practitioners with the ability, via the Trap, to accomplish avoidance of the GST tax.¹¹¹ Intrepid practitioners and academics of the current era of estate planning have since identified the Trap’s benefit in the estate planning process beyond avoidance of the GST tax.¹¹²

B. *Basis Step-Up and the Trap: How It Is Accomplished*

Presently in focus is the Trap’s ability to accomplish a step-up in basis for certain assets. Assets in the gross estate of an individual are typically afforded a step-up in basis at death.¹¹³ Generally, this step-up in basis reflects the fair market value of the property at the time of

death.¹¹⁴ As the incidence of income tax outpaces that of estate and gift tax, practitioners will need to know how to accomplish basis step-up for assets with substantial taxable gain. The following discussion focuses on two potential methods for accomplishing a step-up in basis of assets via the use of the Trap.

1. The “Volunteer” Method

The first method of achieving basis step-up, articulated by a leading practitioner, focuses on the use of a “volunteer” individual.¹¹⁵ The use of this method is beneficial if “no estate tax will be due,” but assets may be still subject to substantial capital gains tax at death.¹¹⁶ The volunteer should be an elderly person with “a substantial unused estate tax exemption.”¹¹⁷ The plan is to “intentionally cause selected assets of an irrevocable trust to become subject to the estate tax of a decedent whose taxable estate tax is otherwise under \$5 million or so,” and is an individual “whose estate could absorb the trust assets in his or her taxable estate without creating a federal estate tax liability.”¹¹⁸ To achieve the intended purpose of basis step-up, the volunteer is given a special power of appointment “over assets in a trust to distribute to the same beneficiary or beneficiaries who would have received the trust assets anyway.”¹¹⁹ This is where the use of the Trap springs to life. The volunteer then exercises the special power of appointment in a manner to spring the Trap by appointing “to another trust in which the beneficiary is given his or her own power of appointment.”¹²⁰ The appointed trust assets are now includable in the gross estate of the volunteer, and the appointed assets’ bases are stepped up to fair market value upon the death of the volunteer.¹²¹

This method comes with a number of caveats. First, states have different Rules (discussed *supra*, Part III). While all states currently allow for springing of the Trap if the power holder creates a PEG power of appointment,¹²² only a small number of states allow for springing

without “giving a beneficiary the immediate power to take the assets out of trust.”¹²³ This is typically unpalatable. Though the ability to utilize the springing of the Trap is not necessarily dependent on the state the trust “is administered or the law of the state that governs the trust,” some states provide better creditor protection for beneficiaries of the trust.¹²⁴ Second, the plan must be in place before the volunteer deceases; the Trap is not sprung if the volunteer is already deceased.¹²⁵ Third, only certain types of trusts are candidates for this method.¹²⁶ These include: (i) irrevocable trusts with assets which have a value in material excess of their bases; (ii) trusts that are not includable in any person’s gross estate; (iii) trusts in which a person has a nongeneral power of appointment; and (iv) trusts in which the trustee has broad discretion to make distributions.¹²⁷ While this list does provide some breadth to work with, it is still important to identify whether a particular trust is actually a candidate before employing this method.

A variant volunteer method exists for at least one state: Arizona.¹²⁸ Arizona permits the exercise of a special power of appointment to create another special power of appointment.¹²⁹ Under Arizona law, the Trap can be sprung by exercising the initial special power of appointment to create a second special power of appointment, “and the exercising powerholder can provide that the date commencing” the Rule period for the second special power of appointment is the “date of exercise” of the first special power of appointment.¹³⁰ The creation of another special power of appointment, unlike a general power of appointment, provides greater benefit because the “appointment of an unvested interest” with a special power of appointment “can avoid the vesting of the trust estate for another generation or more . . .”¹³¹ At its core, Arizona authorizes power creation similar to Delaware before Congress passed the Powers Act.

The variant volunteer method also comes with some additional caveats. Because the creation of a special power of appointment, rather than a general power of appointment, allows for the postponement of vesting, GST must be addressed. This method requires sufficient allocation of the “GST exemption by the powerholder’s estate so distributions to skip persons from that new trust do not trigger the GSTT.”¹³² If sufficient allocation is unavailable, then this method should be avoided if, under any circumstance, a skip person “could receive distributions” before the Trap “is sprung by a nonskip person.”¹³³

2. The “Optimal Basis Increase” Trust Method

The second method of achieving basis step-up is through the use of an “optimal basis increase” trust (“OBIT”).¹³⁴ This method focuses on a surviving spouse rather than a volunteer as the vehicle.¹³⁵ Like the volunteer method, this method is effective when assets would otherwise fail to receive a step-up in basis.¹³⁶ The first step is to create an OBIT.¹³⁷ This trust, unlike an outright bequest or a marital trust, will function primarily for the purpose of asset basis step-up.¹³⁸ Once created, the OBIT grants the surviving spouse a limited testamentary power of appointment (“First Power”).¹³⁹ The First Power permits appointment in further trust.¹⁴⁰ The surviving spouse then appoints assets subject to the First Power to a separate trust which gives a beneficiary a power of appointment which can be exercised without regard to date of creation of the First Power,¹⁴¹ thereby triggering the Trap and causing inclusion in the gross estate.¹⁴² The First Power so exercised, like a standard general power of appointment, would afford the assets a step-up in basis under Code section 1014.¹⁴³

This is where the OBIT method deviates from the volunteer method. Although the function of I.R.C. § 1014 is colloquially referred to as a “step-up” in basis, it can actually “step-down” asset basis as well.¹⁴⁴ This potential for “stepped-down” asset basis is one of the primary

catalysts for development of the OBIT method. If the surviving spouse appoints (by Will, trust, or other document permitted by the first deceased's spouse's trust) any *appreciated* assets to the PEG-power-of-appointment-granting trust, those assets will be included in the gross estate and afforded a step-up in basis.¹⁴⁵ Assets with no appreciation or with depreciation would simply be distributed as they would otherwise.¹⁴⁶ The OBIT method hinges upon the ability of an individual to employ "specific, partial and targeted use" of the Trap.¹⁴⁷

This method also comes with a number of caveats. First, the surviving spouse will be forced to draft a new will or trust exercising the First Power and to draft a new power of appointment trust "with terms that one would ordinarily avoid."¹⁴⁸ Second, the grant of a PEG power of appointment may be the only alternative in those states allowing the Trap to be triggered. This can create asset protection problems, and it also eliminates the ability to spray income or make tax-free gifts.¹⁴⁹ Third, the method is not particularly useful as a planning tool given the propensity of disclaimer funding, which eliminates the nongeneral power of appointment required for a Trap springing.¹⁵⁰

V. Conclusion

The estate planning community has entered a new paradigm. Practitioners should take note of the changing landscape and react accordingly. This paradigm calls for a more well-rounded estate plan with an increased focus on achieving tax savings beyond estate and gift tax. A prudent practitioner can use a tool like the Trap to obtain income tax benefits by utilizing some of the methods discussed. As the Trap's contours continue to be explored, additional planning opportunities may yet be discovered. The Trap's future still has chapters to be written by the next generation of planners.

¹ 3 Ch. Cas. 1, 22 Eng. Rep. 931 (1682). The Duke of Norfolk, Henry the 22nd Earl of Arundel, attempted to pass title to his sons through the use of shifting executory limitations. Provisions of Henry's estate plan addressed future contingencies; if these contingencies were to have occurred, the titles would shift. When one of Henry's sons attempted to enforce the shifting executory limitation, the House of Lords held that the sort of shifting executory limitation Henry had created could not exist *ad infinitum* because it would impinge upon the free alienability of property.

² Black's Law Dictionary (9th ed. 2009). An "executory interest" is a future interest, held by a third person, which either cuts off another's interest or begins after the natural termination of a preceding estate.

³ Charles Donahue, *Cases and Materials on Property: An Introduction to the Concept and the Institution* Ch. 3, p. 219 (4th ed. 2012), http://www.law.harvard.edu/faculty/cdonahue/courses/prop/mat/Mats_c18.pdf.

⁴ *Cadell v. Palmer*, 1 Cl. & F. 372 (1833).

⁵ Alfred F. Topham, *Real Property, An Introductory Explanation Of The Law Relating To Land*, 134 (1908). *Cadell v. Palmer* involved land devised to trustees in trust for a term of 120 years, with the requirement that all or any of twenty eight named persons should so long live, and after the end of that term, the land would go to trustees for a term of 20 years, and after the end of both terms in trust for persons to be then ascertained. The Court determined the gift at the end of 28 lives in being and 20 years (21 years actually became the standard promulgated by the *Cadell* Court) after such lives, without reference to the minority of any person, was valid.

⁶ John Chipman Gray, *The Rule Against Perpetuities* (4th ed. 1942) § 201.

⁷ Mary Arden et al., *The Rules Against Perpetuities and Accumulations*, The Law Commission, available at

http://lawcommission.justice.gov.uk/docs/lc251_The_Rules_Against_Perpetuities_and_Accumulations.pdf.

⁸ Stewart E. Sterk, *Jurisdictional Competition to Abolish the Rule Against Perpetuities: R.I.P. for the R.A.P.*, 24 *Cardozo L. Rev.* 2097, 2099 (2003); *see generally* Arthur Hobbhouse, *The Dead Hand* 188 (1880).

⁹ Howard Zaritsky, *The Rule Against Perpetuities: A Survey of State (And D.C) Law*, http://www.actec.org/public/documents/studies/zaritsky_rap_survey_03_2012.pdf.

¹⁰ Laurence M. Jones, *Reforming the Law-the Rule Against Perpetuities*, 22 *Md. L. Rev.* 269, (1962), available at: <http://digitalcommons.law.umaryland.edu/mlr/vol22/iss4/2>; *see also* Robert J. Lynn, *A Practical Guide to the Rule Against Perpetuities*, 1964 *Duke Law Journal* 207-256 (1964), available at: <http://scholarship.law.duke.edu/dlj/vol13/iss2/1>

¹¹ Charles Donahue, *Cases and Materials on Property: An Introduction to the Concept and the Institution* Ch. 3, p. 219 (4th ed. 2012), http://www.law.harvard.edu/faculty/cdonahue/courses/prop/mat/Mats_c18.pdf

¹² Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 *UCLA L. Rev.* 1303, 1304 (2003); *see also* W. Barton Leach, *Perpetuities in a Nutshell*, 51 *Harv. L. Rev.* 638, 643-44 (1938).

¹³ W. Barton Leach, *Perpetuities in Perspective: Ending the Rule's Reign of Terror*, 65 *Harv. L. Rev.* 721 (1944); *see* W. Barton Leach, *Perpetuities Legislation Massachusetts Style*, 67 *Harv. L. Rev.* 1349 (1954).

¹⁴ Dukeminier & Krier, *supra* note 12, at 1304.

¹⁵ Jones, *supra* note 10, at 278 (citing Leach's *Perpetuities in Perspective: Ending the Rule's Reign of Terror*).

¹⁶ Jones, *supra* note 10, at 278.

¹⁷ *Id.* at 278-79.

¹⁸ George G. Bogert et al., *Bogert's Trusts and Trustees* § 214 (Dec. 2013).

¹⁹ *See* Restatement (Second) of Property, Donative Transfers, App. 127 (Tent. Draft No. 1, 1978) (commentary by ex-reporter Richard R. Powell on proposed draft).

²⁰ Zaritsky, *supra* note 9, at 1.

²¹ Dukeminier & Krier, *supra* note 12, at 1307.

²² *Id.*

²³ *Id.*

²⁴ Sterk, *supra* note 8, at 2099.

²⁵ Dukeminier & Krier, *supra* note 12, at 1307.

²⁶ Sterk, *supra* note 24, at 2099.

²⁷ Jesse Dukeminier, *The Uniform Statutory Rule Against Perpetuities: Ninety Years in Limbo*, 34 *UCLA L. Rev.* 1023, 1065-66 (1987); *see also* Jesse Dukeminier, *Perpetuities: The Measuring Lives*, 85 *Colum. L. Rev.* 1648 (1985).

²⁸ Lawrence W. Waggoner, *The Uniform Statutory Rule Against Perpetuities: The Rationale of the 90-Year Waiting Period*, 73 *Cornell L. Rev.* 157 (1988).

²⁹ Sterk, *supra* note 8, at 2099.

³⁰ 26 U.S.C. § 2601.

³¹ Sterk, *supra* note 8, at 2100.

³² *Id.*

³³ *Id.*

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- ³⁴ Sterk, *supra* note 8, at 2100; *see also* Dukeminier & Krier, *supra* note 12, at 1315.
- ³⁵ *Id.*
- ³⁶ Grayson M. P. McCouch, *Who Killed the Rule Against Perpetuities?*, 40 Pepp. L. Rev. 1291, 1304 (2013).
- ³⁷ *Id.*
- ³⁸ *Id.*
- ³⁹ *Id.*
- ⁴⁰ Sterk, *supra* note 8, at 2104-05.
- ⁴¹ Zaritsky, *supra* note 9, at 2.
- ⁴² Sterk, *supra* note 8, at 2104.
- ⁴³ Zaritsky, *supra* note 9, at 2. In 1990, the Uniform Probate Code made the USRAP an official part of the Uniform Probate Code as Part 9 of Article II. *See* Uniform Probate Code §§ 2-901 to 2-907.
- ⁴⁴ *Id.*
- ⁴⁵ McCouch, *supra* note 36, at 1304.
- ⁴⁶ Sterk, *supra* note 8, at 2104.
- ⁴⁷ *Id.*
- ⁴⁸ Zaritsky, *supra* note 9, at 1.
- ⁴⁹ *Id.*
- ⁵⁰ Zaritsky, *supra* note 9, at 2.
- ⁵¹ Zaritsky, *supra* note 9, at 7.
- ⁵² *Id.*
- ⁵³ *Id.*
- ⁵⁴ Zaritsky, *supra* note 9, at 8.
- ⁵⁵ I.R.C. §§ 2041(a)(3), 2514(d); James P. Spica, *Exercising Special Powers of Appointment Over Tax Advantaged Trusts Post Perpetuities Reform Can Be More Or Less Hazardous*, 36 Mich. Tax Lawyer 37-45, 37 (Fall 2010), available at <https://www.michbar.org/tax/pdfs/fall2010.pdf>.
- ⁵⁶ IRC § 2041(a)(3) (2014).
- ⁵⁷ Zaritsky, *supra* note 9, at 8; *see also* 25 Del. Code § 501.
- ⁵⁸ Stephen E. Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68, 74 (2001).
- ⁵⁹ A “nongeneral power of appointment” consists of any power of appointment that is not “exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate” as described in IRC § 2041(b).
- ⁶⁰ *Id.*
- ⁶¹ Alexander A. Bove, Jr., *Using the Power of Appointment to Protect Assets-More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 353-54 (2010).
- ⁶² Greer, *supra* note 58, at 69.
- ⁶³ Bove, Jr., *supra* note 61, at 353-54.
- ⁶⁴ *Id.*
- ⁶⁵ Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes*, 68 Journal of Taxation 242-248 (1988), available at <http://ssrn.com/abstract=1954062>; *see also* Greer, *supra* note 58, at 69.; *see also* Jonathan G.

Blattmachr & Jeffrey N. Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the 'Delaware Tax Trap,'* 24 Real Prop., Prob. & Tr. J. 75 (Spring 1989).

⁶⁶ *Id.*

⁶⁷ Greer, *supra* note 58, at 69.

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² Bove, Jr., *supra* note 61, at 353-54.

⁷³ *Id.* at 354.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ Greer, *supra* note 58, at 74.

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ Bove, Jr., *supra* note 61, at 354-55.

⁸¹ Spica, *Exercising, supra* note 55, at 37; *see Estate of Murphy v. Comm'r*, 71 T.Cm 671 (1979).

⁸² Spica, *Exercising, supra* note 55, at 37.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ Greer, *supra* note 58, at 74.

⁸⁶ Richard W. Nenko, *Terrors of the Deep: Tax Dangers When Exercising Powers Over Trusts - The GST Regulations and the Delaware Tax Trap*, 34 Tax Mgm't Estates, Gifts & Trusts J. No. 1 (1/1/2009), http://www.wilmingtontrust.com/repositories/wtc_sitecontent/PDF/lib-WP-Terrors_of_the_Deep.pdf

⁸⁷ Bove, Jr., *supra* note 61, at 353-54.

⁸⁸ *Id.*

⁸⁹ Spica, *Exercising, supra* note 55, at 38.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² 25 Del. Code § 504.

⁹³ Spica, *Exercising, supra* note 55, at 40.

⁹⁴ American Taxpayer Relief Act of 2012. Pub.L. 112-240. 126 Stat. 2313.

⁹⁵ Les Raatz, *'Delaware Tax Trap' Opens Door to Higher Basis for Trust Assets*, 41 Est. Plan 03, 01 (Feb. 2014).

⁹⁶ *Id.*

⁹⁷ This statement, of course, is subject to the following disclaimer: Congress can always change the estate and gift tax exemption amounts. However, the language of ATRA suggests that the current exemption amounts, adjusted annually for inflation, will remain constant for the time being. *See* American Taxpayer Relief Act of 2012. Pub.L. 112-240. 126 Stat. 2313.

⁹⁸ I.R.S. Rev. Proc. 2013-35.

⁹⁹ *See* Les Raatz, *How To Step Up Basis In Irrevocable Trust Assets*, <http://www.dickinson-wright.com/~media/Files/Events/2013/HOW%20TO%20STEP%20UP%20BASIS%20IN%20IRREVOCABLE%20TRUST%20ASSETS%20v4b.pdf>; James P. Spica, *A Practical Look at*

Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax, 41 Real Prop. Prob. & Tr. 165 (2006); Edwin P. Morrow III, *The Optimal Basis Increase and Income Tax Efficiency Trust: New Estate Planning Pitfalls of Keeping the Status Quo - Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (or: why you'll learn to love the Delaware Tax Trap)*, leimbergservices.com/collection/LISIMorrow2.doc.

¹⁰⁰ Raatz, *'Delaware Tax Trap'*, *supra* note 97, at 01.

¹⁰¹ See Louis S. Harrison & John M. Janiga, *Discounts vs. Step-Up Basis: Tax Rate Arbitrage Gone Bad (or Not as Good as Expected)?*,

<http://www.harrisonheld.com/sites/default/files/HarrisonColumn.pdf>.

¹⁰² Blattmachr & Pennell, *Using*, *supra* note 65.

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 244.

¹⁰⁵ I.R.C. § 2613(a)(1).

¹⁰⁶ Blattmachr & Pennell, *Using*, *supra* note 65, at 242.

¹⁰⁷ *Id.* at 244.

¹⁰⁸ *Id.* at 245.

¹⁰⁹ *Id.* at 244.

¹¹⁰ Morrow, *supra* note 99, at 31.

¹¹¹ Blattmachr & Pennell, *Using*, *supra* note 65.

¹¹² See, e.g., Raatz, *How To*, *supra* note 99, Spica, *A Practical Look*, *supra* note 99, and Morrow III, *supra* note 99.

¹¹³ I.R.C. § 1014(a). Interestingly, community property states are afforded an even greater benefit: a double basis-step up. IRC § 1014(b)(6).

¹¹⁴ I.R.C. § 1014; *cf.* I.R.C. § 1015(a).

¹¹⁵ Raatz, *'Delaware Tax Trap'*, *supra* note 95, at 1.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.* at 2.

¹¹⁹ *Id.* at 1.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² Blattmachr & Pennell, *Using*, *supra* note 65, at 245.

¹²³ Raatz, *'Delaware Tax Trap'*, *supra* note 95, at 01.

¹²⁴ *Id.* at 3.

¹²⁵ *Id.*

¹²⁶ *Id.* at 3-4.

¹²⁷ *Id.* at 4.

¹²⁸ *Id.* at 7. There may be other states where the described variant may work, including Idaho, Rhode Island, Pennsylvania, and Virginia. Raatz, *How To*, *supra* note 104, at 8.

¹²⁹ Raatz, *'Delaware Tax Trap'*, *supra* note 95, at 7.

¹³⁰ *Id.* at 7.

¹³¹ *Id.* at 8.

¹³² *Id.*

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- ¹³³ *Id.*
- ¹³⁴ Morrow III, *The Optimal Basis Increase*, *supra* note 99, at 14.
- ¹³⁵ *Id.* at 17.
- ¹³⁶ *Id.*
- ¹³⁷ *Id.* at 18.
- ¹³⁸ *Id.*
- ¹³⁹ *Id.*
- ¹⁴⁰ *Id.* at 31.
- ¹⁴¹ Blattmachr & Pennell, *Using*, *supra* note 65, at 245.
- ¹⁴² Morrow III, *The Optimal Basis Increase*, *supra* note 99, at 31.
- ¹⁴³ *Id.*
- ¹⁴⁴ *Id.* at 20.
- ¹⁴⁵ *Id.* at 31.
- ¹⁴⁶ *Id.*
- ¹⁴⁷ *Id.* The “specific, partial and targeted use” of the Trap appears to be sanctioned by the I.R.S. See Treas. Reg. §20.2041-3(e)(2) and Treas. Reg. §25.2514-3(d).
- ¹⁴⁸ *Id.* at 32.
- ¹⁴⁹ *Id.* Compare the *Restatement of Property, Second, Donative Transfers*, §§13.2 and 13.5, with *Restatement of Property, Second, Donative Transfers* §§13.4 and 13.6.
- ¹⁵⁰ *Id.*