The Optimal Basis Increase and Income Tax Efficiency Trust

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)\(^1\)
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IX. Summary – also see attached Comparison Chart 75

Appendix – frequently cited statutes, author bio, sample clauses, proposed statutory amendment to state rule against perpetuities law, comparison chart

\(^{1}\) Portions of this outline were presented at other CLEs 2011-2013 and were published in Leimberg Information Services– LISI Estate Planning Newsletter #2080 (March 20, 2013). © 2011-2013 Edwin P. Morrow III and KeyBank, NA – Contact author for later updates to be made to this outline. Constructive criticism appreciated.
“It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change.” – Charles Darwin

For many taxpayers, the traditional trust design for married couples is now obsolete. This article will explore better planning methods to maximize basis increase for married couples (and, for future generations), exploit the newly permanent “portability” provisions, maximize adaptability to future tax law, enable better long-term income tax savings and improve asset protection over standard “I love you Wills” and over standard AB trust planning. Primarily, this article focuses on planning for married couples whose estates are under $10.5 million, but many of the concepts herein apply to those with larger estates as well.

First, we’ll describe the main income tax problems with the current design of most trusts in light of portability and the new tax environment – and problems with more simplified “outright” estate plans. In Part II, we’ll describe potential solutions to the basis issue, including the use of various marital trusts (and the key differences between them), and why these may also be inadequate. In Part III, we’ll explore how general and limited powers of appointment and the Delaware Tax Trap can achieve better tax basis adjustments than either outright bequests or typical marital or bypass trust planning. I will refer to any trust using these techniques as an Optimal Basis Increase Trust ("OBIT"). In Part IV, we will discuss how these techniques accommodate disclaimer based planning (or disclaimers from lack of planning). Parts V and VI divert to the “double step up at first death” techniques and ancillary asset protection considerations. Part VII discusses the tremendous value of applying OBIT techniques to pre-existing irrevocable trusts. Lastly, in Part VIII, we’ll discuss various methods to ensure better ongoing income tax treatment of irrevocable trusts – not just neutralizing the negatives of trust income taxation, but exploiting loopholes and efficiencies unavailable to individuals. I will refer to these two groups of techniques taken together as an Optimal Basis Increase and Income Tax Efficiency Trust, features of which are summarized in the attached chart in the appendix.²

² No trademark claimed, “Super-Duper Charged Credit Shelter Trust” was apparently unavailable…
Responding to the Portability Threat -- and Opportunity

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“2010 Tax Act”) introduced a profound change to estate planning that was recently confirmed by the American Taxpayer Relief Act of 2012 (“ATRA”). Section 303 of the 2010 Tax Act, entitled “Applicable Exclusion Amount Increased by Unused Exclusion Amount of Deceased Spouse”, is commonly known as “portability”.\(^3\) ATRA recently made this provision permanent, along with a $5,000,000 exemption for estate, gift and generation skipping transfer tax, adjusted for inflation (even with low inflation, it has already increased to $5,250,000).\(^4\)

The concept of portability is simple: the surviving spouse gets any unused estate tax exclusion of the deceased spouse provided the Form 706 is properly filed. While it does have various flaws and quirks, portability goes quite far to correct a basic injustice that would otherwise occur when the beneficiaries of a couple with no bypass trust planning pay hundreds of thousands (if not millions) more in estate tax than the beneficiaries of a couple with the same assets who die without any trust planning.

Portability has been described as both the “death knell” of the AB Trust\(^5\) as well as a “fraud upon the public”.\(^6\) Ubiquitous popular financial press articles now refer to the “dangers” of traditional AB trust planning or the “death of the bypass trust”. While these charges have some surface justification, they all fail to see the tremendous income tax and asset protection opportunities opened up to trusts by the new law – if trusts are properly adapted.

The lure of portability and a large exemption is indeed a siren song for some married taxpayers to avoid trusts. Like Odysseus, we should listen to it despite of our misgivings. The new exemption level, coupled with the advantages of portability, eliminates what was previously the most easily quantifiable reasons to do trust planning – saving estate tax - for

\(^3\) Section 303 of Public Law 111-312, known as the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

\(^4\) Rev. Proc. 2013-15

\(^5\) E.g. “AB Trust can be hazardous to your health”, “Serious tax consequences to AB Trust owners” “Portability Threatens Estate Planning Bar”, “Is it time to bypass the bypass trust for good?”, and dozens more

\(^6\) Frequent Trusts and Estates author Clary Redd at May 2011 Advanced Trust Planning CLE, Dayton, Ohio - to be fair, he made this comment before the provision was made permanent.
the vast majority of taxpayers. More than that, however, the new tax environment seemingly deters taxpayers from using trusts through significant income tax disparities, despite the many non-tax reasons for using them.

What’s wrong with the traditional AB trust?

1) No Second “Step Up” in Basis for the B Trust for the Next Generation. Imagine John leaves his wife Jane $3 million in a bypass trust and Jane outlives him 10 years. Over that time the income is spent but the fair market value has doubled to $6 million. Jane has her own $3 million in assets. At Jane’s death, their children inherit assets in the bypass trust with only $3.5 million in basis (assuming net $500,000 realized gains over depreciation or realized losses). Had John left his assets to her outright or to a differently designed trust and Jane elected to use her Deceased Spousal Unused Exclusion Amount (DSUEA), heirs would receive a new step up in basis to $6 million, potentially saving them $750,000 or more!

2) Higher Ongoing Income Tax. Any income trapped in a typical bypass or marital trust over $11,950 is probably taxed at rates higher than the beneficiary’s, unless the beneficiary makes over $400,000 ($450,000 married filing jointly) taxable income. Including the new Medicare surtax, this might be 43.4% for short-term capital gains and ordinary income and 23.8% for long-term capital gains and qualified dividends. This is a staggering differential for even an upper-middle class beneficiary who might be subject to only 28% and 15% rates respectively.

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7 $3 Million gross gain, assuming $500,000 of gain was realized over time, not counting loss in basis due to depreciation, $2.5 million times a hypothetical 30% combined federal (23.8%) and state (net 6.2%) long term capital gains tax – this may be more if collectibles/gold/1250 depreciation recapture, or if the assets were real estate, one might look at it as depreciation lost and consider the income that could have been offset by the extra basis, which might drive this estimated loss to beneficiaries even higher (though you would have to back out for present value). Of course, if heirs never sell the property (and depreciation does not apply) and hold until death, losses resulting from decreased basis would be non-existent. In short, it’s a rough “guesstimate”.
3) **Special assets can cause greater tax burden in trust.** Assets such as IRAs, qualified plans, deferred compensation, annuities, principal residences, qualifying small business stock and S corporations are more problematic and may get better income tax treatment left outright to a surviving spouse or to a specially designed trust – retirement plan assets left outright get longer income tax deferral than assets left in a bypass trust.\(^8\) Outright bequests of such assets get around many problematic “see-through trust” rules and the minefield of planning and funding trusts with “IRD” (income in respect of a decedent) assets.\(^9\) Other assets, such as a personal residence, have special capital gains tax exclusions or loss provisions if owned outright or in a grantor trust.\(^10\) Ownership of certain businesses requires special provisions in the trust that are sometimes overlooked in the drafting, post-mortem administration and/or election stages.\(^11\)

Yet outright bequests are not nearly as advantageous as using a trust. The best planning should probably utilize an ongoing trust *as well as* exploit portability, which will be discussed in the next section.

**Why not just skip the burdens of an ongoing trust?**\(^{12}\) Here’s a quick dozen reasons:

1) A trust allows the grantor to make certain that the assets are managed and distributed according to his/her wishes, keeping funds “in the family bloodline”. Sure, spouses can agree not to disinherit the first decedent’s family, but it happens all the time – people move away, get sick and get remarried – the more time passes, the more the

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\(^8\) An exception would be qualified plans/IRAs that the decedent had previously inherited and was unable to rollover into their own name outright (as surviving spouses typically do).

\(^9\) For a checklist of reasons why to use a trust and drafting and administration issues to consider if you do name a trust as beneficiary, email the author for CLE outline and checklist. Also, attorney/CPA Sal LaMendola will soon publish a superb comparison of IRA/trust options for second marriage situations in an article to be entitled *Estate Planning for Retirement Plan Owners in Second (or Later) Marriages*.

\(^10\) IRC §121

\(^11\) For S Corp qualification, including QSST and ESBT, see IRC §1361 et seq., for small business stock exclusion and rollovers, see IRC §1202 and §1045, for losses on qualifying small business stock, see IRC §1244

\(^12\) I will avoid the probate/non-probate revocable trust debate, since probate costs and fees will vary from state to state. A bypass or marital trust might be a testamentary trust.
likelihood of a surviving spouse remarrying or changing his or her testamentary disposition.\textsuperscript{13}

2) Unlike a trust, assets distributed outright have \textbf{no asset protection from outside creditors} (unless, like an IRA or qualified plan, the asset is protected in the hands of the new owner) - whereas a bypass trust is ordinarily well-protected from creditors;

3) Unlike a trust, assets distributed outright have \textbf{no asset protection from subsequent spouses when the surviving spouse remarries}. Property might be transmuted or commingled to be marital/community property with new spouse. If it is a 401(k) or other ERISA plan, it might be subject to spousal protections for the new spouse (which cannot be cured via prenup, and become mandatory after a year of marriage).\textsuperscript{14} Most states also have spousal support statutes which require a spouse to support the other - and there is no distinction if it is a second, third or later marriage. Also, most states have some form of spousal elective share statutes that could prevent a surviving spouse from leaving assets to children to the complete exclusion of a new spouse;

4) Unlike a trust, assets left outright \textbf{save no STATE estate or inheritance tax} unless a state amends its estate tax system to allow similar DSUEA elections (don’t hold your breath – none have yet). This savings would be greater in states with higher exemptions and higher rates of tax, such as Washington State (19% top rate) or Vermont (16% top tax rate), both with $2Million exemptions. Assuming growth from $2 million to $3 million and a 16% state estate tax rate, that savings would be nearly $500,000!

5) Unlike a bypass trust, income from assets left outright \textbf{cannot be “sprayed”} to beneficiaries in \textbf{lower tax brackets}, which gets around gift tax but more importantly for

\textsuperscript{13} A contract to make a will may offer a tempting solution, but there are significant problems with those that exceed the scope of this paper, such as triggering a prohibited transaction as to retirement plan assets or disqualifying assets from marital deduction, not to mention various practical enforcement complexities
\textsuperscript{14} See the Retirement Equity Act of 1984, IRC §401(a)(11), IRC §417(d)(1), Treas. Reg. §1.401(a)(20), Q&A 28
most families can lower overall family income tax – remember, the 0% tax rate on 
qualified dividends and long-term capital gains is still around for lower income taxpayers!

6) The Deceased Spousal Unused Exclusion Amount (DSUEA), once set, is not indexed 
for inflation, whereas the Basic Exclusion Amount (the $5 million) is so adjusted after 
2011 ($5.25 million in 2013). The growth in a bypass trust remains outside the surviving 
spouse's estate. This difference can matter tremendously where the combined assets approximate $10.5 million and the surviving spouse outlives the decedent by many 
years, especially if inflation increases or the portfolio achieves good investment returns;

7) The DSUEA from the first deceased spouse is lost if the surviving spouse remarries 
and survives his/her next spouse’s death (even if last deceased spouse’s estate had no 
unused amount and/or made no election). This result, conceivably costing heirs $2.1 
million or more in tax, restrains remarriage and there is no practical way to use a 
prenuptial (or postnuptial) agreement to get around it;

8) There is no DSUEA or “portability” of the GST exemption. A couple using a bypass 
trust can exempt $10.5 million or more from estate/GST forever, a couple relying on 
portability alone can only exploit the surviving spouse’s $5.25 million GST exclusion. This 
is more important when there are fewer children, and especially when these fewer 
children are successful (or marry successfully) in their own right. For example, a couple 
has a $10.5 million estate and leaves everything outright to each other (using DSUEA), 
then to a trust for an only child. Half will go to a GST non-exempt trust (usually with a 
general power of appointment), which can lead to an additional $5.25 million added to 
that child’s estate – perhaps needlessly incurring more than $2 million in additional 
estate tax.

9) Unlike a bypass trust, portability requires the executor to timely and properly file an 
estate tax return to exploit the exclusion. This is easy for non-professional
executor/trustees to overlook and lose. Unlike some areas of tax law, the IRS is not authorized here to grant exceptions or extensions for reasonable cause;

10) Unlike a bypass trust, outright bequests cannot be structured to better accommodate incapacity or government benefits (e.g. Medicaid) eligibility planning.¹⁵

11) A bypass trust can exploit the serial marriage loophole. Example: John Doe dies leaving his wife Jane $5.25 million in a bypass trust. She remarries and with gift-splitting can now gift $10.5 million tax-free. If husband #2 dies using no exclusion – Jane can make the DSUEA election and have up to $10.5 million Applicable Exclusion Amount (AEA), even with the $5.25 million in the bypass trust John left her, sheltering over $15.75 million (three exclusion amounts, not adjusting for inflation increases) for their children without any complex planning, not even counting growth/inflation. Had John and Jane relied on outright or marital trust, even w/DSUEA, their combined AEA would be capped at two exclusion amounts ($10.5 million, not adjusting for inflation increases) – a potential loss of over $2 million in estate tax.

12) Portability only helps when there is a surviving spouse. It may not work in a simultaneous death situation, whereas a bypass trust with proper funding or a simultaneous death clause imputing John as the first to die and Jane as survivor would.¹⁶

Example: John has $8 million in assets, Jane $2.5 million. There is no community property. John believes the popular press and thinks he can rely on portability and the DSUEA to kick in and shelter their $10.5 million. But, John and Jane are in a tragic accident together. Neither John nor Jane has a surviving spouse. John’s estate

¹⁵ Strangely enough, there may be a difference here between a testamentary and living trust. See 42 U.S.C. § 1396p(d)(6); HCFA Transmittal 64 § 3259.1(A)(1)

¹⁶ See Treas. Reg. §20.2056(c)-2(e) – had John’s will/trust had an A/B split or QTIPable trust with a simultaneous death clause stating that Jane is deemed to have survived him that would have overridden the Uniform Simultaneous Death Act and the IRS would respect the marital trust and hence add enough assets to Jane’s estate to use both exemptions. When the order of death can be determined, you cannot simply change the order in the Will/Trust for “surviving spouse” purposes. See Estate of Lee v. Commissioner, T.C. Memo 2007-371. If we include a presumption that Jane dies first, will the IRS respect John as a “surviving spouse” for purposes of DSUEA? Probably, but we have no guidance yet – temporary regs do not mention this issue.
cannot elect to use $2.75 million of Jane’s wasted Basic Exclusion Amount and now their family needlessly pays a tax on John’s estate of $1,100,000 ($2.75 million excess times 40%).

Thinking Outside the “Outright Bequest v. Bypass Trust” Box

Of course, simple outright gifts and traditional bypass trust planning are not the only two options – and they need not be “all or nothing”. Disclaimer funded bypass trusts allow the surviving spouse to choose how much is allocated between those two options. The chief disadvantage of disclaimer planning is that it usually prohibits the surviving spouse from using powers of appointment for greater flexibility (see Part IV) and requires timely and proactive analysis and action (and, just as importantly, restraint) immediately after the death of a loved one. As discussed further herein, this loss in flexibility may cost the family dearly.

Attorneys may wish to consider a savings clause/funding variant similar to the Clayton QTIP17 to save the use of the exclusion via bypass trust even if the Form 706 filing to claim portability is botched.18 The Clayton QTIP/bypass trust combination may also save additional basis if the surviving spouse dies within 15 months.

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17 Clayton v. Commissioner, 976 F.2d 1486 (5th Cir 1992) – decedent’s Will directed that if a QTIP election was not made for a trust that the assets moved to bypass trust with different dispositive provisions. See also Treas. Reg. §20.2056(b)-7(d)(3) “a qualifying income interest for life that is contingent upon the executor’s election under Section 2056(b)(7)(B)(v) [QTIP] will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse.”

18 Example: John wishes to leave his $5 million estate to his longtime wife Jane outright (ignoring all the reasons herein for ongoing trusts), but he certainly does not want to lose his exclusion amount, because his wife Jane also has a $5 million estate. His attorney therefore drafts a savings clause in his Will (or revocable trust) that leaves his available exclusion amount to a bypass trust, but if a proper estate tax return is timely filed to exploit the DSUEA (and the will/trust provisions may even require this, though this might give up some post-mortem flexibility), the assets instead go outright to his wife to the extent of the election. Thus, if the executor files the Form 706 timely and successfully “ports” $5 million DSUE, then $5 million goes outright. If the executor fails to timely file the Form 706 (or opts out), then $5 Million goes into a liberal bypass trust for Jane. Either way, the exclusion is saved.

An independent executor/trustee may be desired here. A surviving spouse would have obvious conflicts with his or her fiduciary duties to other beneficiaries by filing such an election and potentially gift tax issues as well, unless the filing were mandated in the document (in this example that may be best). Even if an independent party is named, it may be best to outline parameters or indemnify the executor from diverse ranges of elections selected.

Drafting Example: “I leave my entire residuary outright to my surviving spouse, on the precondition that my personal representative (or my trustee if no personal representative is appointed, pursuant to IRC § 2203) makes an effective election on an estate tax return pursuant to IRC §2010(c) to grant my wife the use of my Deceased Spousal Unused Exclusion Amount. Should for any reason (intentional or unintentional), such an election is not effectively made, or is made for less than maximum amount available, I hereby leave the maximum amount possible without incurring a federal estate tax to the Bypass Trust described in Paragraph __,
Example: John dies leaving $1.25 million IRA outright and $4 million in non-IRA assets to his wife Jane in trust. To the extent a QTIP election is not made, the $4 million will go into a flexible bypass trust. If the QTIP election is made, the $4 million will go into a QTIP trust for Jane. Jane dies a year later with $5 million of her own assets (including the rollover IRA), and John’s trust has since appreciated to $5 million. John’s estate makes the QTIP election and elects to port all $5.25 million DSEU, Jane’s estate includes her $5 million, plus the $5 million QTIP, and the entire estate receives a new basis (absent IRD/IRA). Conversely, John’s executor would not make the QTIP election had the market dipped and John’s trust depreciated to $3 million, to save from a “step down” in basis.

Clayton QTIP arrangements have the added benefit over disclaimer funded trusts of permitting limited powers of appointment, as well as the six months of additional window of opportunity. Moreover, they do not have dicey acceptance and control issues as with qualified disclaimer rules, nor the potential for fraudulent transfer, Medicaid or tax lien issues for disclaimants. Parties often assume joint brokerage accounts, for instance, can easily be disclaimed but tracing who contributed the funds may be crucial to disclaiming such accounts. However, Clayton QTIP arrangements are best made with an independent executor, whereas the identity of the executor with disclaimers is irrelevant.

Extreme, but not uncommon, scenarios such as this could save hundreds of thousands of dollars in basis by building flexibility into the plan. Even a heavy bond portfolio (approximately 10 yr duration) could easily decrease in value 25% if interest rates went up a couple percentage points. Practitioners may want to file for a six month extension on Form 706 even if no estate tax would be due to buy an additional time, unless one of the preferred Optimal Basis Increase Trust design options, discussed in Part III, is utilized.

and any remaining residuary above this amount shall pass to my surviving spouse outright”.[I hereby indemnify my executor from any such election or failure to elect (be it partial, to the maximum extent or not made at all) made in good faith.] [NB: fractional formula variations on this would be desirable if IRD is involved].


20 Treas. Reg. §25.2518-2(c)(4)(iii), even though IRC §2040(b) would deem 50% to be in each spouse’s estate

21 http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/P204318 - 2% or more jumps happened several times in the late 70s, early 80s.
Part II - Using Marital Deduction Trusts and Other Options to Avoid Basis Stagnation

“Primum, non nocere.” First, do no harm. – dictate from physician’s Hippocratic Oath

There are other alternatives that get us closer to preserving the best basis increase for the family. First, let’s consider the use of marital deduction trusts even when it would not be needed to reduce estate tax. This may strike some people as very odd – why would someone use a marital deduction trust if there is no need for the marital deduction?

Aside from the potential state estate tax deferral/savings, marital trusts receive a second step up in basis without sacrificing the asset protection and control of a trust. Succeeding trusts/beneficiaries generally receive a new basis when assets are in the surviving spouse’s estate in a general power of appointment (GPOA) marital trust or a qualified terminal interest property (QTIP) marital trust.22

The QTIP marital trust can be more restrictive at second death than a GPOA marital trust, by restricting or even eliminating the surviving spouse’s power to appoint.23 Because of this and other advantages, QTIPs are by far the most preferred.24 However, especially in smaller estates of couples with children of the same marriage, and states with no state estate tax, the GPOA marital trust may see a rise in popularity because couples don’t need to file a Form 706 to get the second step up in basis and won’t get hit with additional valuation discounts hampering basis increase.

Example: John and Jane, married, in their mid 70s, have less than $1 million each. They wish to leave assets in trust to each other for all the various non-tax reasons herein, but want to preserve the second step up in basis at the second death. Using a QTIP design requires the first decedent’s executor to file a costly Form 706 with the appropriate QTIP election - otherwise, it’s no different than a bypass trust, and won’t get a step up in basis at the second spouse’s death. However, using a GPOA marital trust does not require such a

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22 IRC §1014(b)(6),(9), (10). There is also a less common “estate trust” which is even less commonly used.
23 At IRC §2056(b)(7) and IRC §2056(b)(5) respectively
24 If the GPOA does not bother a client for non-tax reasons, most of the other advantages, like reverse QTIP and optimizing GST, flexible use of previously taxed property credit if deaths within 15 months or valuation discounts, really only apply to taxable estates – irrelevant to more than 99% of the population now.
filing. Even if no Form 706 is filed at the first death, assets in the GPOA marital get a new adjusted basis at the second death.\textsuperscript{25}

Moreover, GPOA trusts may also be preferred for taxpayers in the 99% who would fund a portion of real estate or fractional interests in LLCs/LP/S Corps, e.g., into trust.

Example: John and Jane, in the example above, plan to fund their trust with their 50% interest in a home, total value $600,000 and 50% of rental property LLC, underlying asset value $500,000. If a QTIP is used, the surviving spouse’s estate must value the ½ in the QTIP and the ½ in the surviving spouse’s estate separately, generating a fractional interest, and/or marketability, non-controlling interest “discount”.\textsuperscript{26} At second death, these “fair market values” might total $500,000 and $300,000 respectively, rather than $600,000 and $500,000. This reduction in valuation would be optimal planning if Jane had a taxable estate, but for most people, “discounting will save no estate tax and cost the heirs significant basis increase” – for Jane and John’s family, $300,000. Had the 50% interest in the home and 50% LLC interest gone to a GPOA marital trust for the survivor, the two halves would be valued together for estate tax at the second death, and therefore retain full FMV of basis.\textsuperscript{27}

GPOA trusts may also be preferred for taxpayers in states such as New York and New Jersey that do not permit a separate state QTIP election.\textsuperscript{28}

Another reason marital GPOA trusts might be preferred for taxpayers with estates under the applicable exclusion amount is the potential threat posed by IRS Rev. Proc. 2001-38. Rev. Proc. 2001-38 outlines a procedure to permit taxpayers and the IRS to disregard a QTIP election, even though the election is irrevocable, under certain circumstances. It was clearly designed to help taxpayers who unnecessarily over/qtipped what should have remained a bypass trust. There is no indication yet that the IRS will use it as a weapon of attack, against a taxpayer’s interests, yet it does purportedly allow them to “disregard the [QTIP] election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7),

\textsuperscript{25} Under IRC § 1014(b)(9), not IRC §1014(b)(10)
\textsuperscript{26} See, e.g. Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999), acq. 1999-2 C.B. 314
\textsuperscript{27} See, e.g. Estate of Fontana v. Commissioner, 118 T.C. 318 (2002), IRS FSA 200119013, interpreting Treas. Reg § 20.2031-1(b), see IRC §754 for inside basis election for partnership/LLCs.
\textsuperscript{28} See, The General Power of Appointment Trust is Back, Bruce Steiner, LISI Estate Planning Newsletter #2060 (February 6, 2013).
2519(a) and 2652.”

Since the basis rules under IRC §1014(b)(10) reference inclusion via IRC §2044, this would be a problem in preserving a second basis increase, because denying the QTIP election would deny inclusion under IRC §2044, and hence deny the new basis. There are persuasive arguments that this Rev. Proc. should not entitle the IRS to retroactively disregard a validly made QTIP election on their own accord. However, until the IRS issues further guidance, some practitioners may prefer to avoid the issue altogether and use a marital GPOA (or use inter vivos QTIPs, to which the Rev. Proc. does not apply if your state has fixed other inter vivos QTIP problems). This will depend on whether a GST/reverse QTIP election would be used, the compatibility of the estate plan with powers of appointment and other factors. QTIPs will probably remain the preferred vehicle for potentially estate taxable estates.

Thus, marital trust planning can combine the income tax basis benefit of the outright/portability option with the estate preservation and the asset protection planning advantages of a bypass trust. Marital trusts can solve the first major drawback of the bypass trust discussed above - basis, and can solve most of the twelve drawbacks of outright planning discussed in Part I above.

But we can do even better. After all, marital trusts typically don’t solve the higher ongoing income tax issue, and are problematic in that they also receive a second step down in basis. Moreover, they cannot spray income as a bypass trust could and they are leaky for both asset protection and tax reasons, because of the mandatory income requirement. They provide greater complications for see-through trust status (aka “stretch IRAs”), especially for GPOA marital trusts. They cannot use broad lifetime limited powers of appointment – which can be important for gifting and income tax planning techniques discussed in Part VIII. They

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29 IRS Rev. Proc. 2001-38, see also PLRs 2009-18014, 2007-29028, 2010-36013, voiding valid QTIP elections
30 The problem with inter-vivos QTIPs is that, after the death of the donee spouse, if assets come back to the donor spouse in trust, even though IRC §2044(c), Treas. Reg. §25.2523(f)-1(f), Example 11 would deem the donee spouse the grantor/transferor for 2036/2038 purposes, under most state laws, the donor spouse is still the settlor, making the trust self-settled and therefore subject to the donor’s creditors despite any discretionary standard or spendthrift provision, and therefore in the donor spouse’s estate indirectly under IRC §2041. See also Rev. Rul 76-103. States that have recently fixed this issue are Arizona (Ariz. Rev. Stat. 14-10505(E)), Michigan (MCL §700.7506(4)), Virginia (Va.Code 55-545.05(B)), Ohio (effective March 27, 2013, Ohio R.C. §5805.06(B)(3)(b)), Delaware (12 Del Code 3536(c)(2), Florida (Fla Stat. 736.0505(3)))
cannot be used by non-traditional couples who are not officially recognized as “married.”

Furthermore, they simply won’t be as efficient in saving state estate taxes or federal estate taxes, especially if the surviving spouse does live long and assets appreciate significantly, since the DSUEA amount is not indexed for inflation.

**What ways other than using marital deduction trusts could we achieve a second step up in basis at the surviving spouse’s death on assets in a bypass trust?**

We could build greater flexibility to accomplish the same goals by either:

1) giving an independent trustee (or co-trustee, or “distribution trustee”) discretion to distribute up to the entire amount in the bypass trust to the surviving spouse;

2) giving an independent trustee or trust protector the power to add or create general testamentary powers of appointment, or effecting the same via decanting or other reformation under state law;

3) giving another party or parties (typically a child, but it could be a friend of spouse or non-beneficiary), a non-fiduciary limited lifetime power to appoint to the surviving spouse; 

4) if the trust otherwise qualifies, and no return was ever filed to not make a QTIP election, try to file a late Form 706 and make a late QTIP election.

5) giving the surviving spouse a limited power to appoint, but enabling both the appointment and the appointive trust to trigger the Delaware Tax Trap over the appointed assets;

6) giving the surviving spouse a limited power to appoint that alternatively cascades to a general power to the extent not exercised.

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31 Although since the Supreme Court recently struck down Section 3 of the Defense of Marriage Act (DOMA), at least some same sex married couples will now get the marital deduction – however, the case does not resolve the situation of couples legally married in one state but residing in a state that does not recognize the marriage.

32 This is known as a collateral power, See Restatement Property, Third, Donative Transfers, §17.3, comment f

33 IRC §2041(a)(3), IRC §2514(d). While it’s very simple to add a limited power of appointment (LPOA) that would in theory permit this, understanding the DTT involves what may be uncertain state law and considerable complexity. States such as Michigan and Ohio have recently amended their Rule Against Perpetuities to specifically prevent most unintentional triggerings of the “trap”, but clearly permit intentional triggerings by appointing to a trust that has a presently exercisable **general** power of appointment and therefore triggering IRC 2041(a)(3). See Ohio R.C. §2131.09 (changes effective 3/27/2013), and a comprehensive article on the subject from Attorney James Spica regarding Michigan’s RAP at http://www.michbar.org/probate/pdfs/Summer08.pdf
7) giving the surviving spouse a general power to appoint appreciated non-IRD assets up to the surviving spouse’s remaining applicable exclusion amount.

This article will focus on the advantages of the last three of these, referred to as an Optimal Basis Increase Trust. The problem with the first two above techniques, which involve placing the burden on the trustee or trust protector, is that they are often impractical and require an extraordinary amount of proactivity and omniscience, not to mention potential liability for the trustee/trust protector. Gallingly, clients don’t tell us when they are going to die, hand us accurate cost basis and valuation statements, marshal beneficiary agreement and give us enough time to amend, decant or go to court to change the estate plan to maximize tax savings. Furthermore, fiduciaries taking such drastic steps are likely to wish to hire counsel, get signed waivers, or consult a distribution committee – time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill.

Distributing assets outright to the surviving spouse, even if clearly under the authority of the trustee, protector or donee of a power of appointment, risks losing the asset protection for the family and risks a disinheriance or removal outside in the family bloodline. Plus, we’ve all heard cases of someone on death’s door that miraculously makes a full recovery and lives another decade or more. Once the assets are out of trust, you can’t simply put them back in and have the same tax results.

Adding a general testamentary power of appointment does not have the same level of risk, nor the same destruction of asset protection from outside creditors, as an outright distribution.35 Some trusts will have a trust protector provision that allows this, and a few states have a decanting statute that allows GPOAs to be added.36 However, it merely begs the question – if it’s worth doing later, why isn’t it worth doing now?

34 A rather clever variation that the IRS fought, lost and finally acquiesced to in Chisholm v. Commissioner, 26 T.C. 253 (1956), but beware Restatement of Property, Second, Donative Transfers §13.1(c), which would deem any LPOA to be a GPOA if the gift in default of exercise were to pass to the powerholder’s estate.

35 See Restatement of Property, Second, Donative Transfers, §13.2 Creditors of the Donee - Unexercised General Power Not Created by Donee. If creditor protection is a potential threat, and state law is unfavorable, consider the LPOA/DTT variant (assuming of course, state law easily allows triggering the trap).

36 For a state that does, see Ohio R.C. §5808.18(A)(3)(a)
The third technique, using a limited lifetime power of appointment, avoids some of these drawbacks, but breeds others. We have all seen cases where a spouse remarries, and perhaps one child would happily distribute 100% to mom or dad whenever they asked, but the other children would be livid (and potentially disinherit indirectly by their sibling). There is no reason that such a lifetime limited power to appoint could not be made conditional upon unanimous consent of the children, but this of course brings up the possibility of one child’s obstinace holding back the family’s tax planning.

The 4th technique above, making a late QTIP election, may surprise people. Some bypass trusts might qualify as a QTIP with the proper election (e.g. if spouse is sole beneficiary during his or her lifetime and entitled to demand/receive all net income). A QTIP election can be made on the last timely filed estate tax return, or, if no timely return is filed, on the first late return.\textsuperscript{37} This might be a full or, perhaps better for Rev. Proc 2001-38 reasons, partial election. You need not reopen a probate estate to appoint an executor, the trustee may file.\textsuperscript{38} If estate administration is finished, it may be too late to divide a trust subject to partial election into two separate trusts for optimal efficiency.\textsuperscript{39} Additionally, you have to wonder how many years later the IRS would permit this. Could the trustee even wait until after the death of the surviving spouse? Would the QTIP election “relate back” to reliably cause inclusion in the surviving spouse’s estate to seize the additional step up in basis? And, are there assets that would “step down”?

So, how do we better ensure that assets get a step up, not a step down, don’t cause extra state estate tax (or federal), and get better ongoing income tax treatment and asset protection than a typical bypass or marital trust, without the above drawbacks?

We’ll now turn to the final three methods above, which use formula powers of appointment to allow for firmer and more precise tax planning. I will refer to all of these variants together as an Optimal Basis Increase Trust (OBIT).

\textsuperscript{37} Treas. Reg. 20.2056(b)-7(b)(4)(i)
\textsuperscript{38} Treas. Reg. 20.2056(b)-7(b)(3)
\textsuperscript{39} Treas. Reg. 20.2056(b)-7(b)(2)
**Part III - The Optimal Basis Increase Trust (OBIT)**

Using testamentary general and limited powers of appointment more creatively can assure that assets in the trust receive a step up in basis, but not a step DOWN in basis, and these powers can be dynamically defined or invoked so as to not cause additional state estate tax.

**Example:** John Doe dies in 2013 with $2 Million in assets left in trust for his wife Jane. She files a Form 706 and “ports” $3.25 million DSUE. We’ll assume that most of this gain has been realized, though with more tax efficient or buy/hold strategy, realization may be less. After 8 years, when she dies, these trust assets have grown to $4 million, as follows:

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional deductible IRA</td>
<td>$0</td>
<td>$700,000</td>
</tr>
<tr>
<td>Total “IRD” Property</td>
<td>$0</td>
<td>$700,000</td>
</tr>
<tr>
<td>Apple Stock (the iPhone 9 flopped)</td>
<td>$500,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Condo in Florida (hurricane depresses value)</td>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>LT Bond portfolio (inflation depressed value)</td>
<td>$400,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Various stocks that have decreased in value</td>
<td>$150,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total “loss” property</td>
<td>$2,050,000</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>Rental Real Estate</td>
<td>$200,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Various stocks that have increased in value</td>
<td>$400,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>ST Bond Portfolio, Money market</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Gold</td>
<td>$100,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total “gain” property</td>
<td>$1,100,000</td>
<td>$2,100,000</td>
</tr>
<tr>
<td>Total at Jane’s death</td>
<td>$3,150,000</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

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40 In many cases, I would not recommend that an IRA be used to fund a bypass trust, since a spousal rollover has better income tax treatment, but it may be preferable when needed to soak up state estate tax exemption, or for various non-tax reasons. This is mostly included to show the lack of effect on basis on IRD at death. If an accumulation trust (as opposed to conduit trust) design is used, consider a separate or standalone trust so that no broad power to appoint can be construed to apply to the retirement benefits. Blanket savings clauses may not save the stretch, especially since most POAs by default can include non-qualifying trusts. See *Restatement of Property, Third, Donative Transfers* §19.14, other IRA CLE and checklist materials developed by author and ¶6.3.09, *Life and Death Planning for Retirement Benefits*, 6th Edition, by Natalie Choate.

41 If real estate is held in an LLC/LP or other entity taxed as a partnership, the underlying assets do not automatically get a date of death basis even if the LLC/LP is in the decedent’s estate, but the partnership may make an election under IRC §754 to step up inside basis. Treas. Reg. §1.754-1. And where are the articles explaining how to REDUCE discounts to FLPs/FLLCs by amending operating agreements (put rights, etc)? I’ve read multiple articles stating essentially “you can just reduce the discount you take”, which is absolute nonsense.
Had John used an outright bequest, or a marital trust, all of the assets above (except the IRA) would get a new cost basis – including the loss properties.\textsuperscript{42} Had John used an ordinary bypass trust, none of the assets above would get a new cost basis, including $1 million of unrealized gains (see chart below)!

Instead, John’s Optimal Basis Increase Trust (OBIT) grants Jane a \textit{limited} power of appointment (or no power at all) over all IRD assets and assets with a basis higher than the fair market value at the time of her death (total assets $1.9 million). It grants Jane a \textit{general} power of appointment (“GPOA”) over any assets that have a fair market value greater than tax basis (total assets $2.1 million). As discussed below, this may also be accomplished with a limited power of appointment (“LPOA”) that triggers the Delaware Tax Trap.

\begin{itemize}
\item \textbf{John Doe Trust}
\item \textbf{Traditional AB Trust}
\item \textbf{John Doe Trust}
\hspace{1cm} Fbo Spouse (& poss. children)
\hspace{1cm} < $5.25mm (or basic excl)
\item \textbf{Trust for children}
\hspace{1cm} No change in basis
\item \textbf{John Doe Trust}
\hspace{1cm} Fbo spouse only QTIP,
\hspace{1cm} > $5.25mm (or basic excl)
\item \textbf{Trust for children}
\hspace{1cm} All new basis
\end{itemize}

\textsuperscript{42} Potentially, the QTIP may be worse than an outright marital transfer if there is no estate tax, since you may have discounting if, for instance, a QTIP owns half the home and the surviving spouse owns half – this would result in less basis for remaindermen than if the surviving spouse had owned the whole.
New Basis at Surviving Spouse’s Death if using: Ordinary Bypass QTIP/outright OBIT

Traditional deductible IRA $0 $0 $0
Apple Stock (the iPhone 9 flopped), $500,000 $200,000 $500,000
Condo in Florida (hurricane depresses value), $1,000,000 $600,000 $1,000,000
LT Bond portfolio (inflation depressed value) $400,000 $300,000 $400,000
Various stocks that have decreased in value $150,000 $100,000 $150,000
Rental Real Estate $200,000 $600,000 $600,000
Various stocks that have increased in value $400,000 $900,000 $900,000
ST Bond Portfolio, Money market $400,000 $400,000 $400,000
Gold $100,000 $200,000 $200,000
Total Basis for Beneficiaries at Jane’s death $3,150,000 $3,300,000 $4,150,000
**Result:** John and Jane Doe’s beneficiaries get a step up on the trust assets, but, more uniquely, do not get a “step down” in basis for any loss property (in our example, new basis is $4,150,000 versus $3,150,000 had a standard bypass trust been used and only $3,300,000 of basis had a marital trust been used. *That’s a lot of savings.* The beneficiaries (through a continuing trust or outright) get a carry over basis over any assets received via limited power of appointment (or received by default if such assets were not subject to a general power of appointment at death). This allows them to use the higher basis for depreciable assets to offset income, or sell assets to take the capital loss to offset other capital gains plus $3,000/yr against ordinary income, or hold for future tax-free appreciation up to basis.

Think people won’t die with unrealized capital losses? It happens all the time. Ask anyone who handled an estate in 2008-2009. It is a dangerous misnomer to call the basis adjustment at death a “step up” without realizing it’s equally a “step down” when assets don’t appreciate as we had wished them to, yet we are all guilty of this Pollyannaish shorthand. Increasing trust capital gains tax rates, discussed in more detail in Part II, may cause more tax sensitivity, meaning more use of individually managed bonds and equities or at least low-turnover funds or ETFs in order to decrease turnover and gains realization, which may mean even more unrealized gains in future spousal trusts.

*Why haven’t people done this before?* Besides the frustrating instability of the transfer tax regime and the smaller exemptions prior to EGTRRA, there are two main reasons: if not properly curtailed with careful drafting, it could increase estate tax exposure and decrease testamentary control by the first spouse to die. Solutions for these two issues will be discussed below. Regarding the first reason, we need to wake up and smell the new paradigm. What percentage of the population cares about the estate tax now, even with some assets included in both estates?

Let’s revisit our example above. Let’s say Jane has $3 million of her own assets. Her DSUE from her late husband John was $3.25 million (frozen, not adjusted for inflation), and her own basic exclusion amount is $6.25 million ($5.25 million plus 8 years of estimated inflation adjustments adding $1 million more). Even if she had missed the Form 706/portability filing, adding $2.1 million to her estate doesn’t even come close to her $9.5
million applicable exclusion amount. But what if Jane wins the lottery and has $9 million in her estate without John’s trust? Could this type of trust provision cause $640,000 of additional estate tax ($9 million plus $2.1 million, minus $9.5 million AEA, times 40% rate)?

Fortunately, John’s Optimal Basis Increase Trust includes a formula. The GPOA is only applicable to those assets to the extent it does not cause increased federal estate tax (and takes into account state estate tax, discussed further below). Powers of appointment can be limited in scope as to either appointees or assets. Many existing trusts already have GPOAs over only a portion of the trust (typically, the GST non-exempt share). There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula.43 All of our traditional planning has A/B/C, GST formulas that the IRS has blessed and this should be no different.44

Furthermore, the appointment could be applicable to the assets with the greatest embedded gain to satisfy this amount. The drafting difficulty is not so much in capping the GPOA but in creating the ordering formula and adjusting for individual state estate taxes.

Let’s take the non state-taxed situation first. In our lottery scenario above, Jane’s estate has only $500,000 of applicable exclusion to spare, but the appreciated “stepupable” assets of the OBIT total $2.1 million. Which assets should be stepped up first?

Assets that may incur higher tax rates, such as collectibles (artwork, antiques, or gold, in the example above) would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property,

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43 Treas Reg. §20.2041-1(b)(3) states that “(3) Powers over a portion of property. 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.” There are probably dozens of cases and rulings about limiting powers and funding trusts with “caps” - a few in the GPOA context are PLR 2001-23045, 2000-101021, 2002-10051, 2004-03094, 2006-04028

44 Formulas tied to tax exemption have always been used for AB/GST funding, and even formula gifts designed for specific tax results have had recent success in the Wandy, Petter and Christiansen line of cases, but there are good examples even in Treasury guidance. See Treas. Reg. §25.2518-3(d), Example (20) in the area of qualified disclaimers: “A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A’s surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A’s estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B’s disclaimer is a qualified disclaimer.” An OBIT formula is the same concept applied to powers of appointment - would the IRS dare to fight against such similar Treasury guidance?
which can offset current income, before allocating to stocks, bonds, raw land, family
vacation home, etc. Therefore, ultimately a weighting may be optimal, but at the most basic
level practitioners would want the GPOA to apply to the most appreciated assets first.

Some of this analysis will sound similar to those who handled estates of those who
died in 2010 when the price to pay for no estate tax was a limited step up in basis. While the
concept sounds similar, in practice, it is quite different. In 2010 the executor could choose
assets to apply a set quantity of basis to, pursuant to specific statute. Ideally, we would
like to give Jane’s executor or the trustee the power to choose the assets to comprise the
$500,000 of appointed assets – in both drafting and in practice that is deceptively simple.
However, this is quite different from 2010 carry over/step up law, and different from “pick
and choose” formula funding.

If the power of appointment is deemed to apply to a pecuniary amount (here, $500,000),
rather than a fractional formula (500,000/2100,000), it may have undesired
income tax consequences upon funding.

Thus, we should avoid simple powers of appointment over, for example, “an amount
of assets equal to my spouse’s remaining applicable exclusion amount”.

45 IRC §1022
46 See IRS Chief Counsel Memorandum (CCM) 200644020 regarding IRD assets. Also see Treas. Reg. §1.1014-
4(a)(3): “Thus, for example, if the trustee of a trust created by will transfers to a beneficiary, in satisfaction of a
specific bequest of $10,000, securities which had a fair market value of $9,000 on the date of the decedent's
death (the applicable valuation date) and $10,000 on the date of the transfer, the trust realizes a taxable gain of
$1,000 and the basis in the hands of the securities in the hands of the beneficiary would be $10,000. As a further example, if
the executor of an estate transfers to a trust property worth $200,000, which had a fair market value of $175,000
on the date of the decedent's death (the applicable valuation date), in satisfaction of the decedent's bequest in
trust for the benefit of his wife of cash or securities to be selected by the executor in an amount sufficient to
utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other
property qualifying for the marital deduction), capital gain in the amount of $25,000 would be realized by the
estate and the basis of the property in the hands of the trustees would be $200,000. If, on the other hand, the
decedent bequeathed a fraction of his residuary estate to a trust for the benefit of his wife, which fraction will not
change regardless of any fluctuations in value of property in the decedent's estate after his death, no gain or loss
would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of
the trustee would be its fair market value on the date of the decedent's death or on the alternate valuation date.”
and Treas. Reg. 1.661(a)-2(f): “(f) Gain or loss is realized by the trust or estate (or the other beneficiaries) by
reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution
of a specific dollar amount, of specific property other than that distributed, or of income as defined under section
643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is
realized if the trustee or executor makes the election to recognize gain or loss under section 643(e). This
paragraph applies for taxable years of trusts and estates ending after January 2, 2004.” Presumably the result here
would not be too harsh, since assets would get a step up in basis at death and hence less gain, but executing the
appointment transfer may take place months after death, by which time assets might have appreciated
significantly. Best to avoid the issue and have it apply to specific assets based on date of death or AVD value.
If Jane’s testamentary power potentially extends to all of the applicable property equally ($2.1 million), only limited to $500,000, all property subject to that provision should get a fractional adjustment to basis accordingly – no different than if a child dies at age 36 and had a power to withdraw 1/3 of corpus at age 35 and did not take it – all assets would get a 1/3 basis adjustment.\textsuperscript{47} A pro rata adjustment would lead to wasted basis, since a $1,000,000 asset with $1 gain would soak up the same applicable exclusion amount as a $1,000,000 asset with $900,000 gain. This would be better than no extra basis at all, but not as optimal as the trustee limiting the powerholder’s general power, or, more conservatively, establishing an ordering rule to determine exactly which property the power pertains to.

The trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the beneficiary’s testamentary GPOA. Black letter law defines a power of appointment as “a power that enables the donee of the power to designate recipients of beneficial ownership interests in or powers of appointment over the appointive property.”\textsuperscript{48} Arguably, a trustee with such a power would be the donee of a fiduciary limited power of appointment to designate recipients of powers of appointment over the appointive property.\textsuperscript{49} Assuming the trustee is independent, this could arguably limit the spouse/donee’s GPOA over only specific assets chosen by the trustee.

However, it is probably more conservative and simpler in concept to simply make clear the GPOA never applies to the less appreciated assets, and is never subject to any powerholder’s discretionary choice. So, in our example, the trust provides that the GPOA applies to the most appreciated asset first, cascading to each next individual asset until $500,000 in total property is reached. In our case, the real estate has the greatest appreciation (assuming there is not a more appreciated stock in “various stocks” category), thus the GPOA would apply to 5/6 interest (be it % as tenant in common, or more likely, % LLC membership interest). Thus, the basis would be increased to FMV on the date of Jane’s death as to 5/6 of the property (5/6 times $600,000, or $500,000) and the remaining 1/6

\textsuperscript{47} If the power to withdraw 1/3 had lapsed, 5\% might be “lapse protected”, causing slightly less to be in the beneficiary’s estate (and thus less basis adjustment).
\textsuperscript{48} Restatement, Third, Property, Wills and Other Donative Transfers §17.1
\textsuperscript{49} See comment g in Restatement, Third, Property, Wills and Other Donative Transfers §17.1
would retain its carry over basis (1/6 of $200,000, or $33,333). This means a basis increase from $200,000 to $533,333. This method could easily make for a rather extensive spreadsheet when dealing with many dozens of individual stock positions, but it’s less burdensome than what 2010 executors had to deal with for carryover basis.

In our ordering example, the GPOA could never apply to the less-appreciated assets, and hence the IRS would have no statutory basis to include them in Jane’s estate (or accord them an adjusted basis). It applies to specific property, not a dollar amount or a fraction (though it could apply to say, 34 of 100 shares, etc). If the most appreciated property is family business stock, that’s what it applies to, and there is no discretion in the trustee or the powerholder to change the appointive assets subject to the GPOA. While this gives up a small amount of flexibility over the trustee power noted above, it is probably the more conservative route.

If the spouse is the sole trustee or sole investment advisor under direction or delegation, could his or her indirect power to manipulate gains and losses on investments, and therefore basis, somehow deem such powers to be general over all the assets up to the remaining applicable exclusion amount? This would be quite a stretch, since the Uniform Prudent Investor Act and other common law fiduciary duties preclude any self-dealing or avoidance of diversification unless the document waives them. Thankfully, there is a clear regulation to protect from this: “The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.”

50 The example did not specify whether the property TIC or LLC shares in trust was 100% or a mere fractional share. I assume here that taking 5/6 of the property is valued at 5/6 of the whole, which might be the case if the trust owned say 40%. If the trust owned 100% or 51% of the LLC, it may apply to a greater number of shares/membership interests.
51 See, Gifts by Fiduciaries by Tax Options and Elections, November/December 2004 Probate and Property, by Jonathan Blattmachr, Stephanie Heilborn and Mitchell Gans, for a good discussion of gift tax effects of interested fiduciary decisions regarding Clayton QTIPs, investment choices, alternate valuation date, choice of where to deduct expenses and other dilemmas, concluding that independent fiduciaries are generally safer, but that investment choices by a beneficiary/trustee should not lead to GPOA inclusion.
52 Treas. Reg. §25.2514-1(b)(1)
Still, this may simply be one more reason for a conservative practitioner to use an independent trustee, co-trustee and/or investment trustee. Often there are important side benefits to this – there is much better asset protection when a current beneficiary is not sole trustee, plus this protects the surviving spouse from breach of fiduciary duty charges from remaindermen for bad investment decisions, or, simply protects the family from bad investment decisions in the first place.53

If such a design is still undesirable, it may be good reason to rely instead on granting the spouse a limited testamentary power of appointment eligible to trigger the Delaware Tax Trap, which could be over all assets equally. Any structuring to exploit a step up or avoid a step down would be done through the spouse’s own Will or Trust exercising the non-fiduciary LPOA, rather than through the trust document or vagaries of investment return, and therefore immune to any such argument. However, I believe the regulation cited above provides ample cover for surviving spouses as sole trustees.

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53 For a recent case “piercing the trust veil” by creditors where a son inherited funds from his deceased mother in a spendthrift trust, but he could appoint himself sole trustee, see In re Heifner, 2012 Bankr. LEXIS 3032 (Bankr. N.D. Ohio, 2012), also see separate trust piercing cases in author’s separate asset protection CLE outlines. For a disastrous case of surviving spouse/trustee not only losing the inheritance through mismanagement, but also losing bypass trust benefits, see Estate of Wendell Hester v. U.S. (4th Cir. 2008).
Variations to Accommodate Separate State Estate and Inheritance Taxes

We do not want inclusion in the federal estate, even if it causes no estate tax, to also inadvertently increase state estate tax, unless there is a greater overall income tax benefit. Consider the extremes: we may not want to grant a GPOA over stock bought at $95 rising to $100 at date of powerholder’s death, because the $1 or so in potential capital gains tax savings does not justify inclusion if the state estate tax incurred is $12-16! Clients in those states may have a $1 of $2 million state estate tax exempt trust and up to $3.25 or $4.25 million state-QTIPed trust. Obviously the latter is first choice to cull any basis from by inclusion in the beneficiary’s estate.

Conversely, assets with a lot of gain may benefit from an increase despite any state estate tax. With the exception of Washington, most states that have estate tax also have a substantial state income tax, so that savings should be considered as well. The gold in the example above might be said to benefit from $40,000 of so of savings by increased basis ($100,000 gain time 31.8% federal, 8.2% net state income tax), as opposed to perhaps $24,000 or so in state estate tax loss ($200,000 inclusion times 12% rate). Again, this can be accomplished with a formula to ensure that increases to the estate are only made to the extent that the value of the step up exceeds the cost of the extra state estate tax.

Practitioners in states with a $1 million or less estate tax exemption may opt for simplicity of drafting/administration and simply forego the GPOA over any state-estate tax exempt trust property, since the savings may not be as great. However, surviving spouses may change residence or the state tax regime may change (as it has recently in Ohio, Indiana Minnesota and other states). Some states have larger exemptions of $2 million, $3.5 million or more that make it more compelling.

54 Ohio’s former estate tax, eliminated this year, failed to catch the Delaware Tax Trap (R.C. §5731.11), but most states piggy back onto the federal estate.
55 While most states with an estate tax use the same criteria as the federal estate tax and Form 706 as their base, this is necessarily state specific. Pennsylvania’s inheritance tax, for example, does not tax a general power of appointment (or limited power of appointment triggering the Delaware Tax Trap) as the federal estate tax would. See http://www.picpa.org/Content/Files/Documents/Resources/Presentations%20and%20Brochures/6545-Inheritance%20Tax%20Brochure.pdf. This creates a great loophole for Pennsylvania residents (which should be discussed with anyone planning to otherwise leave assets directly to a Pennsylvania resident).
Practitioners may want to modify their formula with something similar to soak up available state estate tax exclusion, and then limit appointive assets also subject to state estate tax. For example, only “collectible assets with basis 70% or lower than fair market value at date of death, real estate with basis 60% or lower, or any other asset with a basis 50% or lower.” The above percentages are approximations and clients and practitioners may deviate from these considerably, but the concept is to create some greater threshold for inclusion if state estate tax were to be paid. Some clients may prefer to forego a basis increase at second death altogether if a 12-19% state estate or inheritance tax were incurred, on the theory that any capital gains tax can theoretically remain unrealized until the beneficiary’s death and receive an additional step up. Depreciable assets may be preferred as appointive assets due to the ability of additional basis to decrease current taxation.

Practitioners in states with an estate/inheritance tax should consider whether to modify any formula to account for out of state real estate or tangible personal property. Some states’ tax regimes exempt such assets from tax altogether, in which case you would want any GPOA (or LPOA appointment triggering the DTT) to apply to those assets first without fear of causing additional state transfer tax.56

Other states apply a convoluted percentage to tax out of state real estate and tangible property (it smells unconstitutional, but it would probably be upheld). For example, a taxpayer has $3 million estate, $1 million is out of state real estate and the state has $2 million exemption. Rather than interpreting this as a $2 million net estate for state tax purposes, resulting in $0 tax, this may result in a $3 million estate, tentative tax of $150,000, reduced by 1/3 due to the percentage of estate that is out of state property, or $100,000. Would a client (or his beneficiaries) want to pay a reduced state estate tax to gain additional basis? Again, it would depend on the nature of the asset, likely use in the hands of the beneficiary and its appreciation, but it becomes a closer call if state tax is reduced.

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56 Although the situs state may have its own separate tax, this is unlikely to be an issue because most taxpayers who have real estate/tangible property out of state over a state’s exemption amount (usually $1, $2 or $3.5 million), will have such assets in an LLC. However, some states such as Maine may attempt to tax that as well. See description of Pennsylvania tax in footnote above for example of state that does not tax out of state property.
Crafting GPOAs to Keep Fidelity to the Estate Plan and Preserve Asset Protection

This brings us to the second perceived drawback of such planning—a potential thwarting of an estate plan by the inclusion of a testamentary general power of appointment. Remember that the IRS has historically bent over backwards to construe a GPOA, because in the past it produced more revenue than a more restrictive interpretation.57 Thankfuly, we have a broad statute, regulations and many tax cases on which to rely, as well as favorable law in the asset protection context, so that GPOAs may pose little threat to the estate plan if properly constructed.

If the GPOA marital deduction is claimed, any GPOA must include the spouse or spouse’s estate, not just creditors, and must be “exercisable by such spouse alone and in all events” 58 However, if no marital deduction was claimed, as we aim to do in an Optimal Basis Increase Trust, the following limitations may be included:

A GPOA may limit the scope of eligible beneficiaries so long as creditors of the powerholder are included. For example: “I grant my beneficiary the testamentary power to appoint to any of my descendants [or to any trust primarily therefore, which is usually an option for trusts not designed to qualify as a “see through accumulation trust” for retirement benefits]. My beneficiary also may appoint to creditors of his or her estate.” 59

Furthermore, a power is still a GPOA if it may only be exercised with the consent of a non-adverse party.60 Surprisingly, even a trustee with fiduciary duties to adverse

57 Like horseshoes and hand grenades, you only have to be close. Someone does not have to know the extent of their power or even if they have one – if you give a mentally incompetent person or a minor a GPOA they don’t even know or can’t do anything about, it’s still a GPOA for tax purposes. A surprising number of appellate cases address these issues, all finding GPOAs, even if someone is incompetent and even if a state court appointed guardian could not exercise the GPOA. Fish v. United States, 432 F.2d. 1278 (9th Cir 1970), Estate of Alperstein v. Commissioner, 613 F.2d 1213 (2nd Cir 1979), Williams v. United States, 634 F.2d 894 (5th Cir. 1981), Boeving v. United States, 650 F.2d. 493 (8th Cir. 1981), 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), Estate of Alperstein v. Commissioner, 71 TC 351 (1978), aff’d 613 F.2d. 1213 (2nd Cir 1979), Estate of Freeman v. Commissioner, 67 T.C. 202 (1979). See also Rev. Ruls 75-350, 75-351.
58 IRC §2056(b)(5) – though generally the whole purpose of the OBIT is to avoid forcing the marital, it’s important to remember. This language is also why you can’t simply let 5% of a GPOA lapse every year to let the marital trust escape estate tax altogether after 20 years or so.
59 IRC §2041(b)(1) is in the disjunctive “or”. See also Estate of Edelman v. Commissioner, 38 T.C. 972 (1962), Jenkins v. U.S., 428 F.2d 538, 544 (5th Cir. 1970)
60 IRC §2041(b)(1)(C)(ii), Treas. Reg. §20.2041-3(c)(2)
beneficiaries is not considered adverse. For example, one might add to the above:

“However, my beneficiary may only exercise said appointment with the consent of [name of non-adverse party, and/or] my trustee, who must be a non-adverse party.” If you name a trustee, then you would then want provisions to enable appointment of a non-adverse party as trustee if, for instance, a beneficiary were the successor trustee (and adverse) and the beneficiary actually attempted to appoint to their creditors. If you name a non-adverse party, make sure to name alternates in the event the first is deceased or incapacitated. In theory, one could name multiple non-adverse parties necessary for unanimous consent, but pushing that envelope is hardly necessary.

Furthermore, a GPOA is “considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.” This offers even more opportunity to make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a treasury regulation.

If there is a qualified plan or IRA payable to the trust designed to be a see through trust (specifically, an “accumulation” trust, it would not be necessary for a “conduit” trust), one might consider a further restriction to prevent disqualification – “to creditors who are individual persons younger than my beneficiary” (a technique seemingly blessed by a recent PLR that permitted such a circumscribed GPOA to retain see through trust status). Although the OBIT techniques herein to increase basis would not apply to IRAs or qualified

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61 To be adverse, the party must have a “substantial interest in the property subject to the power which is adverse to the exercise of the [GPOA]”. An independent bank co-trustee, for example, is not sufficiently adverse. Estate of Vissering v. Commissioner, 96 T.C. 749 (1971), reversed on other grounds, Estate of Jones v. Commissioner, 56 T.C. 35 (1971), Miller v. United States, 387 F.2d 866 (1968). Treas. Reg. §20.2041-3(b), Example 3

62 Treas. Reg. §20.2041-3(b)

63 See PLR 2012-03033; and discussion thereof in separate IRA “see through trust” checklist CLE materials developed by author. This PLR addressed the effect of a release creating such a limitation for “see through trust” purposes of identifying the oldest beneficiary applicable, but it did not discuss whether, after such a limitation, the power was still a GPOA and what the later tax effects might be (e.g. when the gift via release is complete upon the powerholder’s death). Pursuant to the plain language of the statute and Regs, it is still a GPOA, but at some point you have to wonder whether the IRS would argue such GPOAs are illusory – how many creditors out there are young individuals?
plans, you may have a GST non-exempt share over which a GPOA is desired. It would probably be preferred to use a conduit trust, but if for some reason that is undesirable, there may not be a lot to lose in circumscribing the GPOA in this manner as applied to such a trust.

Generally, I would not attempt to limit a GPOA in this manner for any non-standalone IRA accumulation trust – requiring appropriate non-adverse parties’ consent should be more than adequate to prevent unwanted exercise. Although I could find no discussion in any restatement, case or otherwise, a reasonable interpretation might be that an attempted GPOA relying on the ability to appoint to creditors must include commonly found creditors to avoid being illusory. That said, it may still be prudent to limit the power to appoint to creditors to the amount of the debt incurred and to reasonably equivalent value for contractual debt. Otherwise, a powerholder could in theory borrow $1 from anyone and/or promise to pay unlimited amounts in exchange for some peppercorn of valid consideration to enable an appointment of all the assets to whomever they wished.

In addition, any “consent” provision should ensure that there are backups and defaults to ensure that the consenting party has a bona fide ability to act. This would entail naming alternates (my recommendation) and/or allowing a trustee, trust protector or local court to appoint a non-adverse consenting party (which might be a co-trustee). For example, if there is no way the “consenter” COULD consent, and the default in its absence were to deny the appointment, then the IRS may have an argument (albeit weak, considering the precedent) that there was no GPOA. What if a child who would be an adverse party is trustee or co-trustee and never gets around to appointing a non-adverse trustee? What if the non-adverse party is dead or incapacitated, renounces (or worse, disclaims) their power to consent, or is simply never informed of the existence of their consent power, or never returns the trustee’s phone calls, letters, emails (all very possible)? Those problems can be drafted around. For instance, the document can permit an agent/guardian to act for

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64 IRC §1014(c), IRC §691

65 Actually, the Restatement, Third, Donative Transfers, §19.2 discusses the concept of a “fraud upon the power” as voiding any shenanigans to circumvent the intention of the creator of the power by attempting to appoint to impermissible beneficiaries, so extreme manipulations may not succeed anyway.

66 It is unclear whether a “consenting party” would be as liberally found as a GPOA powerholder, logically it should follow the jurisprudence cited in footnote 56 above, but, like Crummey powers, why not be safe and ensure the power is acknowledged? See Rev. Rul. 81-7 for the IRS take on the present interest issue – but they consistently lose cases in this area even with shoddy trust administration, and it is a completely different statute.
incapacitated "consenter", you can name alternates, and, of course, you should probably have the default be to ALLOW exercise rather than deny it.

For instance, a default might be to allow the decedent's GPOA to be exercised unless a written acknowledgment of the "consent" power is received from a "consenter", or the trustee has actual knowledge that the consenter has been informed, within so many months. Then you would need language to allow agent/guardian consent, and language to trigger or even appoint an alternate "consenter" under certain circumstances. You could have mere receipt of acknowledgment deny the effectiveness of the GPOA unless consent is timely granted, or draft it as a veto power. Then you have a "default" of sorts that makes it clear that the GPOA is never illusory. Careful drafting can ensure it is clear that the capability of exercise is always there.

While a handful of states have creditor-friendly state law impacting testamentary GPOAs (e.g. California), the law is generally quite favorable as to whether and when a testamentary general power of appointment subjects the appointive assets to the donee powerholder’s creditors, and even in bankruptcy the assets are not subject to creditors.\(^67\) It may depend on whether the power is exercised or whether it is merely allowed to lapse. Creditor access should be less likely if there are additional consent and notice requirements as discussed above, but again this depends on state law and there are apparently no cases discussing asset protection differences of GPOAs with the various proscriptions described above. This is in stark contrast to the exposure of a *presently exercisable* general power, which will be discussed further below.

\(^{67}\) See *Restatement of Property, Second, Donative Transfers*, §13.2, §13.4 (state law), §13.6 (bankruptcy, which could be applicable if decedent was in bankruptcy prior to death) – best to check those for citation to your individual state law. If your state law is unfavorable, it may be preferable to use the Delaware Tax Trap technique, which uses *limited* powers of appointment only.
Using the Delaware Tax Trap Instead of a GPOA to Optimize Basis

In our examples of John and Jane Doe above, we presumed that the Optimal Basis Increase Trust used a formula GPOA to cause estate inclusion and increased basis. However, there is also a technique to accomplish the same result with a limited power of appointment. This involves IRC §2041(a)(3), colloquially known as the Delaware Tax Trap (“DTT”).

“(3) Creation of another power in certain cases
To the extent of any property with respect to which the decedent—
(A) by will, or
(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent’s gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.”

The application of this rule, in conjunction with various states’ rules against perpetuities, is complex. While many states have enacted “savings clauses” into their statutes (or passed a Uniform Act) that has closed off the ability of an LPOA to trigger this in most instances, there is one method usually left out of these savings statutes, and that appears to be available in most states. I will refer the reader to more learned articles on the subject, and concentrate on the method of triggering §2041(a)(3) the most likely to be available in most states.69

68 See also Treas. Reg. §20.2041-3(e). There is a gift tax analog, §2514(e), but triggering gift tax only increases basis to the extent of gift tax actually paid, so this paper will primarily discuss the estate tax variant.
69 For your specific state, see Howard Zaritsky’s ACTEC 50 State and D.C. Survey of Rule Against Perpetuities Law, specifically p 8-10: http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf. There is also good discussion in Estate of Murphy v. Commissioner, 71 T.C. 671 (1979) (analyzing an LPOA appointment to a trust that contained another LPOA and finding under Wisconsin rule against perpetuities law §2041(a)(3) was not triggered). See also Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes, Johnathan Blattmachr and Jeffrey Pennell, 68 Journal of Taxation 242 (1988), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954062. While the DTT was not considered or discussed for this type of planning, this is not the fault of two of the sharpest estate planning minds in the country, rather, the exclusion was only $600,000 at the time. See also A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax, James P. Spica, 41 RPTL Journal 167, Spring 2006; The Delaware Tax Trap and the Rule Against Perpetuities, Stephen Greer, Estate Planning Journal Feb 2001. Revising the RAP, Patricia Culler, Probate Law Journal of Ohio, March/April 2012.
Generally, if Jane in our example had a limited power of appointment which permitted appointment in further trust, and Jane appointed those assets to a separate trust which gives a beneficiary a presently exercisable general power of appointment (sometimes referred to as a “PEG power”), this would trigger §2041(a)(3), cause estate inclusion, and therefore an increased basis under IRC §1014, just as a standard GPOA would.70

Thus, Jane’s Will (or trust or other document, if permitted by John’s trust) would appoint any appreciated assets to such a “Delaware Tax Trapping” trust as discussed in the above sections, and other assets outright or to another ordinary trust. Treasury Regulations outline examples of specific, partial and targeted use of the Delaware Tax Trap as this article recommends:

“Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includable in the decedent’s gross estate under section 2041(a)(3).”71

In drafting mode, using the DTT is probably not an optimal strategy to employ for John’s trust, because it will necessarily require Jane to draft a new Will/Trust invoking the LPOA and a new appointive trust with terms that one would ordinarily avoid. Giving a beneficiary a presently exercisable GPOA impairs asset protection much more than a testamentary power, and destroys any chance of spraying income or making tax-free gifts, nor does it allow avoidance of state or federal estate taxation or avoidance of a step down in basis at the child’s death.72

With all of the above negatives, using the DTT to harvest the basis coupon probably has more realistic application in the context of preexisting irrevocable trusts that already

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70 See discussion in articles in the above footnote. All of those, plus other sources I consulted, conclude that this should trigger §2041(a)(3) under most states’ RAP. However, they all beg the riposte that “how would such an exercise delay vesting/ownership since a beneficiary holding a typical PEG power appears the de facto owner?”
71 Treas. Reg. §20.2041-3(e)(2). There is a near identical gift tax reg at Treas. Reg. §25.2514-3(d)
72 Contrast lifetime GPOAs in Restatement of Property, Second, Donative Transfers, §13.2 and §13.5 with the testamentary variations in §13.4 (state law), §13.6 (bankruptcy). Whether it’s a testamentary or lifetime (presently exercisable) GPOA makes a difference in bankruptcy. See 11 U.S.C. § 541(a)(1). Also for spousal elective share: see Uniform Probate Code § 2-205(1)(A). Surprisingly, the Uniform Probate Code is protective of GPOAs as against non-spousal creditors. See UPC §6-102, especially comment 3 at www.uniformlaws.org. No cases reported in the 2nd or 3d Restatements discuss the impact, if any, of a non-adverse party’s required consent on creditors’ rights.
contain an LPOA, as discussed in Part VII, and should probably not be used in planning mode to accomplish optimal basis adjustments, especially since many practitioners and clients rely on disclaimer funding, which kills the LPOA necessary for a DTT (unless limited as discussed in Part IV). However, if the trust for children pays outright anyway, and no disclaimer funding is anticipated, this route may be the easiest, and most flexible, to take.

Practitioners might even craft a “Crummey” power into the appointive trust so that if the GPOA lapses, assets flow into a self-settled, incomplete gift domestic asset protection trust with situs in Ohio, Delaware or other permitted state. My personal preferred route would be to avoid “baking in” the DAPT, but to instead strongly encourage the non-adverse party to consent to such an appointment and to mandate that trust funds be used to pay attorney fees and/or trustee set up fees associated therewith. It may also be possible to use non-voting, restricted LLC/LP shares to effectively curb a spendthrift beneficiary, and use the 5% lapse protection to effectively “freeze” the estate as to PEG powerholder’s appointive assets.\(^73\)

Another counter-intuitive technique a powerholder may use to trigger the DTT, but still protect from an improvident or spendthrift beneficiary would be to only grant the beneficiary a lifetime income interest coupled with a “presently exercisable” GPOA over only the remainder interest. This is still deemed a “presently exercisable” GPOA.\(^74\) In an earlier version of this article, I had initially opined that this technique would probably cause only partial inclusion based on actuarial value of the remainder. \textit{I was wrong,} and a step up in basis over the 100% of the appointed assets is available:

\begin{quote}
“(2) For purposes of the application of section 2041(a)(3), the value of the property subject to the second power of appointment is considered to be its value unreduced by any precedent or subsequent interest which is not subject to the second power. Thus, if a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includable in the decedent’s gross estate under section 2041(a)(3). \textbf{If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the}
\end{quote}

\(^73\) IRC §2514(e) – the so called “5 and 5” lapse protection.
\(^74\) See Restatement Third Property, Wills and Other Donative Transfers, §17.4, comment a, illustration 1, and draft Uniform Power of Appointment Act, §102, comments re ¶14. It is not testamentary because the powerholder can make an irrevocable transfer of the remainder effective immediately.
entire $100,000 will be includable in the decedent's gross estate under section 2041(a)(3) if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.\(^7\)

Remember that you cannot use a non-adverse party consent if the goal is also to qualify the DTT/estate triggering for the marital deduction (this would be rare, however, since LPOAs often exclude appointment to subsequent spouses, but it is possible – imagine the LPOA in the bypass or other inherited trust is broad enough to permit appointment to a spouse, in which case the powerholder could appoint to a Delaware Tax Trapping GPOA marital trust for the surviving spouse getting a full step up without causing estate tax).

The formula GPOA would be more advantageous than using the PEG/DTT because of better estate/gift/gst sheltering, ability to spray income, and superior third party settled trust protection, but using the PEG/DTT techniques can offer substantial protections and advantages nonetheless. Ideally, states will amend their Rule Against Perpetuities statutes to permit LPOAs creating further LPOAs to trigger the DTT, obviating the need to use PEG powers.\(^6\)

**Is the DTT safer than a formula GPOA for capped estates? Addressing the Kurz case**

Some conservative practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that the surviving spouse’s de facto control of his/her net estate value (either through spending, or by leaving assets to charity/spouse), may permit indirect control of the value of the appointive assets in the bypass trust subject to the formula GPOA provision and hence could trigger over-inclusion. Here is an example of the theoretical argument: John leaves Jane $4 million in a trust with a formula GPOA (optimal basis increase provision as discussed). She has $4 million of her own assets and $6.5 applicable exclusion amount. At her death, John’s trust caps the Jane’s GPOA at $2.5 million, based on her remaining applicable exclusion amount. Might the IRS argue, however, that

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\(^{75}\) Treas. Reg. §20.2041-3(e)(2), there is an identical gift tax DTT regulation at §25.2514-3(d)

\(^{76}\) See [http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf](http://www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf), ironically, even Delaware has foreclosed this use for GST exempt trusts, the very situations where it will now most often be useful. According to the survey, Kentucky and Wisconsin have the most useful (or, treacherous, if dealing with an inadvertent appointment and large estates) statutes, in that appointing to a trust that grants a testamentary GPOA can also trigger 2041(a)(3), which would at least improve upon the asset protection/control issues.
Jane could have spent all her money, or left it to charity, thus de facto being able to control the disposition (GPOA) of all $4 million of John’s trust? That’s a bit weak – formula funding/channeling clauses based on a surviving spouse’s available GST amount have been used for decades in GST non-exempt trusts without such specious arguments. However, there is a case that could be used to make such an argument, so let’s distinguish it:

In the Estate of Kurz, husband died leaving his wife a marital trust with an unrestricted lifetime GPOA, and if that were exhausted, a lifetime 5% withdrawal power over the bypass trust. The estate argued that the 5% power was not in the estate because of a condition precedent not being met. Treas. Reg 20.2041-3(b) provides that:

“A power which by its terms is exercisable only upon the occurrence during the decedent’s lifetime of an event or 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. For example, if a decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent’s death if the condition precedent to its exercise had not occurred.”

However, all the wife had to do was ask for funds for the marital trust and she was entitled to the 5% from the bypass. It would not surprise anyone that both the tax court and the appellate court concluded that the wife held a GPOA - she could effectively access the 5% of the bypass trust at any time, for any reason, without affecting her estate, during her lifetime.

The tax court’s rationale was that the “contingency” was illusory and lacked any independent non-tax consequence or significance. The appellate court preferred a test that looked through the formalities to determine how much wealth the decedent actually controlled at death. It looked to the examples in the regulation quoted above, and noted that those examples of contingencies were not easily or quickly controlled by the powerholder, “something that depends on the course of an entire life, rather than a single choice made in the administration of one’s wealth.”

77 See, e.g., Howard Zaritsky, Carol Harrington and Lloyd Plaine’s treatise Generation Skipping Transfer Tax, various forms channeling distribution of “the largest amount, if any, of my wife’s available GST exemption”
78 Estate of Kurz, 101 T.C. 44 (1993), affirmed by 68 F.3d 1027 (7th Cir. 1995)
In contrast to Kurz, a formula GPOA OBIT clause is not a *lifetime* GPOA. More importantly, unlike Kurz, it is not subject to a condition precedent, nor does the capping of the GPOA hinge *at all* on Treas. Reg. 20.2041-3(b) – it is pursuant to other treasury regulations cited herein. It’s closer to Treas. Reg. 25.2518-3(d) Ex 20. Additionally, unlike the ability of a beneficiary to withdraw at will as in Kurz, which the appellate court deemed “barely comes within the common understanding of ‘event or...contingency’”, the ability of an OBIT formula GPOA powerholder (if it would otherwise be capped) to increase their testamentary GPOA would require giving away or spending a significant portion of their assets, which even still would not cause the powerholder to have access to even a dollar more of wealth during their lifetime (quite unlike Kurz) – a significant non-tax consequence if there ever was one.

However, while Kurz is distinguishable, some practitioners would prefer avoiding even the hint of a Kurz type argument against formula GPOAs until there is more positive precedent. So, a conservative practitioner might ignore any charitable/marital deduction otherwise available to the powerholder’s estate in the GPOA capping formula.80

Unlike a GPOA, the Delaware Tax Trap is only applicable to the extent of EXERCISE – there is no such thing as mere existence of an LPOA or a lapse of an LPOA causing inclusion under IRC §2041(a)(3) just because it *could have been* exercised to trigger 2041(a)(3).

Therefore, using the Delaware Tax Trap OBIT technique is completely immune to the Kurz or “powerholder control” argument. Hence, many attorneys may prefer it, despite the advantages of formula GPOAs, for those estates that would likely be subject to capping.

Some may fear that using an LPOA to appoint to the same beneficiaries as would inherit by default might be illusory or disregarded. Treasury has prevented this result.81

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79 Quoted in full and discussed on page 20, footnote 44
80 Thanks to California attorney Terence Nunan for pointing out this conservative drafting option. This would preclude any application for a widow with $7 million AEA, $7 million estate who has a formula GPOA over a $4 million bypass trust, even if the widow gave half her estate to charity, which would otherwise allow her $3.5 million of additional basis increasing “coupon”, but it may be safer drafting until we get better guidance.
81 Treas. Reg. 20.2041-1(d): “However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment.”
Comparing/Contrasting Formula GPOA v. LPOA/Delaware Tax Trap
Issues Favoring Use of Delaware Tax Trap/LPOAs over Formula Testamentary GPOAs

- **Spousal Use of Lifetime LPOAs/Gift Tax** - When someone exercises a lifetime LPOA, there is less chance of gift tax exclusion being used. Unless the appointment triggers the DTT, or unless income is mandated payable to the powerholder, there is no gift, whereas exercising a lifetime LPOA raises complicated issues if those assets are otherwise subject to a formula or capped testamentary GPOA – would IRC §2514 trigger a taxable gift even if the appointed assets were annuities, insurance, IRD or loss property not subject to the testamentary power?

- **Access by Powerholder’s Estate’s Creditors** – There is no asset protection issue if powerholder’s estate is insolvent and a testamentary LPOA is exercised (or lapses) – creditors have no access. However, if the powerholder had a testamentary GPOA, depending on the state (e.g. CA allows creditor access), and whether the GPOA is exercised, creditors of the testamentary GPOA powerholder’s estate may have access.

- **Subsequent Amendments/Releases/Non-Qualified Disclaimers/Decanting** – Generally, LPOAs can be removed or limited without gift/estate tax issue, by decanting, reformation, release, trust protector or otherwise. While there are PLRs holding otherwise, any removal or limiting of a testamentary GPOA, even with a court approval, might have gift/estate tax effects under §2514.

- **Easier to go beyond formula wherever/whenever inclusion may be desirable** – Because the LPOA in the document would not be limited by formula, it can easily be used to cause inclusion beyond estate tax exclusion amount if desired for specific circumstance or change in tax code. As discussed in the section on state estate taxes, there may be cases where paying state estate tax is desirable because the income taxes saved by beneficiaries outweigh the state estate tax. In fact, if Congress were to change the tax code again, this could also be true of the federal estate tax. E.g. consider low basis collectibles taxed to a beneficiary in a high tax state.

- **Actions of the powerholder/trustee irrelevant.** As discussed herein, there is a weak argument that trustee’s investment policy, powerholder spending or estate devise, pursuant to the Kurz case or otherwise, could be invoked to override the cap and cause more assets than desired to be subject to a formula testamentary GPOA. The LPOA/DTT technique is immune to these arguments, since §2041(a)(3) is triggered only upon and to the extent of exercise.

- **The beneficiaries have more post-mortem control over estate taxation/basis** – As discussed herein, someone might disclaim a PEG power received by exercise of LPOA and affect the upstream taxation/basis adjustment, but this is impossible with receipt via GPOA.
Issues Favoring Use of Formula Testamentary GPOAs over Using LPOAs/DTT

- **Don’t rely on obscure/arcane rule against perpetuities nuances.** Experts seem to agree that appointing to a trust that grants someone a presently exercisable GPOA triggers 2041(a)(3) because the GPOA powerholder can postpone vesting – but aren’t they already completely vested – how can they postpone it further? How confident are you that your state law triggers 2041(a)(3) in such a case? How does this interpretation further Congressional intent of thwarting continued transfer tax avoidance if the GPOA causes gift/estate tax in the PEG powerholder’s estate? While this technique may appear from the citations herein to work, there is no actual case confirming this.

- **Less documentation/probate/paperwork, less chance of something falling through the cracks** A formula GPOA doesn’t even have to be exercised to get the intended benefit, but the LPOA/DTT technique requires an additional exercising document (usually by will), potentially a probate if by will. Plus, it needs a new separate “DTT-trapping” trust to appoint to.

- **Better ongoing asset protection for beneficiaries** – although the LPOA/DTT technique might be more prone to access by a powerholder’s estate (discussed above), it is much more likely that one of the children have creditor issues than a wealthy bypass trust spouse. Even aside from outside creditors, granting a child a PEG power may jeopardize the assets (or even more likely, the growth on those assets), in a divorce.

- **No waste of GST exclusion, assets can excluded from beneficiaries’ estates** – when a child or other beneficiary inherits in trust pursuant to a formula GPOA, GST will be allocated, and if properly drafted the subsequent trust escapes taxation in the beneficiaries’ estate for federal and state estate tax. By contrast, this is impossible to do if the beneficiary receives assets with an attendant PEG Power.

- **Children or other beneficiaries can spray income** – If a beneficiary receives trust assets with a typical PEG Power, there is a forced grantor trust status under IRC §678(a), whereas if a beneficiary inherits in a standard trust, there can be income shifting and above the line charitable tax deduction opportunities availed of.

- **Next generation use of Lifetime LPOAs/Gift Tax** – If a beneficiary receives trust assets with a PEG power, any subsequent use of lifetime POAs will trigger a gift tax and could be an assignment of income. By contrast, if a beneficiary receives assets without that burden, lifetime LPOAs and spray provisions may be used for better income tax planning.
- **No potential issue re triggering DTT if powerholder moves state** – If a surviving spouse moves states, will the new state of residency have the same ability to trigger the DTT? Perhaps, but maybe not. It raises a potential issue.

- **For inter vivos SLATs, can revert to Settlor w/o impairing protection** – If the trust in question is a SLAT (aka inter-vivos bypass trust), and the donee spouse appoints back in trust to the original settlor/donor spouse, is the new trust considered “self-settled” subject to the original settlor’s (now beneficiary’s) creditors? If the spouse executed a GPOA, she would be considered a new grantor/settlor, but if the spouse merely executed an LPOA, this would “relate back” and therefore under most state laws the trust would be accessible to the settlor-beneficiary’s creditors. This favors the use of formula GPOAs for SLATs.

**NOTE:** in the above section and comparison I have assumed use of only the most commonly discussed/accepted method of triggering §2041(a)(3), which involves the powerholder appointing to a new trust which grants a PEG power. If, in your state, there is a reliable way to trigger §2041(a)(3) without this generally undesirable feature (e.g. by appointing to a new trust that can postpone vesting/ownership and need not refer to the RAP applicable to the first trust and does NOT have a PEG power), then this would tip the scales to using the §2041(a)(3) over a formula GPOA. According to Zaritsky’s compiled ACTEC survey, no state currently has a satisfactory method of this on the books. Kentucky and Wisconsin will apparently allow 2041(a)(3) to be triggered by appointment to a new trust with a testamentary GPOA, which is about as close as we get. Delaware, surprisingly, does not help, because it bars use if the trust is GST exempt (zero inclusion ratio). State bars should consider amending their RAP statutes to “open the trap”, preferably by an affirmative opt-in, similar to states such as Ohio that have an “opt-out” of the Rule Against Perpetuities. This could be done in a variety of ways. In the Appendix is a proposed variant of Delaware’s law, modified for this use.\(^\text{82}\)

\(^\text{82}\) 25 Del. Code §504
Flexible Post-Mortem Use of Disclaimers by Beneficiaries of LPOA Appointive Assets to Cause Greater or Lesser Estate Inclusion in the Powerholder’s Estate

There is no practical way for general power of appointment appointees, or broad limited power of appointment appointees, to collectively disclaim their right to receive property in order to change the tax result to the powerholder’s estate. But consider various ways in which an LPOA appointee/beneficiary may be able to disclaim, and affect the taxation of an estate (and hence, of course, basis step up/down) if properly planned for. This could be important to flexibly allow increased inclusion for state estate tax purposes to yield federal, state and/or local income tax benefits by additional step up, or prevent overinclusion. Disclaimers can be made partial or by formula.83

1) Jane Doe has the limited power under the John Doe Bypass Trust to appoint to her daughter Margaret – not to any other party. To the extent that the limited power is not used, there is a default GPOA or the trust pays to her estate. This effectively allows Margaret to decide her mother’s estate inclusion by a qualified disclaimer, but her requirement to give up indirect retention of benefits would be an issue (unlike below).

2) Jane Doe has the limited power to appoint to the Jane Doe Delaware Tax Trapping Trust fbo Margaret, which grants Margaret a PEG power (presently exercisable general power of appointment). To the extent Jane appoints to this trust, and Margaret has a PEG power, it triggers IRC §2041(a)(3) – the Delaware Tax Trap. But, what if Margaret makes a qualified disclaimer of the GPOA? She can disclaim the GPOA and even remain trustee and beneficiary as long as her discretion is limited to an ascertainable standard.84 This appears to allow Margaret to eliminate any estate inclusion due to the DTT, and hence any basis adjustment, by qualified disclaimer. Non-qualified renunciations are disregarded.85

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83 E.g. Estate of Christiansen v. Comm., 586 F.3d 1061(8th Cir., 2009)
84 Treas. Reg. 25.2518-3(d)(6) – a qualified disclaimer is not a taxable release. Treas. Reg. 25.2518-3(a)(1)(iii): (iii) Powers of appointment. A power of appointment with respect to property is treated as a separate interest in such property and such power of appointment with respect to all or an undivided portion of such property may be disclaimed independently from any other interests separately created by the transferor in the property if the requirements of section 2518(b) are met. See example (21) of paragraph (d) of this section. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficial enjoyment of the property which is retained by the disclaimant is limited by an ascertainable standard. See example (9) of paragraph (d) of this section.
85 Treas. Reg. 20.2041-1(e): “However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 ***irrespective of whether *** the appointee renounces any right to take under the appointment.” Presumably, Treasury did not mean “disclaims” instead of “renounces” here.
IV. Busting Disclaimer Myths and the Conventional Wisdom on Disclaimers: Why OBITs are Superior to Bypass Trusts for Disclaimer Based Planning

After Congress’ awkward dance with estate tax repeal over the last decade, many practitioners and clients have embraced disclaimer planning as the go-to tool for married couples with identical estate plans (e.g. long-time marriage, all children from current marriage). This usually involves setting up a bypass trust (and potentially marital trust, depending on design, assets and circumstance) that is ONLY funded if the surviving spouse makes a qualified disclaimer of funds that would otherwise be inherited outright.

There are several drawbacks to relying on disclaimer funding – inadvertent disqualification through acceptance or control, nine month window, uncertainty with certain jointly owned assets, and quite simply, the powerful inertia causing a widow/widower to “go with the flow” – especially when the flow is an outright bequest. For purposes of this Section, however, I will concentrate on another important drawback of disclaimer planning and how the OBIT largely eliminates it.

One of the axioms estate planners are continually taught is that surviving spouses must disclaim a power of appointment granted in a trust they are disclaiming into. Such a disclaimer removes a tremendous estate, asset protection and income tax planning tool from the surviving spouse’s toolbox. **Moreover, this general rule is wrong.** The disclaimer regulations for spouses are much more nuanced than that:\(^{86}\)

> “If the surviving spouse, however, retains the right to direct the beneficial enjoyment of a property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property.”

Thus, if the spouse is trustee and retains a discretionary spray power not limited by an ascertainable standard, or the right to transfer property by power of appointment that does not trigger estate/gift tax, then the disclaimer would not be qualified. However, this still leaves tremendous opportunities for various OBIT powers as discussed in Part III above.

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\(^{86}\) Treas. Reg. 25.2518-2(e)(2)
Thus, a GPOA can be retained by a spouse without tainting a qualified disclaimer, because GPOA transfers are of course subject to federal gift and estate tax under IRC §2514 or IRC §2041 respectively. As discussed in Part III, this would ideally be a formula testamentary GPOA with a cap. There is no real advantage to retaining a lifetime GPOA.

Thus, an LPOA may also be retained, but only if can only be exercised so as to trigger the DE tax trap (IRC §2041(a)(3) and IRC §2514(e)), is limited by an ascertainable standard, or, unless the LPOA transfer would be in the surviving spouse’s estate via IRC §2044 (QTIP). Thus, a disclaiming spouse must disclaim broad LPOAs in a bypass trust if funded via disclaimer, but may retain narrowly crafted ones.

Thus, appropriately worded “OBIT” LPOAs and GPOAs are still compatible with disclaimer planning. Practitioners should consider creative post-mortem planning opportunities with these tactics as well (see further discussion in Part VII) – perhaps an LPOA can be partially released rather than completely disclaimed, for example. Most states should allow a partial release/nonqualified disclaimer of a testamentary LPOA unless the document forbids it. See various sample clauses in the appendix.

Retention of LPOAs and GPOAs not only offers much better basis increase (and avoiding basis decrease), but they also open up more flexible ongoing income tax planning opportunities discussed in Part IX of this paper.

Moreover, even trusts that are not initially planned to be “disclaimer” trusts, may someday be forced to be, since clients inevitably fail to keep their trust fully funded. So these techniques should be kept in mind – disclaimer funding does not mean giving up all POA flexibility whatsoever – it just requires tailoring it.

87 There is authority that an LPOA may be retained by a surviving spouse to the extent the QTIP election is made: Estate of Lassiter v. Commissioner, T.C. Memo 2000-324, p70-74, ruled a disbeliever was qualified despite the surviving spouse retaining a testamentary LPOA, because the later transfer at the surviving spouse’s death would be subject to federal estate tax due to the QTIP election, an exception under Treas. Reg. §25.2518-2(e)(2) quoted above. “We therefore conclude that retention of such a testamentary power does not cause the disclaimer of an inter vivos power to fail to satisfy the section 2518 requirement when a QTIP deduction will be taken for the trust to which the powers relate.”

88 Treas. Reg. §25.2518-2(e)(5) Ex. 5 illustrates why disclaiming spouses may not retain ordinary LPOAs in a bypass trust in order to be qualified, but Ex. 7 illustrates that disclaiming spouses may retain GPOAs (the “5 and 5” withdrawal power in the example is a lifetime GPOA, aka PEG power)

89 See, e.g., the draft Uniform Powers of Appointment Act, §401 and §404, but see Mich. Comp. Laws §556.118(2) for a counterexample.
V. Optimizing Basis Increase at First Death

a. Community Property Nuances – Can Residents of Non-CP States Elect CP?

Married couples living in community property states automatically receive a new date of death basis for 100% of community property (which can, of course, mean a step down in basis for 100% of such property as well).90 Some property might be separate even for those in community property states – such as property received by gift/bequest, or assets acquired prior to marriage. Increasing step up in basis at first death for such separate property (or avoiding double step downs for community property that has tanked in value) may be accomplished through postnuptial transmutation agreements.

For married couples in separate property states, jointly owned property is usually only entitled to 50% step up (or down).91 Although, if a couple recently moved from a community property state, assets acquired as community property may be able to retain that status. Those living in separate property states may be able to accomplish the same result as community property state residents through the use of an Alaska Community Property Trust, keeping “loss” and/or qualified plan or other problematic property out of the trust and transferring only appreciated gain property to the trust to elect into a community property regime.92

Example #1 (community property state): John and Jane are on their second marriage late in life and therefore have significant separate property. Residents of a community property state, John and Jane might enter into an agreement that $1 million each of their low basis property is community property (“CP”). Of course, if John’s former separate property value skyrockets to $2 million, and Jane’s stays the same at $1 million, and they are later divorced, this $3 million is 50/50 for divorce purposes. But many clients could live with

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90 IRC §1014(b)(6)
91 See IRC §2040(b), regarding tenancy by the entirety or joint with right of survivorship
92 Alaska Statute § 34.77.100 et seq. for how one may elect into community property treatment for low basis assets using an Alaska Community Property Trust (and avoid such treatment for problematic assets such as IRAs or assets with higher basis than FMV). See, The Tax Advantages of Using Joint Revocable Trusts and Alaska Community Property Trusts in Common Law Property States, http://shaftellaw.com/article15.html. Alaska Enacts an Optional Community Property System which Can be Elected by Both Residents and Nonresidents, by David Shaftel and Stephen Greer, http://shaftellaw.com/article3.html
Disclosure: the author’s employer, KeyBank, has a subsidiary with trustee powers and operations in Alaska.
this, when considering that if one dies, all $3 million gets a new adjusted basis – a substantial windfall for the widow/widower and potentially others.

Example #2 (separate property state): Same as above, but John and Jane have never lived in a community property state. They gift those assets into an Alaska Community Property Trust, in which they elect to treat the property as community property. This should give the same result as above.

While there is a compelling argument that Alaska Community Property Trusts should work equally well, to date this technique has not been tested in the courts or subject to any IRS ruling. The only IRS pronouncement, a mere parenthetical in an IRS publication, takes no position. Conflict of law principles should permit spouses to choose a state other than their domicile to govern their respective interests in property, and that state’s laws should apply unless the domiciliary state has a strong interest or public policy in applying its own laws instead. Using an Alaska trustee to hold legal title and provide various trustee services (even if they may be limited to investment or custodial services), should greatly strengthen the argument that it is appropriate to apply Alaska law.

Many couples, however, may not be interested in a solution that requires Alaska trustee services. Furthermore, this may not appeal to a spouse who has much more separate property than the other, because of the obvious divorce ramifications.

Additionally, there is at least one state in the union (probably the only state) that has a confusing prohibition on post-nuptial agreements (arguably, a “strong public policy” against them) – Ohio. Would Ohio’s statute prohibit its residents from entering into any agreement to deem property as community property? An Alaska CP Trust might be a good solution for recent Ohio transplants from CP states who may seek solutions to keep such property’s character, because such transfers would not “alter their legal relations”. But what about a couple that transfers what would be all marital property for divorce purposes

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93 IRS Publication #555 “Community Property”, page 2
94 See Restatement, Second, of Conflicts of Laws, §258, comment b, and §270 (regarding trusts). See also Uniform Probate Code 2-703
95 Ohio R.C. §3103.06 “Contracts affecting marriage. A husband and wife cannot, by any contract with each other, alter their legal relations, except that they may agree to an immediate separation and make provisions for the support of either of them and their children during the separation.” Currently, committees of the Ohio State Bar Assn are exploring elective and trust community property revisions to circumvent this statute.
in Ohio to community property? Have they “altered their legal relations” if the result upon divorce would likely be the same 50/50 split? How would the IRS see this? Couples would obviously intend to “alter their legal relations” for tax purposes. Would a simple declaratory judgment from an Ohio court that such an arrangement will not violate the statute help? Ohio’s strange law in this area raises additional questions that have no clear answer.

a. Attaining Additional Basis at First Death – Integrating Optimal Basis Techniques

The so-called “joint GPOA” (fka poorer spouse funding technique) trust proposed by some to use in separate property states could be a disaster, because IRC §1014(e) may require a step down, but deny a step up. Moreover, it may use up twice the gift/estate tax exclusion for no good reason. This section will discuss ways to avoid these results and tweak for optimal basis increase results, and ensure the best chance for obtaining step ups in basis for both spouse’s assets at first death, even in a non-community property state.

First, how does this structure typically work in the PLRs and articles discussing them? Let’s say H has $2 million of property and W has $2 million. Copying PLR 2006-04028, H puts his $2 million into his revocable living trust, W puts her $2 million into her revocable living trust. Each trust grants the non-grantor spouse a general power of appointment (GPOA) up to their remaining applicable exclusion amount (some GPOAs in the PLRs are presently exercisable, some testamentary). Thus, if H dies, H can not only control disposition of his $2 million, but W’s $2 million in trust as well (and vice versa). Mimicking the PLR, H amends his Will to appoint W’s trust assets to his own trust at his death. Should H die, all $4 million goes into his trust.

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96 See PLRs 2001-01021, 2002-10051, 2004-03094, 2006-04028, TAM 9308002. Some practitioners question the holdings that transfers from the owner-spouse to the decedent-spouse at death qualify for the marital deduction under IRC §2523. However, other aspects of those rulings are non-controversial, and include the idea of capping a GPOA to an amount able to be soaked up by an appointee’s available applicable exclusion amount – a key feature in this article that the IRS has expressed no problem with. Furthermore, smaller estates may not care about the marital deduction and “double use” of exclusion anyway.

97 Thus, this is no longer really a “poorer spouse” technique, the “poorer spouse” problem has largely been eliminated by portability except for GST exploitation and common disaster scenarios – see Part I of this article.

98 Other PLRs use joint trusts, but my preference, and the preference of most attorneys in non-CP states, would be to use two separate trusts for better tracing and administration, but the same concepts apply to joint trusts.
What everyone agrees on, including the IRS: at H’s death, W’s $2 million trust is included in H’s estate because of the GPOA. W is deemed to have made a taxable gift by allowing H to appoint her $2 million to H’s trust for her.

What everyone does not agree on: how the gift of the $2 million in W’s trust transferred via H’s GPOA is treated (does it qualify for the marital deduction? If not, is it partially a gift to oneself?) and whether an adjustment in basis is required. In addition to these two main issues, there are also potential issues with the step transaction doctrine, reciprocal trusts and state law creditor protection issues.

**Marital deduction.** All of the PLRs and TAM accept the premise that the $2 million gift qualifies for the marital deduction, even though the donee spouse would arguably be dead – the GPOA becomes effective, and the relinquishment of control by W to complete the gift, at death. Those rulings were quite favorable to taxpayers - arguably IRC §2523 would not allow the deduction.99

However, the marital deduction is now completely moot for many clients, whose combined estates may be under one spouse’s applicable exclusion amount, especially when augmented by portability. In our example above, using 2013 values, denying the §2523 deduction would cause W to have $3.25 million basic exclusion amount instead of $5.25 million (due to $2 million gift not qualifying for the marital deduction). Her DSUE from H’s estate would be either $5.25 million (if H’s own $2 million and GPOA appointment went to his wife or a marital deduction trust), or $1.25 million (if none of H’s $4 million qualified for marital deduction), or in between for other dispositions, partial QTIP elections, etc. This still gives her between $4.5 million and $8.5 million AEA – either way, she is nowhere near having a federal estate tax issue by the loss of $2 million gift/estate tax exclusion (if it is that much, see below)! Even this effect can be mitigated with techniques discussed below.

The smart play by W may be (if the value merits) to at least try to claim the deduction and additional DSEU on H’s estate Form 706 and attach all relevant information – at least

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99 Learned attorney opinions of the IRS’s conclusions range from scathingly dismissive - “smoke and mirrors” to accepting - “common sense suggests that the IRS is correct on the marital deduction issue”, from Clary Redd’s article *Sharing Exemptions? Not So Fast, Trusts and Estates, April 2008* and *It’s Just a JEST, the Joint Exempt Step-Up Trust, LISI* Estate Planning Newsletter #2086 (April 3, 2013) by Alan Gassman, Thomas Ellwanger & Kacie Hohnadell, respectively. The issues are much more complex than you would think for a simple technique.
there is a decent argument and several PLRs. After all, as discussed in Parts I and II of this article, treasury regulations accept the fiction of surviving spouses in qualifying for the marital estate tax deduction in simultaneous death scenarios, and there are cases that suggest the gift at the moment of death is to a surviving spouse.100

Furthermore, if IRC §2523 does not apply, who is the gift to if not to the spouse, and how much is taxable? This is never addressed in articles on this subject, but it may be quite important. If you cannot gift to a corpse (here, W gifting to her dead H), then the gift must be to H’s estate or appointees, who are – you guessed it – W and children! If W makes a $2 million gift to a corporation or LLC in which she is 40% owner, the IRS looks through to the company owners as donees - it is not a gift of $2 million, it is a gift of 60% of $2 million - $1.2 million.101 If a spouse or charity owns portions of the 60% it may be deductible for gift tax.102 If you gift to a probate estate, the gift is really to the beneficiaries of that estate. If W inherits 100% of H’s estate, then the gift is to herself, and not taxable. But, presumably, H’s estate would pour into a trust in which W has a lifetime interest plus HEMS. If her share might be valued at 40%, shouldn’t the result be similar to the corporation donee example? This is easy to value with a simple net income or unitrust, but if there are spray provisions, LPOAs, etc, keep in mind that “if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.”103

More confusingly, I mentioned above that the true donees would logically be “H’s estate OR appointees” – what if those are not the same? Arguably, W’s gift would be to H’s estate, not the appointees, because it was H’s intervening decision to use his GPOA to appoint to the appointees. Thus, if W were H’s heir at law and/or sole residuary beneficiary outright under his Will, there would be no taxable gift (because W would be gifting to herself), and yet, H may have appointed those assets elsewhere, to a trust that may or may

101 Treas. Reg. 25.2511-1(h)(1)
102 Of course, these deductions are based on what the donee receives, which, depending on the valuation of the business before and after, may not increase by the full $1.2 million – it may increase by less
103 Treas. Reg. 25.2511-1(e)
not include W. This leads us to the more important subtopic of how the step up in basis works, after which we will address ways to integrate the two statutes into planning and use savings clauses to prevent estates from the potential negative interpretations.

**Into the Wind of IRC §1014(e) – Tacking Techniques to Increase Basis.** Some of the PLRs referenced below, like PLR 2006-04028 and PLR 2004-03094, do not even address IRC § 1014(e). PLRs 2002-10051 and 2001-01021 and TAM 9308002 under similar facts did address this issue, and would deny the step up.\(^\text{104}\) Or would they? The PLRs merely say that “Section 1014(e) will apply” – they do not say how and to what extent. And the TAM addressed an outright to spouse scenario rather than a typical trust bequest.

Here is §1014(e) in its entirety for better understanding:

“(e) Appreciated property acquired by decedent by gift within 1 year of death.
   (1) In general. In the case of a decedent dying after December 31, 1981, if--
   (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
   (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),
   the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
   (2) Definitions. For purposes of paragraph (1)--
   (A) Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.
   (B) Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.

Did H “acquire the property by gift”? Arguably, H did not – for the same good reasons that argue against the marital gift tax deduction under IRC §2523 – he was dead at the time of the completed gift, so how can a corpse receive a gift? How is it “acquired by the decedent by gift”? Although Congress is not required to be consistent or even logical, the interpretation of these two sections should be consistent regarding the tax treatment of a transfer occurring at death. Either a court should deem the recipient alive at the moment of

\(^{104}\) From PLR 2002-10051 - “In addition, section 1014(e) will apply to any Trust property includible in the deceased Donor's gross estate that is attributable to the surviving Donor's contribution to Trust and that is acquired by the surviving Donor, either directly or indirectly, pursuant to the deceased Donor's exercise, or failure to exercise, the general power of appointment over the Trust property.” PLR 2001-01021 has near identical language.
transfer, in which case §2523 AND §1014(e) apply, or, you deem the recipient dead at the moment of transfer, in which case NEITHER §2523 NOR §1014(e) apply.

While some practitioners scathingly dismissed the former interpretation as a “gift to a corpse”, the IRS may ultimately have been quite savvy to have allowed that interpretation, in that consistency would assure that §1014(e) also applies, and that interpretation may ultimately be more valuable to the federal fisc.

Let’s assume H did “acquire” the $2 million “by gift” prior to death (consistent with the IRS’ §2523 rulings in the four PLRs/TAM) and address the second prong. Is it “acquired by the donor”? The simple answer in our case is “no”, it is acquired by a trust in which the donor is a beneficiary. But trusts are simply legal fictions dividing legal and equitable title, obviously W is acquiring part of the equitable title. IRC §1041(e)(2)(B) contemplates this possibility by specifically including someone who inherits outright through an estate or trust “to the extent the donor ...is entitled to proceeds”. In addition, PLRs 2001-01021 and 2002-10051 cite the Congressional record – §1014(e) should apply to property “acquired by the donor...indirectly”. Most articles on this subject conclude that 1014(e) applies either 100% or 0% in our example of assets left in trust for W- but basic equitable law and trust valuation principles, coupled with the above language, argue that the step up for appreciated assets should be pro rated based on the valuation of the underlying equitable interests, based on the age of the donor/beneficiary and the terms of the trust.

But there are simple planning techniques that avoid the above nuances and argument that the assets should be denied a step up, or partial step up. First, of course, practitioners should make sure that only the surviving spouse’s share of assets where the step up is warranted are subject to the GPOA, so at least any step down is avoided (see sample clause in appendix and discussion in Part III). Recall that IRC §1014(e), craftily, does not apply to “depreciated” property and cannot be applied to deny a step down in basis.

Furthermore, to make it clear that IRC §1014(e) should not apply to the appreciated assets, yet retain nearly the same access for the surviving spouse, consider making the surviving spouse a permissible appointee of such trust under a child or other party’s lifetime limited power of appointment, rather than a beneficiary.
Example #2: John and Jane, with children of the same marriage, each have $1 million of low basis property, and $1 million of cash equivalents, retirement plans, annuities, property with basis higher than FMV etc. John and Jane give each other a formula testamentary GPOA over each other’s low basis property (this could be via joint trust, but my preference is still to use separate trusts). John dies. He leaves his $2 million to an OBIT trust for Jane (although he would likely leave retirement plans and annuities to her outright). Jane keeps her $1 million of cash, retirement plans, annuities, high basis “loss” property. John appoints Jane’s $1 million low basis property over which he had a GPOA to a Power Trust with their children as beneficiaries in a pot trust, granting each of the children the lifetime limited power to appoint (“LLPOA”) income and/or principal to Jane for whatever reason. This should result in a full step up in basis despite IRC §1014(e) because the funds are not coming back to Jane nor to a trust in which she is a beneficiary. Giving each child an LLPOA is to prevent the King Lear effect – as long as one of the children is a Cordelia rather than a Goneril or Regan, Jane should be fine. For an extensive discussion of the other asset protection benefits of “Power trusts” as opposed to DAPTs, email the author for a separate outline.

Example #2b (why NOT to use the Delaware Tax Trap): Same as above, but John and Jane give each other a formula testamentary LPOA – John’s will or trust exercises the LPOA to appoint to a DTT trust that grants Jane a PEG power (presently exercisable general power of appointment), triggering 2041(a)(3) inclusion. In contrast to the above, this should trigger §1014(e) to deny the step up 100%, because Jane’s PEG power is equivalent to having assets pass back to the donor within one year – with a PEG power, she is arguably 100% the equitable owner. If the appointment were to a trust granting the children a PEG power (e.g. to appoint unlimited income/principal to their creditors with, and thereafter only to their mother), this would severely impair asset protection if the children had creditor problems, not to mention the King Lear effect. This would also cause a taxable gift upon any transfer to their mother – for many families this would not pose a problem, but for wealthier beneficiaries it might.
Thus, using the Delaware Tax Trap does not work nearly as well for various joint step up scenarios at the first death. The formula GPOA with Power Trust as appointee is far superior for seizing basis.

Using OBIT techniques at the first death for a married couple brings up additional planning techniques and concerns. First, despite the four PLRs discussed, to be conservative we may want to assume that §2523 will not apply (which enables us to circumscribe the GPOA for better asset and family protection as discussed in Part V above), and the technique will use TWICE the exemption amount (e.g. appointing $1 million will cost $1 million from both H’s and W’s AEA). For 90% of the population, this is still a winning deal, but we would be more selective with assets over which the GPOA applies for those with total estates over $5 million – favoring depreciable real estate that gives the surviving spouse a tax write-off, for instance, rather than artwork, home, etc that might not be sold until after the surviving spouse’s death. Let’s modify our example above with double the assets.

Example 3: John and Jane have $4.5 million each, comprised of $1.5 million in QP/IRA/annuities, $800,000 million vacation home in JTWROS, $200,000 in art, autos and furnishings, $500,000 cash equiv, $1 million stock portfolio, $500,000 rental property JTWROS with low basis. A GPOA over all the assets, as in the PLRs, could be disastrous here, if §2523 does not apply, but often couples won’t need or use the step up at first death – the vacation home won’t be sold until after the first death, and wouldn’t be entitled to depreciation anyway, same with the art and cars. So, the GPOA in this case might be modified to apply to only the rental property and stock that has appreciated more than 25%. Let’s say that is $1 million. If §2523 does not apply, and John dies, his DSUE is reduced by $1 million. For simplicity, assume Jane inherits John’s other assets outright or in marital trust, so her remaining AEA is only $8.5 million due to the two $1 million transfers. However, she obtained the step up which could save her significant income taxes in retirement, and her remaining estate is only $8 million. The inefficient use of exemption may be a moot point, especially if Jane decides to make some charitable bequests in her estate. In fact, couples without children often have significant charitable intentions – such techniques should be strongly considered for them, even with larger estates, as noted above.
Flexible Provisions for Lifetime GPOA Trusts (JESTs) Using OBIT Techniques to Adapt to Either Interpretation of §2523/§1014(e)

As discussed above, when husband grants wife a lifetime GPOA over husband’s assets, at H’s death, there is a taxable gift of the amounts subject to that GPOA – we just don’t know whether it will ultimately be interpreted as a gift to the decedent spouse, in which case §2523 allows the marital deduction, but §1014(e) would deny the step up, or whether it will be interpreted as to the decedent spouse’s estate, in which case §2523 should not allow the marital deduction, but §1014(e) should not apply either, because the decedent spouse never received a gift.

Wouldn’t it be great to adapt our planning to either interpretation? For instance, a couple might prefer that if §2523 allows the marital deduction, such that §1014(e) would apply if the spouse is the beneficiary of the appointive trust, that the spouse is removed as beneficiary altogether to ensure the step up. The surviving spouse may effect this through a qualified disclaimer, of course, but that assumes that you know the answer to that question within 9 months of the date of death. Or does it?

Recall the Treasury guidance cited earlier in this article on formula disclaimers? Disclaimers don’t have to be over an entire estate or trust or IRA, they can be over any asset, and can reference a tax determination that may be years later in coming. The language could be adapted as follows, substituting the appointive assets in question for the entire estate, and income tax reference for the estate tax reference: “The numerator of the fraction disclaimed is the smallest amount which will allow the appointive assets to pass with an adjustment to date of death basis under IRC §1014(a) and (b) and free of application of IRC §1014(e) and the denominator is the value of the appointive assets.” If the IRS settles on a “gift to spouse at death” interpretation that permits a step up in basis even if the spouse is a beneficiary, the “smallest amount” disclaimed will be $0. If the IRS settles on a “gift to spouse at death” interpretation that would deny a step up under IRC §1014(e) if the spouse were a beneficiary, then the “smallest amount” under the above disclaimer will the entire

105 Treas. Reg. 25.2518-3(d), Ex. (20) “A bequeathed his residuary estate to B. B disclaims a fractional share of the residuary estate. Any disclaimed property will pass to A's surviving spouse, W. The numerator of the fraction disclaimed is the smallest amount which will allow A’s estate to pass free of Federal estate tax and the denominator is the value of the residuary estate. B's disclaimer is a qualified disclaimer.”
amount, the spouse is removed as a beneficiary (but might remain a permissive appointee), and the trust assets can still achieve the step up in basis.

Alternatively: what if the testamentary GPOA in question were only granted to the decedent spouse using language similar to AB marital trusts? So, back to our example #3, Jane’s trust might say “At my husband’s death, if I survive my husband, my husband shall have a general testamentary power to appoint the Qualified Appointive Property. Qualified Appointive Property shall mean such property, or its proceeds, in the trust estate that, if given outright to my husband at his death, would qualify for the marital deduction for purposes of determining the United States gift tax payable because of the transfer made complete at the death of my husband.”

Would such a precondition, in some ways similar to language in many marital trusts, pass muster? Would the trend of the taxpayer victories in formula gifting in Wandry, Petter, Christiansen, Hendrix cases help? Perhaps – but those concerned valuation rather than whether a gift qualifies for a deduction or not.

As complicated and uncertain as all of this is, we have not even addressed whether the IRS might make other arguments regarding §2523, such as whether the donee deceased spouse has a valid lifetime income interest that is not “terminable” at the time of death, or whether the infamous step transaction doctrine might apply. While there are plenty of cases where the IRS has argued “prearrangement” between spouses and lost, one of the most important “bad facts” for any step transaction case would be instantaneous successive transfers – an inevitable fact here.

In conclusion, until there is further guidance, wealthier couples with estates close to $10 million or above should simply avoid these techniques, unless the bulk of their estate will go to charity at the second death anyway, because of the potential for double use of exclusion. They should consider an Alaska Community Property Trust instead. For couples with much lesser estates, there may be little to lose by attempting these techniques, and many of the ideas in the above pages should be improvements over the designs in the various PLRs.
VI. Increased Asset Protection Opportunities Mimicking DAPTs Due to Larger Exclusion (the “poor man’s DAPT”?)

The increased exclusion also offers up greater asset protection planning opportunities. Consider this variant for smaller estates: Husband sets up an irrevocable trust (aka SLAT) for Wife (which may be defined as whomever he is married to at the time, since we do not need to qualify for the marital deduction as an inter vivos QTIP or GPOA). Wife has a testamentary GPOA, circumscribed as discussed above. Wife and children have a *lifetime* limited power of appointment to appoint to Husband/Father. Merely being a permissive appointee of a limited power of appointment should not threaten asset protection, even if the donor of the power is a permissive appointee.\footnote{While this is generally the common law, Ohio clarified its common law with R.C. §5805.06(B)(3)(a) – for additional CLE material on asset protection aspects of powers of appointment, email author for separate CLE outline discussing/contrasting the advantages of “Power Trusts” over DAPTs.} If wife dies first, and the GPOA is not exercised, or if it is exercised successfully in favor of the husband, husband becomes beneficiary of the trust. Unlike inter vivos QTIPs or LPOA exercises that “relate back”, the settlor changes at Wife’s death pursuant to a GPOA (though with a lapse of the GPOA, it may only change as to 95%).\footnote{UTC §505(b), for Ohioans, see newly amended Ohio R.C. §5805.06(B)(3)(b) – protection is 100% in Ohio – note that for GST purposes, the 5% lapse is disregarded and the spouse with the lapsing GPOA would be considered the transferor of 100% for GST purposes – generally the optimal result. See Treas. Reg. 26.2601-1(b)(1)(v)} This means that the trust is *not* self-settled if Husband later becomes beneficiary.

In some states, you can do this with an inter vivos QTIP as well, so that less gift/estate tax exclusion is used. In other states, an inter vivos GPOA marital may be preferred to achieve the same tax and asset protection result, but recall that the GPOA for a marital trust must be more open to use/abuse, and is therefore less protected.

Unlike DAPTs, which have to be done in certain states, use certain trustees, and have various uncertainties, requirements and drawbacks, such trusts can be done in any state. For a comparison chart between “Power Trusts” and DAPTs, see author’s separate outline.

Furthermore, you may even have flexibility regarding grantor trust status for income tax purposes after W’s death. This gets tricky. If H establishes a trust for W and she exercises a GPOA to appoint back to a trust for H, W is now the grantor for income tax

purposes, overriding H as the grantor.\textsuperscript{108} This overrides any provisions or conclusions that would otherwise deem H the grantor under IRC §671-679, making it a non-grantor trust.\textsuperscript{109}

However, if H establishes a trust for W, with a testamentary GPOA that W merely allows to lapse at her death, and the trust then continues for H, then it is unclear whether the regulations cited above apply.\textsuperscript{110} This may be another area where state law, estate tax and income tax law do not necessarily stride in lock step.

\textsuperscript{108} Treas. Reg. §1.671-2(e)(6), Example 9 – thanks to attorney Gary Maddox for correcting a typo and suggesting clarifications to this discussion.
\textsuperscript{109} Treas. Reg. §1.671-2(e)(5)
\textsuperscript{110} Treasury could have simply added the words "lapse" or "release" of a GPOA in §1.671-2(e), as in other sections, but did not. Absent an "exercise" of a GPOA, it is unclear under what authority one would override grantor trust rules that otherwise conclude that H is still the grantor under IRC §671-679 (due to access to income, swap/substitution power, income for insurance or other administrative power). Therefore, H may still be considered the grantor of the trust for income tax purposes, since, contrary to the regulation, W did NOT exercise her GPOA.

So which would H and H's family prefer? In most cases the simplicity and leveraging of grantor trust status, taxable to H, would be preferred. However, in some situations H might be able avoid state income tax on accumulated income with a non-grantor trust, or H might want to use income tax spraying techniques to beneficiaries in lower brackets (either via spray provision or lifetime limited power of appointment, as discussed later in this paper). Those advantages are unavailable to grantor trusts. In such cases, H would prefer non-grantor trust status, and encourage his wife to exercise her GPOA in favor of him in trust to ensure this result.
VII. Use of Optimal Basis Increase Techniques by Pre-Existing Irrevocable Trusts

The concepts herein can also be applied to inter-vivos irrevocable trusts and trusts continuing for additional generations. Similar techniques can be incorporated in downstream dynastic trusts for better basis increases to grandchildren and beyond. This would involve GST considerations as well.

Most importantly, practitioners should not overlook the significant value in adapting many pre-existing irrevocable bypass trusts (including intervivos SLATs, or other irrevocable trusts) to fully use this $5.25 million (and increasing) basis increasing “coupon”. This may be done by various ways – triggering the Delaware Tax Trap using an existing limited power of appointment that permits appointment to trusts, or changing the trust via decanting, private settlement agreement or court reformation to add a limited or general power of appointment. Choice of these options will be trust and state law dependent.

The advantages may be significant. Imagine how many current irrevocable bypass trust surviving spouse beneficiaries have well under $5.25 million in their personal estate? (actually, a widow(er) might have quite a bit more if their spouse died after 2010 and they elected DSUEA).

Example: John died in 2008, leaving his wife Jane $2 million in non-IRA assets in a typical bypass trust, which has now grown to $3.5 million. Although some of the assets have been sold, rebalanced, the trust assets now have a basis of $2.5 million. Jane’s assets are $2.5 million. Why waste $2.75 million of her $5.25 million “coupon” she is permitted to use to increase basis step up for her family? Jane therefore amends her will/trust to exercise her limited power of appointment granted in John’s trust, mirroring language discussed above: assets with basis greater than FMV or IRD go to a trust for her children (or simply continue in trust under the residuary), and assets with basis under FMV (for which Jane and her family desire the step up) simply go to a similar trust for her children that contains a presently exercisable general power of appointment, triggering IRC §2041(a)(3) and getting the family up to an additional $1 million of basis free of charge. And, of course, this exercise can be limited to her available Applicable Exclusion Amount and applied first to the most appreciated assets first, capped to prevent any estate tax and/or account for any state
estate tax, or even chosen to exploit the assets most likely to be sold by beneficiaries first, as discussed above.

Many beneficiaries do not have current asset protection issues, asset levels close to a taxable estate or any desire to spray or gift inherited assets. Thus, the vast majority of LPOA powerholders and their prospective appointees would probably prefer to save income tax with a higher basis than avoid the theoretical negatives of a presently exercisable GPOA. Unless there are current creditors on the horizon, beneficiaries can always avail themselves of self-settled asset protection trust legislation in Ohio, Delaware, Alaska or one of the other jurisdictions that permit this. If there are, beneficiaries can disclaim their GPOA. So, in practical terms, the main reason to forego any use of the Delaware Tax Trap is if a powerholder wants to preserve assets for grandchildren or other beneficiaries.

But let’s say Jane did not have a limited power of appointment, or doesn’t like the drawbacks of granting the beneficiaries a presently exercisable general power of appointment. Aren’t we taught after Bosch and similar cases and PLRs that trying to reform a trust for the marital or charitable deduction post-mortem (or post gift) should not be recognized?111 Isn’t this a similar trend for IRA “see through trust” rulings?112

These cases and rulings can easily be distinguished. Most of them concerned taxpayers trying to change the legal effect of what the trust terms were at the death of the original transferor (i.e., does it qualify as a marital, charitable or see through trust at death).
They do not concern what a transferee decedent owned or didn’t own at the time of a transferee’s death.

IRC § 2041 concerns what rights and powers a decedent has over property. If trust terms change so as to be legally binding, they absolutely change those property rights. We know of cases and rulings, not to mention every treatise recommendation on the subject, wherein a beneficiary who becomes their own trustee without ascertainable standards (or can remove and cause himself or related/subordinate party to be trustee) should have those assets included in their estate. A GPOA is no different. The IRS can certainly try to enact a double standard, but the vast body of 2041 jurisprudence is to the contrary.

In Rev. Rul. 73-142, a grantor/decedent established a trust for his wife and children, not subject to ascertainable standards, and mistakenly retained the power to remove and become the trustee.113 Years prior to his death, he went to court to successfully construe the trust to mean that he could not be appointed trustee (nowadays, we would also preclude removal and replacement with any related/subordinate party).114 The IRS ruled that this court order had tax effect to negate the IRC §2036/2038 issue despite the state court decree being contrary to the decisions in the state’s highest court. While this is not an IRC §2041 case, this Rev. Rul. bodes well for such proactive planning to add a limited GPOA for better tax results.

One PLR following Rev. Rul. 73-142 noted a key difference with Bosch: “Unlike the situation in Bosch, the decree in the ruling [73-142] was handed down before the time of event giving rise to the tax (that is, the date of the grantor’s death).”115 In that PLR, a state court order construing a tax apportionment clause to apply to the GST non-exempt marital share rather than equitably to both GST exempt and GST non-exempt shares was given effect. This was good proactive planning by counsel prior to the taxing event to keep more funds in a GST sheltered trust.

Like the above rulings, any such modifications to ensure an Optimal Basis Increase would similarly affect a surviving spouse’s rights before the time of his or her death, and with

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113 Rev. Rul. 73-142
114 Treas. Reg. §20.2041-1(b)(1), Rev. Rul. 95-58
115 PLR 2005-43037
current trust law trends, such reformations would unlikely even be contrary to the state’s highest court. Obviously, if beneficiaries try to fashion such a solution *after* both parents’ deaths, this would be unavailing under *Bosch* and many other decisions. However, there is strong precedent that private settlement agreements, court actions pursuant to statute, decanting, trust protector or other methods to add a formula GPOA *prior* to the time of the event giving rise to the tax (the surviving spouse’s death), should (and must) be given effect.

The reverse, removing a GPOA, is a more difficult issue, so any reformation should strongly consider the irrevocable nature of it. Generally, releasing a general power of appointment would trigger gift tax, and could trigger taxation of any IRD.\(^{116}\) However, in one recent PLR, the IRS allowed a post-mortem court reformation to essentially remove a GPOA without adverse tax effect.\(^{117}\) I would not count on this result for every post-mortem reformation removing a GPOA, but the PLR is instructive as to how the IRS applies the Supreme Court’s holding in *Bosch*.

Any added powers of appointment can limit appointees to certain trusts. In our example above, if Jane had not been granted a limited power of appointment, the trustee might decant to a near identical trust which grants Jane the limited testamentary power to appoint certain assets to the Jane Doe Irrevocable Delaware Tax Trapping Trust, a trust established with terms nearly identical to her husband John’s trust for the children, only granting the children a PEG power circumscribed using techniques discussed above. Indeed, this would be a more prudent exercise of the trustee’s decanting power (or court’s power to amend), since it would do less harm to the original settlor’s intentions than adding a broad LPOA or GPOA (indeed, many trusts pay outright to children at some point anyway).

While adding a limited lifetime or testamentary LPOA or formula GPOA, consider changing any “all net income” requirement to a more flexible standard that would allow spraying and/or accumulating income, and address capital gains, for better income tax planning (see Part VII below). In a very recent PLR, the IRS ruled that such a modification was not a taxable gift, did not trigger gain, nor did it affect the GST zero inclusion ratio.\(^{118}\)

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116 IRC §2514
117 PLR 2011-32017, see also PLR 2010-06005 approving reform of a GPOA to an LPOA w/o adverse tax effect
118 PLR 2013-20004, modifications complying with GST grandfathering regs were OK for allocated GST exempt
VIII. The Income Tax Efficiency Trust – Ongoing Trust Income Tax Planning Techniques

As mentioned above in Part I, there is another tax issue with trusts after ATRA that may now dissuade the average couple from using ongoing trusts for planning. With the new tax regime, unless we plan, administer and invest carefully, the overall income tax to the surviving spouse and family will be higher every year, sometimes by a considerable amount.

Creative use of IRC §643 and/or IRC §678(a) loopholes can ensure that capital gains are not trapped in trust at the highest rates, may get better tax treatment for special assets, and may even be sprayed to beneficiaries or charities in much lower (or even 0%) brackets. Non-grantor trusts may have an additional advantage in some states in their ability to shelter from state income taxation.

First, let’s pause for a refresher on how the new tax regime, including the Medicare surtax, affects non-grantor trusts and beneficiaries, and why 2013 changes the game.

For individuals, the 3.8% tax will apply in 2013 to the lesser of net investment income or the excess of a taxpayer’s modified adjusted gross income (MAGI) over:

- $125,000 (married filing separately)
- $250,000 (married filing jointly and qualifying widower)
- $200,000 (single) (individual thresholds in IRC §1411(b))

The “modified” applies to those who live abroad and use the foreign earned income exclusion – for 99% of taxpayers, this is the same as adjusted gross income (AGI), the bottom line of Form 1040.

For estates and trusts, it applies to the lesser of the undistributed net investment income or the excess of an estate/trust’s adjusted (not modified) gross income (AGI) over:

- $11,950 (top tax bracket, adjusted for inflation) (IRC §1411(a)(2))

“Net investment income” is

“A (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in paragraph (2),

(ii) other gross income derived from a trade or business described in paragraph (2), and

(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in paragraph (2),
[Minus,]
(B) the deductions allowed by this subtitle which are properly allocable to such gross
income or net gain.”

Qualified retirement income is excluded, as well as wages, self-employment income,
active business income or gain from a sale of such a business.120

There are many basic ways of restructuring finances and investments to avoid the
surtax, most of which also avoid/defer income tax, such as:

- using tax exempt investments such as municipal bonds;
- using investments or accounts with tax deferral features such as life insurance,
defered annuity contracts, deferred comp or retirement plans;
- utilizing traditional techniques to defer recognition/timing of gains, such as tax-free
  exchanges, installment sales or charitable remainder trusts;
- investing in assets with tax depreciation features, such as traditional real estate or oil
  and gas investments;
- more sensitive attention to tax recognition, such as using low turnover funds, ETFs
  and/or managing individual stocks and bonds;
- accelerating the timing of income recognition into 2012, via Roth IRA conversions,
distributing C Corporation dividends or harvesting long-term capital gains;
- for decedent’s estate/qualifying trusts, electing fiscal years ending/beginning in
  November, 2012 (the tax applies to years beginning after Dec 31, 2012, so a Dec 1,
  2012-Nov 31, 2013 fiscal year would allow eleven months of 2013 income to avoid
  the tax).

Most of these techniques are not new to the surtax and have traditionally been used
for basic income tax planning. While some are effective planning for any year, overuse can
simply become the “tax tail wagging the investment dog”.

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119 IRC § 1411(c)(1)
120 IRC §1411(c)(2),(4),(5),(6)
This outline will discuss more unique opportunities and pitfalls of this new surtax and higher tax rates as applied to ongoing non-charitable, non-grantor trusts, through more proactive trust drafting, planning and administration. Without such planning, many trusts will get stuck paying a tax that might be easily avoided. The article first sets forth an example of the basic problem, then explores potential solutions to avoid the surtax.

The first example below assumes that all trust/beneficiary income is otherwise subject to surtax pursuant to IRC §1411(c) (i.e. interest, dividends, capital gains, annuities, rents, royalties, passive activity income, not retirement income, municipal bond interest, active business income, sale of active business or other exception) and any capital gains is not within a special tax rate category (such as IRC §1250 depreciation recapture or special rate for collectibles). The $100/$300 deduction and other common deductible expenses are ignored for simplicity, as well as any state income taxes.

CONSIDER: Barbara, recently widowed, is the primary beneficiary of a $2 million bypass trust established by her late husband. Her income outside the trust is $70,000. For 2013, the trust has ordinary income of $40,000 (which I have assumed to be also equal to the trust’s accounting income and distributable net income (DNI)), short-term capital gains of $30,000, and long-term capital gains of $70,000. The trustee allocates all capital gains to trust principal. In its discretion, the trustee distributes to Barbara all of the accounting income ($40,000) as well as a discretionary distribution of principal of $75,000 needed for her support. The trust is entitled to a distribution deduction of only $40,000 and has taxable income of $100,000 (the sum of its short-term and long-term capital gains).

The $75,000 principal distribution is not ordinarily included as part of what is called the “DNI deduction”. It is this latter aspect of trust income taxation that is often overlooked and misunderstood by practitioners, and is potentially the source and trap for higher tax. Once the trust is over $11,950 of taxable income (roughly $88,050 in this case), it

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121 It does not apply to fully charitable trusts and charitable remainder trusts – see page 135 of the Congressional Joint Committee on Taxation Report JCX-18-10 and IRC §1411(e). This article will skip discussion of the surtax and higher rates as applied to estates, because it will often be less of a problem, due to recent step up in basis, higher than usual deductions such as attorney, executor and probate fees, and the fact that terminating estates pass out capital gains as part of DNI – but estates taking over a year to settle or pouring over into a trust will involve the same issues.

122 IRC §643(a)(3), Treas. Reg. §1.643(a)-3(a)
is taxed at 39.6% (20% if LTCG/qualified dividends), plus, unless it meets an exception such as IRA/QP distributions, it is also subject to the 3.8% surtax.

Back to our example and the new effect of the higher rates and the surtax: beginning in 2013, all of that short term capital gains (after $11,950) is subject to top income tax rate (39.6%), plus the 3.8% surtax. All of the long-term capital gains is subject to a top long-term capital gains tax rate of 20%, plus the 3.8% surtax. Can we work some trust accounting alchemy allow capital gains to escape being trapped in the trust? In our example, this may allow investment income to completely avoid the surtax and lower taxes on short-term and long-term capital gains as well. This would subject the short-term gains to a mere 25% or 28% tax in the hands of the beneficiary (the lower rate would apply if Barbara is a qualifying widower or remarried), instead of 43.4% (39.6% +3.8% surtax), and subject the long-term gains to a mere 15% in the hands of the beneficiary instead of 23.8% (20% +3.8% surtax).

Potential tax saving in this example if no capital gains is trapped in trust (assuming remarriage or qualifying widow filing status, if not, savings slightly less):

23.8%-15% (8.8%) times total LTCG ($70,000) = $6,160
(amount of overall LTCG and surtax savings by taxing to beneficiary not trust)

plus

43.4%-28% (15.4%) times STCG ($30,000 -$11,950) = $2,780
(amount of STCG and surtax savings from taxing to beneficiary, not trust)

(for simplicity, we’ll assume the first $11,950 taxed to the trust would generate approximately the same tax if taxed to the beneficiary)

Total Potential Tax Savings, Annually = $8,940

If a beneficiary is otherwise in the highest tax bracket (currently $400,000/yr single, $450,000 MFJ taxable income), then the fact that income is “trapped” in a bypass/marital trust in 2013 at the highest bracket, plus a 3.8% tax makes no difference - she would have paid that same level of tax anyway. Whether income is taxed to the trust or to such a beneficiary would usually be income tax rate and Medicare surtax-neutral. Most trust beneficiaries will not fit in this elite bracket of taxable income, however. And, even high-
bracket taxpayers may have capital loss carry forwards that could soak up distributed capital gains.

But if distribution standards would otherwise require or permit significant distributions from principal to be made to the beneficiary, then why not arrange the accounting of those same distributions in the most tax-effective manner?

Some family situations, such as second marriages where a settlor wants the maximum proscription on the spouse’s distributions and maximum remainder for beneficiaries, do not offer much in the way of flexibility. We are mostly left with standard income tax deferral techniques. But for many families, there are good options to avoid this fate of higher ongoing trust taxation, especially if we are in drafting mode or have not yet established any history of trust accounting and administration.

There are two main methods – 1) using IRC §678(a) to allow the spouse to withdraw all net taxable income, specifically including all net capital gains or, usually better, 2) coming within one of the three exceptions in Treas. Reg. §1.643(a)-3(b) which allow discretionary distributions to carry out net capital gains. 123

**IRC §678(a)** – A trust that merely directs all net income, or even pays all taxable income, to a beneficiary, is NOT necessarily a beneficiary-defective grantor trust – those report under the 1041/K-1 Subchapter J tax regime. To report straight to the beneficiary’s Form 1040, the beneficiary must have an unfettered right to withdraw the taxable income in question.

IRC §678(a) states that a beneficiary is considered the owner of a trust when a beneficiary has the power to vest income or principal in themselves. 124 For instance, a trust

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123 Another less desirable method to pass out capital gains to beneficiaries is for the trust to invest in an entity taxed as a partnership. Cash distributed from an entity such as a partnership/LLC and paid to the trust is generally trust accounting income, even if the cash is derived from capital gains - Uniform Principal and Income Act, §401(b). Thus, because they are “properly allocated to income” pursuant to Treas. Reg. 1.643(a)-3(b)(1), they may be included in the DNI deduction and pass out to beneficiaries on the K-1 as any other income. This, of course, does not help if there are “phantom gains” or cash distributions are not sufficiently made from the partnership to the trust. To structure an entire portfolio in this manner is highly unwieldy. Assuming the other partner can be found and the fiduciary duties worked out, there would still be issues under IRC §2519 if it were a QTIP trust, and one can imagine other practical problems in managing a large portion of the trust in this manner – not to mention the additional tax reporting.

124 This is sometimes referred to as a Mallinckrodt Trust, after Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945) or, more common in recent parlance, a beneficiary-defective grantor trust.
may provide that the primary beneficiary has the right to withdraw all income *including capital gains*. Some trusts have a 5% of corpus withdrawal power that already does this, at least in part.\(^{125}\) While this kind of clause would shift the income taxation (and with it, the Medicare surtaxation), such powers bring up many other negative ramifications - decreased asset protection (amounts taken or subject to such power may be subject to the beneficiary’s creditors), increased estate inclusion (amounts taken or subject to withdrawal at death are in beneficiary’s estate) plus, if assets are *not* withdrawn in a given year, it results in a partially self-settled trust as to the beneficiary, which may have negative ramifications for asset protection, GST allocation/inclusion or estate tax inclusion. Such a provision may also complicate income tax and trust accounting even if the amount not withdrawn is within the 5/5 lapse protection, because it may create a part non-grantor, part grantor (as to beneficiary) trust, for which applicable percentages might even change every year – a real quagmire.

To understand the basics, let’s go back to Barbara’s bypass trust in our example above: with a fully §678(a) trust, Barbara would simply report all $140,000 of taxable income on her Form 1040 regardless of what she actually receives, and the trust has no income. A trust could be partially subject to §678(a). If Barbara only had an unfettered right to withdraw accounting income (interest, dividends, rents), then $40,000 would go onto her Form 1040 (ultimately, the same as if it had been K-1’d).

A fully “beneficiary-defective” grantor trust does have a few advantages, and may be useful in specific situations. For instance, it may be preferable that certain assets, such as a personal residence, non-qualified annuity or qualifying small business stock, be owned by a

\(^{125}\) And, there are persuasive arguments that a sole beneficiary/trustee also has this 678(a) power even when limited by an ascertainable standard, but this is generally unreliable for proactive planning purposes. See page 17-20 of attorney Howard Mobley’s outline at [http://www.howardmobley.com/articles/FixingBrokenTrusts.pdf](http://www.howardmobley.com/articles/FixingBrokenTrusts.pdf) and Jonathan Blattmachr, Mitchell Gans and Alvina Lo’s article at [http://www.eagleriveradvisors.com/pdf/A_Beneficiary_as_Trust_Owner_Decoding_Section_678.pdf](http://www.eagleriveradvisors.com/pdf/A_Beneficiary_as_Trust_Owner_Decoding_Section_678.pdf)
§678(a) trust, because of the preferred tax treatment that individual Form 1040 taxpayers may avail themselves of that non-grantor trusts simply can’t.\textsuperscript{126}

In fact, there is no reason that the trust cannot be provide different standards for income from these special assets, perhaps as a separate trust, but you would not necessarily have to. The most common of these, the capital gains exclusion on principal residence, should be recognized in a §678(a) trust and such a trust would not have many of the negatives of a §678(a) trust mentioned above.\textsuperscript{127} For example, there is very little asset protection risk granting a beneficiary the right to withdraw capital gains/taxable income from sale of a personal residence if an independent trustee doesn’t sell the property! A trust might allow the beneficiary to withdraw net capital gains from the sale of a residence or small business stock, but have ordinary distribution provisions for all other assets.

Many practitioners already segregate IRA/qualified plan assets into separate or standalone trusts for various tax and administrative reasons.\textsuperscript{128} Taxpayers may need to use such special assets to fund a trust to exploit the state’s estate exclusion amount, and making it a beneficiary-defective trust as to the income generated therein may be a significant benefit, even if it is slightly more “leaky”.\textsuperscript{129} This asset protection drawback and inherent “leakiness” might be partially mitigated through a Crummey/hanging power wherein the

\textsuperscript{126}There is some uncertainty and debate among practitioners, as well as differing interpretations among insurance companies, as to whether non qualified annuities may get the same “stretch” opportunity if payable to a trust, even if one can argue that the trust is an “agent for a natural person” per IRC §72(u) (which a 678(a) trust would make more convincing, along with investment authority or other incidents of ownership, so as to be closer to PLR 2003-23012). For a good discussion of this see Chapter 8 of Michael Kitces and John Olsen’s The Annuity Advisor. Non-qualified annuities, perhaps even more so than IRAs/QPs, are best left to spouses outright unless the negatives of outright bequest (higher state estate tax, protection for other family, vulnerable spouse, etc), outweigh the income tax benefits potentially lost by using a trust (which will depend on the gain in the contract). For small business stock exclusion and rollovers available to individual owners, see IRC §1202 and §1045, for losses on qualifying small business stock, see IRC §1244

\textsuperscript{127}See Rev. Rul. 66-159, Rev. Rul. 85-45 and PLR 1999-12026, in which the IRS looked through the trust to the beneficial owner under 678(a) for qualification under IRC §121 and its predecessor. Although in those cases the beneficiary had a right to withdrawal the entire trust principal, not just the capital gains from the sale of the home, they should apply to extend the exclusion if all the capital gains are available to withdraw. A conservative practitioner may want to get a PLR, or pay tax and file for refund, but there is certainly authority for the position.


\textsuperscript{129}For instance, someone in Seattle could easily have a $1 million home, $1 million in other assets, and wants to fund the entire $2 million to exploit the $2 million because their spouse has the same amount of assets — not funding the bypass with the home might cause $200,000 or so in additional state estate tax. WA estate tax has a $2 million exclusion with 10%-19% rates.
beneficiary merely has a power to withdraw the taxable income and to the extent it is not withdrawn, the power lapses annually over 5%.130

Treas. Reg. §1.643(a)-3(b) - The best solution in most cases is to utilize one of the three methods noted in the Treasury Regulations to allow capital gains to be treated as part of the DNI deduction. This will allow any discretionary distributions to the beneficiary to carry out capital gains as part of DNI so that the K-1 can take care of the surtax and higher tax rate issue by putting the capital gains on the beneficiary's Form 1040.

Once capital gains are part of the DNI deduction, they can be carried out on the K-1 and taxed to the beneficiary. So, how do we get out of the default rule that capital gains are not ordinarily part of DNI?131 Generally, they will be included if they are 1) allocated to fiduciary accounting income or 2) allocated to principal and “paid, credited or required to be distributed to any beneficiary during the year”.132 The regulations regarding these exceptions are more specific.133

“(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)–3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.”

130 IRC §2514(c). However, the 5% would pertain to the taxable income available to withdraw, not the entire principal, as some may think – see Rev. Rul. 66-87. My preference in such situations would be to simply withdraw the full amount and if asset protection is desired, have the beneficiary contribute it to an IRA/QP, life insurance, LLC, DAPT or other protective structure, or gift it.

131 See Treas. Reg. §1.643(a)-3(a) for this default

132 IRC § 643(a)(3)

133 Treas. Reg. 1.643(a)-3(b)
Let’s discuss these out of order, taking the easiest and “cleanest” first. The second method, (b)(2), is very straightforward. The trustee simply treats capital gains consistently as part of the beneficiary’s distribution. Ideally, language in the trust will address this, which might even give some cover in case the trustee failed to be consistent.\textsuperscript{134} For new estates and trusts, this is quite easy. For an existing trust, there is a question whether it can change this practice as of January 2013 when in prior years it has been consistently NOT treating capital gains as part of a beneficiary’s distribution. Potential remedies of amendments and decanting will be further discussed below.

The third method, (b)(3), is more problematic. It can be divided into two methods – the first is to “actually distribute” capital gains. This presumably means tracing the proceeds. So, the trustee takes the proceeds from the sale and gives the net capital gain therefrom to the beneficiary. This sounds easier than it is. For instance, what if principal distributions are needed early in the year and cannot wait until later when the net gains can be determined? What about “phantom” capital gains?

In lieu of tracing, the third method also allows capital gains to be part of DNI if the trustee uses capital gains “in determining the amount that is distributed or required to be distributed”. Very few trusts would use capital gains as part of a distribution provision in this manner. For instance, a trust might say that “gains from the sale of a particular business property shall go to beneficiary X.” In theory, the trust could mandate that “the trustee pay all (or X%) of net income and net capital gains to the beneficiary” to invoke this section, but if these were the goals, it would make more sense to use §678(a), not §1.643(a)-3(b)(3).

\textsuperscript{134} Example: “To the extent that discretionary distributions are made from principal, the trustee shall make them and/or account for them in the books, records and tax returns of the trust in the following order:
1) from any current year net short-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC 1411(c)(2), or attributable to disposition of an active trade or business as described in IRC 1411(c)(4);
2) from any current year taxable income attributable to assets described in IRC 1411(c)(1)(A)(i), such as an annuity payment, that was allocated to principal.
3) from any current year taxable income attributable to a qualified retirement plan distribution described in section 401 (a), 403 (a), 403 (b), 408, 408A, or 457 (b) allocated to principal
4) from any remaining current net short term capital gains not described in paragraph 1
5) from any current long-term capital gains, except those net gains attributable to disposition of property held in a trade or business not described in IRC 1411(c)(2), or attributable to disposition of an active trade or business as described in IRC 1411(c)(4);
The first method, (b)(1), offers more flexibility than the latter two, but potentially offers more complexity, because it involves changing the scheme of principal and income allocation.

For many modern trusts, the distinction between principal and income is anachronistic. These distinctions are often meaningless in determining what beneficiaries receive from the trust. However, they are still important for tax purposes.

Corollary to the above regulation, Treas Reg. §1.643(b)-1 states that:

“In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.”

Thus, in theory, not only could capital gains be allocated to income, but it can be done at the trustee’s discretion. Sections 103-104 of the Uniform Principal and Income Act, which provides the default principal/income rules in most states, allow a trustee to make adjustments to income and principal, in theory. However, the default prerequisites and rationale for invoking these provisions do not fit our proactive tax planning example above, where the goal is simply to shift taxation of the capital gains that is arguably already being distributed to the beneficiary.

But this does not mean that a trust cannot be drafted to override Section 103-104’s limitations. Section 103(a)(1) first requires a fiduciary to “administer a trust or estate in accordance with the trust or the will, even if there is a different provision in this Act”.

Section 103(a)(2) further permits a trustee to “administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this Act.” Thus, the attorney merely has to override the UPIA default to grant

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135 This is in spite of an admonition earlier in the same regulation that “Trust provisions that depart fundamentally from traditional principals of income and principal will generally not be recognized”. This ability of the fiduciary to “manipulate” tax consequences through its discretion pursuant to this regulation has generally been respected. See BNA Portfolio 852-3rd, Acker, A67 and authorities cited therein.
wider discretion to allocate between principal and income (perhaps, to the extent of discretionary distributions), while keeping in line with both state law and Treas Reg §1.643(b)-1 and §1.643(a)(3)(b).136

Discretion to exploit such adjustments is best done by an independent corporate trustee, rather than a beneficiary/trustee, especially if there is “all net income” language. So, how would our power to adjust solution work under our bypass trust example above? The independent trustee would adjust all (or most) of capital gains to accounting income, then the $75,000 distribution becomes part of DNI and the distribution deduction is K-1’d out to the beneficiary.

Comparing the three methods – again, the second method in the regulation is the simplest and probably preferred for most new trusts. The first method may offer more flexibility, but there would be the additional complexity of changing internal trust principal/income accounting. After all, the greatest flexibility is gained through use of the trustee’s authority to vary discretionary distributions.

Problems with Adapting Current Irrevocable Non-Grantor Trusts

In the case where a trustee has been historically not been treating capital gains as part of distributions in its “books, records, and tax returns”, query whether a private settlement agreement, decanting or other reformation to prospectively change this would have any impact, for instance incorporating something akin to the sample language above? Arguably, the trustee would thereafter be consistent in its treatment of capital gains pursuant to the new governing instrument. Would the IRS permit a one-time change? The IRS may not consider it to be a new trust for Treas. Reg. 1.643(a)(3)(b) purposes simply because of a minor administrative amendment, and might therefore regard new treatment of capital gains as inconsistent with prior practice. After all, trustees don’t typically get a completely new EIN for such changes. Therefore, practitioners might seek a private letter

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136 Example: “Pursuant to Section 103 of the UPIA [or state UPIA citation], I hereby override the state law default treatment of allocation of capital gains to trust principal as follows: any Trustee not a beneficiary nor “related or subordinate” (as those terms are defined in IRC § 672) to any beneficiary of a trust may reallocate capital gains taxable income from fiduciary accounting principal to fiduciary accounting income in the sole discretion of the trustee. In doing so, the trustee may consider the net tax effect of the allocation to the trust and the beneficiary together, such as whether leaving capital gains as taxable to the trust would otherwise cause a Medicare surtax or short-term capital gains rates in excess of the net additional tax effect of a reallocation on a beneficiary’s taxes.”
ruling to adapt existing trusts that have a history of not treating capital gains as part of distributions, or use one of the other methods mentioned herein, such as changing the principal and income scheme.

Impact of changing tax burden on beneficiary distributions.

If capital gains are considered part of Barbara’s distribution and ordinary non-grantor trust rules are applied, the $40,000 of accounting income and the $75,000 of principal distribution is also taxed to her and only $25,000 of capital gains is left trapped in trust. However, because of her extra personal tax burden, she would probably ask for approximately $20,000 in additional distributions to compensate, which would lower the income trapped in the trust to well under $11,950. Thus, the 43.4%/23.8% highest marginal trust tax rate is completely avoided and her personal rates of 28%/15% would be applicable. This can lead to tremendous ongoing tax savings. Even the remainder beneficiaries are happy because, although Barbara got $20,000 more in gross distributions under this planning, the trust saved more than that in taxes, so they are better off as well.

Whether these techniques will save taxes depends on many factors, primarily the trust distribution provisions, state principal and income law, state taxation, preexisting tax attributes such as capital loss carryforwards of the trust and beneficiary, and of course, the beneficiary’s income and deductions. However, in many cases of trust planning and administration for the vast upper-middle class, it will pay to rethink the trust boilerplate, administration and tax preparation as regards to capital gains starting in 2013.

Practitioners should review the terms of their trusts for discussion of how capital gains are accounted for in making trust distributions and/or allocated to fiduciary accounting income. For existing irrevocable trusts, attorneys should not only review the terms of the trusts as to how capital gains are accounted for, but they should also review how the trustee has historically handled the treatment of capital gains regarding the beneficiary’s distributions. An experienced corporate trust department would best ensure consistent documentation of the “books, records and tax returns” to comply with the regulations necessary to exploit these potential savings.
If the trustee has not been treating capital gains as a part of the beneficiary’s distributions (which is likely), consideration should be given to a private settlement agreement or reformation to either correct prospective treatment of capital gains on the “books, records and tax returns” of the trust, or, better, amend the trust provisions regarding allocating capital gains to fiduciary accounting income. In the latter case, a professional and independent trustee or co-trustee should be considered to properly exploit this flexibility.

**Exploiting Spray Powers and Lifetime Limited Powers of Appointment** - Even better than having capital gains taxed to the beneficiary, the settlor may give additional spray powers to the trustee, to spray income to other beneficiaries, including the family’s favorite charity, donor advised fund or private foundation.\(^{137}\) Or, perhaps better in many ways, the settlor may give the surviving spouse or another party a limited lifetime power of appointment.\(^{138}\) For instance, let’s say Barbara receives more income outside the trust, putting her in a higher bracket, and decides that she only needs $30,000 from the trust, but her children could use funds to pay for grandchildren in college. She uses her limited power of appointment, or asks the trustee to spray $80,000 to her children (or grandchildren) and $20,000 to the family’s donor advised fund at the local community foundation that John had also named in the trust as a permissible beneficiary.\(^{139}\) Whether this makes sense depends

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\(^{137}\) Spray powers have practical issues that require careful drafting to protect the primary beneficiary and prevent a sense of entitlement by secondary beneficiaries. Typically language would be completely discretionary and instruct the trustee to consider secondary beneficiaries only if income is insufficient for the primary beneficiary, or give the primary beneficiary a veto power over secondary beneficiary distributions. Spray powers may also implicate additional reporting/accounting requirements.

\(^{138}\) This should not cause estate inclusion, nor a taxable gift, if it is properly circumscribed with support obligation savings clause provision to forbid distribution to someone whom the donee powerholder owes an obligation of support. See Treas. Reg. §20.2041-1(c)(1)(B). It could trigger a gift if exercised so as to trigger the Delaware Tax Trap, discussed elsewhere herein. IRC §2514(d).

\(^{139}\) See IRC §642(c)(1) and Regs. The Supreme Court held in *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) that “pursuant to the governing instrument” in IRC §642(c) plainly includes discretionary distributions, and need not be pursuant to a mandatory direction. There is some uncertainty, however, from narrower lower courts. Generally, you would be more secure in getting the §642(c) deduction the more direct, certain and specific the trust’s charitable provision is, but a recent PLR permitted it for a discretionary distribution pursuant to a lifetime limited power of appointment. See discussion of such nuances in Chapter 6.08 of *Federal Income Taxation of Trusts, Estates and Beneficiaries* by Ascher, Ferguson, Freeland. Does a lifetime LPOA carry out *income*, since it is a power over specific *property*, not “income” or “principal”? Despite an argument that appointing a specific asset might be a “specific gift or bequest” under the relation back doctrine and therefore not carry out DNI (Treas. Reg. 1.663(a)-1), other sections under that regulation indicate that even appointing a specific dollar amount or asset *does* carry out DNI under the same rules as any other trustee.
on the family situation, trust and brackets of the parties involved (and potentially the assets, such as whether an S Corp or IRA is involved, which would suggest using separate trusts). There are many scenarios where the family would be far better off with this spray capability, potentially lowering tax rates by 20% or more. Remember, the 0% rate for taxpayers in the bottom two tax brackets for LTCG/qualified dividends was permanently extended with ATRA as well.

IRC § 642(c) - Notably, not only would IRC §642(c) offer “above the line” charitable deductions for the family from the trust, but it offers a better deal for internationally minded clients with ties/interests in foreign countries – unlike IRC §170 for individuals, the trust income tax charitable deduction is expressly not limited to charities organized in the U.S..

Furthermore, regulations specifically permit that the governing instrument can provide an ordering rule and control the character of the income distributed via §642(c) provided it “has economic effect independent of income tax consequences.” For instance, if the trust limits the charities’ potential distribution to gross income from net short-term capital gains, taxable interest and rents, it has the economic effect apart from income tax consequences because the amount that could be paid to the charity each year is dependent upon the amount of short term capital gains, taxable interest and rents the trust earns within that taxable year. Therefore, in our example, Barbara’s donor advised fund would not receive any long-term capital gains or qualified dividend or tax exempt income – the $20,000 would be limited to coming from the interest and short term capital gains. What a deal – the taxable beneficiaries can get the LTCG/QD eligible for 15%/0% brackets, while the charity gets the ordinary income.

distribution to a beneficiary. This is the most logical interpretation, but I could find no specific authority. Regardless, a lifetime LPOA has enormous power and efficacy as a backstop to the trustee’s spray power. If the LPOA powerholder is a mandatory income beneficiary, however, it may be deemed a gift of the lost income. Estate of Regester, 83 T.C. 1 (1984), though contrary is Self v. United States, 142 F. Supp. 939 (1956). If the powerholder also has a testamentary GPOA it would be considered a gift as well. Treas. Reg. §25.2514-1(b)(2). A deemed gift may not be a problem, but why not allow for both if the spray power is properly circumscribed. IRA “see through trust” rules don’t play well with most POAs and neither do QSSTs. ESUTs force higher rate taxation regardless of who the distributions are made to, so consider segregating those to separate trusts.

140 IRA “see through trust” rules don’t play well with most POAs and neither do QSSTs. ESUTs force higher rate taxation regardless of who the distributions are made to, so consider segregating those to separate trusts.

141 Treas. Reg. §1.642(c)-1(a)(2)

142 Treas. Reg. 1.642(c)-3(b)(2), and Ex. 2
Furthermore, a distribution pursuant to a lifetime limited power of appointment may also qualify for the IRC §642(c) deduction. In a recent PLR, the trust had this clause:

“[T]he Trustee shall distribute all or any portion of the trust estate, including both income and principal, as A may appoint, at any time and from time to time during A’s lifetime or upon A’s death, to any one or more organizations each of which is, at the time contemplated for an actual distribution to such organization, exempt from federal income taxation under § 501(a) as an organization described in § 501(c)(3) and also is described in al of §§ 170(c), 2055(a) and 2522(a).” (sic)

In this ruling, the IRS held that a distribution of gross income from the trust to one or more charitable organizations made pursuant to A’s limited power of appointment will be made “pursuant to the terms of the governing instrument” as provided in §642(c)(1) and provided that the other requirements of §642(c) are satisfied, such distribution from the trust will qualify for the charitable contribution deduction under §642(c).143

In short, with all the above tax planning ideas, we have the Holy Grail of income tax planning available to widows/widowers with bypass trusts – the ability to trap income in trust if state tax savings can be had, to spray income to lower bracket beneficiaries, and get above the line charitable deductions on the most highly taxed income!

143 PLR 2012-25004
IX. Conclusion - Pros and Cons of the Optimal Basis Increase and Tax Efficiency Trust

Much of the planning and techniques for the über-wealthy are unchanged after ATRA – the increased exclusion merely turbocharges previous gifting techniques. The Optimal Basis Increase techniques herein won’t help a wealthy couple with $100 million, but they can be extremely valuable for sub-$10.5 million estates.

The ongoing trust income tax planning techniques discussed herein apply to nearly all estate levels – even more so to wealthier families. After all, how many trust beneficiaries, even of wealthy families, will always make over $400,000 or $450,000 in taxable income and therefore be subject to the same tax rates as a non-grantor trust?\textsuperscript{144}

For married clients with estates under approximately $10.5 million, the Optimal Basis and Income Tax Efficiency Trust offers the following advantages over an outright bequest, even where DSUE is successfully claimed: better asset protection from creditors, better divorce/remarriage protection, better protection from mismanagement, better sheltering of appreciation/growth from both federal and state estate and inheritance taxes, better planning in event of simultaneous or close death (potentially millions in savings for those estates where one spouse’s estate is over $5.25 million), better use of GST exclusion, better incapacity planning, better Medicaid/VA/benefits planning, avoidance of step down in basis at second death and the ability to spray income to children/charities in lower brackets. The drawbacks are the same as with any trust planning: increased attorney fees (and potentially post-mortem, accounting/trustee fees) and complexity.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over the traditional bypass trust: better step up in basis at second death, better compatibility with disclaimer planning, better ongoing income tax treatment for the trust and spouse overall and better income tax flexibility and charitable deduction treatment via spray provisions.

The Optimal Basis and Income Tax Efficiency Trust offers the following advantages over a traditional QTIP (assuming amount under exclusion amount): better asset protection

\textsuperscript{144} Thresholds for single and married filing jointly couples to incur the top 39.6\% and 20\% long-term capital gains and qualified dividends rates
during the surviving spouse’s life (for accounting income), better ability to augment or curtail powers of appointment, no chance of losing exclusion due to remarriage, better ongoing income tax treatment for the primary beneficiary, ability to spray income or capital gains to lower (or 0%) tax bracket beneficiaries, ability to shelter from state estate/inheritance tax, no requirement to file Form 706 to make appropriate QTIP election, no prospect of the IRS using a Rev Proc 2001-38 argument to deny the effect of the election, and the prevention of a second step down in basis.

Just as importantly, although not extensively discussed herein, if the surviving spouse’s estate, including the QTIP trust, increases over time above the survivor’s Applicable Exclusion Amount (including portability), the bypass trust will almost certainly have saved more in estate taxes than the capital gains tax savings from getting new (presumably mostly increased) basis. 145

And let’s not forget another potential disaster with leaving everything outright or to a marital deduction trust and not using the first spouse’s exclusion – despite the supposed “permanence” of ATRA’s $5 million gift/estate/GST exclusion (adjusted for inflation), there is still the possibility of Congress REDUCING this amount with new law after the first death. This would have no effect on bypass/OBIT savings, but could have a disastrous effect on those who relied on marital trusts or outright bequests to their spouse.

There may be some situations in which a marital trust might generate better results than an OBIT. 146 To be more precise, you need to know asset mix, depreciation info, the date of 2nd death, the beneficiary’s distribution needs, tax rates/exclusions, inflation, investment turnover, investment returns and more to make an accurate prediction – all

145 For illustrations of this savings if investment returns net 11% and the surviving spouse lives 15 or 30 more years, see Gassman, Crotty, Buschart & Moody On the $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability, Steve Leimberg’s Estate Planning Newsletter #2061, concluding savings to be…$28 million. While I may have used different assumptions, the general thrust of the article/spreadsheets is in the right direction and makes a powerful point.

146 For the wealthy, a QTIP bequest with full DSUEA elected and reverse QTIP election would probably always beat a standard bypass trust for wealthy married couples if the surviving spouse then immediately funded via gift a maximum (e.g. $10.5 million in 2013) irrevocable grantor trust (or released a portion of the QTIP to trigger IRC §2519). This could then potentially exploit installment sales, swaps, etc. Using intervivos QTIPs or grantor trusts funded via gift after the first death enable the use of pre-estate tax dollars to pay the income tax burden of the grantor trust. This will be more efficient for estate tax, unless the Obama Administration closes the grantor trust “loophole” per its 2013 Greenbook proposals (page 83). Most couples of such wealth will have already used the gift tax exclusion during their lifetime, but those who haven’t should strongly consider that technique.
beyond the capability of any mortal being or computer program. The Optimal Basis Increase and Income Tax Efficiency Trust offers the best bet and most flexibility to optimize tax benefits long-term – all of the benefits of the traditional bypass trust but with avoidance of most of the drawbacks.

There will be certain situations in which some of these techniques should not be used. For instance, the common situation in which someone wants to protect an inheritance for children from a prior marriage and severely curtail the spouse’s interest – but even then many taxpayers will prefer variations of some of these techniques (e.g., would a surviving spouse really appoint to his/her creditors to spite their late spouse’s children and would an independent trustee or other non-adverse party consent?).

Some people have been reticent to pay attorneys for needed amendments to planning due to “tax volatility fatigue” and frustration with Congress. The pitfalls and techniques discussed in this article, coupled with apparent permanency, should give substantial financial incentives for clients to revisit their old estate plan. These techniques are not available to “do it yourselves” or general practitioners – there are no off the shelf or online form books for any of this. However, any attorney specializing in estate planning can adapt these ideas to provide tremendous value to their clients.
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• Licensed to practice in all Ohio courts, U.S. District Court of Southern Ohio and U.S. Tax Court
• Certified Specialist through Ohio State Bar Assn in Estate Planning, Trust and Probate Law
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Recent Speaking Engagements and Published Articles:
• Speaker, 2013, Ohio State Bar Association Annual Conference on Wealth Transfer Planning, Asset Protection and the Ohio Legacy Trust, Optimal Basis Increase Planning
• Leimberg Information Services, March 2013, The Optimal Basis Increase Trust
• Trusts and Estates, December 2012, Optimizing Trusts to Avoid the New Medicare Surtax
• Speaker, 2012, ABA Tax Section Annual Meeting: Estate Planning for Large Retirement Plans
• Speaker, 2011 Purposeful Planning Institute and 2011 SFSP Annual Tax Symposium, Exploiting Asset Protection and Tax Planning Opportunities after the 2010 Tax Act
• Speaker, 2010 Ohio Wealth Counsel CLE: Advanced Asset Protection Planning
• Speaker, 2009 Annual Meeting of Cincinnati Financial Planning Association, Roth IRA Conversion Analysis: What Advisors are Missing and Software Won’t Tell You
• Speaker, 2009 Dayton Bar Association CLE, Protecting Trust Assets from Tax Liens
• Author, Trusteed IRAs: An Elegant Estate Planning Option, September 2009 Trusts and Estates
• Co-Author, Ensuring the Stretch, July/August 2007 issue of Journal of Retirement Planning

(how powers of appointment are included in gross estate, sections bold/italicized are sections discussed by author, [bracketed comments inserted by author])

(a) In general

The value of the gross estate shall include the value of all property—

(1) Powers of appointment created on or before October 21, 1942

[omitted – but important if you have an old trust]

(2) Powers created after October 21, 1942

To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent’s gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent’s death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent’s death notice has been given or the power has been exercised.

(3) Creation of another power in certain cases [aka the Delaware Tax Trap]

To the extent of any property with respect to which the decedent—

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent’s gross estate under section 2035, 2036, or 2037,

exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

(b) Definitions

For purposes of subsection (a)—

(1) General power of appointment

The term “general power of appointment” means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that—

(A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

(B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

(C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person—

(i) If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power of appointment.

(ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment.

For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent’s power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent’s power.

(iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.

For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(2) Lapse of power

The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

(A) $5,000, or

(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.
Sample Language for Formula GPOA for Bypass (Family) Trust

Subject to the remaining provisions of this Section, my spouse has the testamentary power to appoint all or any portion of assets, be they allocable to principal or undistributed income, remaining in the Family Trust at my spouse’s death. However, this power shall apply differently to different assets and shall be constrained and limited as follows:

1) **General Power of Appointment** – My spouse may appoint certain assets of the Family Trust to my spouse’s creditors or to my descendants in such amounts and subject to such terms, including trusts, as my spouse directs. [alternatively, this may be broader and include other uncles, cousins, friends, charities, etc] [it is highly recommended that you require a non-adverse party consent, which might apply only to appointment to creditors, or, some clients may also wish it to apply to other non-equal appointments as well – e.g. “my spouse may only appoint to his or her creditors with the consent of __________ and/or ___________” (these persons or entities cannot be a beneficiary or “adverse party” – an independent trust company for instance, may be non-adverse), or “Any appointment that is other than equal to my children or to trusts for my children, per stirpes, may only be made with the consent of _____________]”. The assets subject to this general power of appointment shall be all assets of the Family Trust, excluding:

   (i) all property that constitutes income in respect of a decedent (IRD), except employer securities previously received in a lump sum distribution from a qualified plan containing net unrealized appreciation (NUA) that would also be IRD pursuant to IRC §402 and §1014(c). Only such employer securities that have unrealized gains post-lump sum distribution are eligible to be an appointive asset pursuant to this paragraph, those without unrealized gains post-distribution shall not be;

   (ii) Roth IRA accounts or Roth variants of other retirement plans such as 403(b), 457(b), or 401(k)s;

   (iii) 529 Plan Accounts or Coverdell Education Savings Accounts (ESAs);

   (iv) all property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my spouse’s death;

   (v) all life insurance policy or annuity death benefit proceeds owned by and payable to the trust as a result of my spouse’s death.

After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets’ inclusion in my spouse’s taxable estate for federal and/or state estate tax purposes would not increase my spouse’s federal or state estate tax liability, the general power described above shall apply to all remaining assets of the Family Trust.

[Alternate clause to exclude the spouse from using any charitable/marital deductions to indirectly augment her GPOA: “After eliminating the above described assets from the appointive assets subject to this general power of appointment, if such remaining assets’ inclusion in my spouse’s taxable estate for federal and/or state estate tax purposes would
not increase my spouse’s federal or state estate tax liability, even with any marital or charitable deduction denied to my spouse’s estate, the general power described above shall apply to all remaining assets of the Family Trust. Note – with this variation, you would want to modify some of the paragraphs below as well.]

However, should such inclusion otherwise result in federal or state estate tax liability, the appointive assets subject to this general power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust in the following order. The power shall apply to the asset with the largest percentage of difference between fair market value at the time of death and the cost basis immediately prior to the powerholder’s death first, cascading in turn to each subsequent asset with the next largest percentage difference between fair market value and cost basis (e.g. an asset with basis of $10, FMV of $100 would have a “percentage of difference” of 90/100, or 90%). Once an asset’s (or group of assets’) inclusion as appointive assets would otherwise cause an increase in my spouse’s federal or state estate tax liability [even if the marital or charitable deduction were denied the estate], the power to appoint them shall be limited to that fraction or percentage that will not cause any estate tax liability. Upon reaching this limit, all other assets are excluded from this general power of appointment [and shall be subject to the limited power of appointment described in paragraph 2 below].

Property with different cost basis for different lots or purchases shall be considered completely separate property for this purpose (e.g. 100 shares of ABC stock bought at $350/sh shall be considered different from 100 shares bought at $500/sh a year later), and may be divided or fractionalized accordingly.

Property that is employer securities received as a lump sum distribution from a retirement plan with net unrealized appreciation shall consider said net unrealized appreciation for this purpose (e.g. 1000 shares of P&G stock with a tax basis of $50,000, net unrealized appreciation of $20,000 and fair market value of $85,000 shall consider the basis to be $70,000 for purposes of application of this paragraph. If the stock’s value were equal to or less than $70,000, it would accordingly not be an appointive asset subject to this GPOA).

For purposes of illustrating the intent of this Paragraph 1, if $50,000 could be added to my spouse’s estate prior to application of this Paragraph 1 without causing state or federal estate tax, and the asset with the largest percentage difference between cost basis and fair market value is 100 shares of ABC stock with a basis of $35,000 and fair market value of $100,000, then this general power of appointment shall extend to only 50 shares from that lot of stock.

A material purpose of this paragraph 1 is to grant my spouse a general power of appointment as defined under IRC §2041 and to maximize the income tax basis increase under IRC §1014 of the property held in the Family Trust without increasing my spouse’s federal or state estate tax, so as to provide the maximum benefit to our ultimate beneficiaries. This trust may accordingly be amended or decanted pursuant to applicable state law [or, reference a trust protector or independent trustee amendment clause if
there is one already in the trust to permit amendments] to comply with this intended purpose should:
   a) IRC §1014, IRC §2041 or other applicable income and estate tax law be materially changed,
   b) the state, federal or foreign estate or inheritance tax applicable to my spouse’s estate be materially changed.
   c) my spouse’s estate appear likely to be insolvent and my spouse resides in a state which does not protect assets subject to a testamentary general power of appointment from a decedent’s or decedent’s estate’s creditors
   d) or any other situation which would frustrate the intention of this paragraph.

2) **Limited Power of Appointment** [note, there is no tax need for the LPOA in this paragraph, it is entirely dependent on whether a settlor wants to grant flexibility of distribution]- My spouse may appoint all other assets not subject to the general power of appointment in paragraph 1 above or the exclusion in paragraph 3 below to my descendants or to any trust primarily therefore, which shall specifically exclude my spouse, my spouse’s estate, my spouse’s creditors, or creditors of my spouse’s estate. [This may be in such amounts or shares as my spouse shall determine, including all to one descendant to the exclusion of all others]. [Alternatively, many clients may want to make this much more specific (e.g. descendants only unless all predecease, or to descendants and/or trusts therefore equally), or even require a non-adverse party’s consent, for non-tax reasons (to prevent disinheriting one child, for example) Further note – if IRA/Qualified Plan assets were payable to the trust, and there is no conduit provision, then further limitations are recommended – see separate outline/checklist on IRA and see-through trust issues.

3) **Proceeds of life insurance held by the trust insuring the life of my spouse** – My spouse shall not, however, have any power of appointment (limited or general) over any proceeds of life insurance owned by the trust and payable to the trust that insures the life of my spouse [I am skeptical that this is needed at all – a testamentary POA over the trust assets may not be an incident of ownership pursuant to IRC §2042 of a policy owned by the trust. And, few bypass trusts would own life insurance on the surviving spouse – avoiding IRC §2042 would preclude the surviving spouse acting as trustee as well. However, I included this in an abundance of caution pending research. Also, you could have a scenario where 2042 inclusion would be moot (ie not cause estate tax), a nuance which is not accounted for in this paragraph. Theoretically, someone may want their spouse to be able to appoint life insurance proceeds as well if no additional tax is caused].

**Form and Method of Exercise of Any Power of Appointment** -

My spouse has the exclusive right to exercise the above limited and general powers of appointment. [However, an agent for my spouse under a Power of Attorney or a court appointed guardian may also exercise the testamentary power of appointment under the same conditions as noted above.] The above powers may be exercised by specific reference to this trust in a Will, revocable living trust, or other written instrument that is witnessed or...
notarized. Should multiple attempts to exercise conflict, the last executed document shall control. The trustee may rely on a power of appointment exercised via Will not yet admitted to probate, but the trustee may in its discretion insist that any Will containing such exercise be admitted to probate or filed for public record. In determining whether a testamentary power of appointment has or has not been exercised, the trustee may rely on its knowledge of any exercise or lack thereof and proceed accordingly without liability (except for actions taken in bad faith), in the absence of actual knowledge to the contrary made known within three months after the powerholder’s death.

Unless appointive assets are otherwise curtailed, such appointments may be in cash or in kind and may direct specific property to any one or more of the permitted objects of the power, either in trust, or by creating life estates or other restrictions or conditions for any one or more permitted objects of the power and remainders to other permitted objects.

Conditional expansion of permissible appointees if appointments made in further trust primarily for permitted appointees [note, something like this paragraph should be considered if there is not a broad class of appointees, for instance, only to descendants under Paragraph 2 or only to descendants or creditor in Paragraph 1]. If my spouse makes appointment in trust for any of the permitted appointees as noted above, such that a permitted appointee or appointees are the primary beneficiary or beneficiaries during their lifetimes, then a permitted appointee may in turn be given a broad lifetime or testamentary, limited or general power of appointment, permitted appointees of which may include charities, creditors or other parties, even if such parties were not in the original class of permitted appointees. For example, my spouse may appoint to a trust for my child and grandchildren, granting my child a broad lifetime limited power of appointment and/or testamentary powers of appointment similar to this section [Article]. [strongly consider using something like this unless someone demands that grandchildren, for example, be fully vested, not subject to divestment by a child’s exercise of a POA or otherwise (in that case, you might modify this further). This clause allows further LPOA/GPOA OBIT language to harvest basis for the next generation, allows further spray capabilities via LLPOA for better income tax planning, better asset protection if the primary beneficiary is frozen out, etc. The Restatement of Property, 3d, Donative Transfers, §19.2 is clear that appointments to non-permitted appointees may be voided as a fraud upon the power, but what if later remaindernen, spray beneficiaries, etc are not among initially permitted appointees? In most states, but not all, a POA that can distribute outright or to a permissive appointee in trust can also grant that same appointee a broad POA in the appointive trust under the theory that the beneficiary could have been granted outright ownership. However, unless you know for certain your client’s residency and state law on this issue, it safest to expressly permit it. See e.g., 25 Del. Code 505, which is mostly positive, but still has flaws re LPOAs - http://codes.lp.findlaw.com/decode/25/5/505].

Any assets not so appointed under paragraph 1 or 2 above shall pass according to the takers in default of appointment clause below. All values determined for purposes of this Section shall be as finally determined for federal estate tax purposes as of my spouse’s death. My trustee may rely on values obtained from my spouse’s executor (or trustee, if no executor is
appointed) used for any state or federal estate tax filing. Should assets later be determined upon audit or amended return to be higher or lower than initially determined, the trustee is absolved from liability for having transferred items to any impermissible appointee via General Power of Appointment. However, any impermissible appointees shall hold such funds in constructive trust for those appointees of any limited power of appointment or takers in default who would have otherwise received the assets.

**Takers in Default of Appointment**
Should my spouse fail in whole or in part to appoint any trust assets, they shall be held in trust and/or distributed under the following terms: XXXXXXXXXXXXXXXXXXXXXXX

**Note #1** – GST/Dynastic - this language may be adapted to apply to non-spousal powerholders (in which case GST may need to be considered as well as estate tax), and some of this may be adapted so as be incorporated in part in the exercising of any limited power of appointment designed to trigger the Delaware Tax Trap as discussed in this article. Usually, one would have the same or greater GST exclusion as estate/gift exclusion, but not always – consider someone who used annual exclusion Crummey gifts and allocated GST exclusion. Thus, the above may be adapted to apply to the extent of GST exclusion and probably should be adapted to the extent it would not cause GST tax (I did not address because most couples would want the second basis step up even if it caused partial GST non-exempt trust, and most leave assets to children’s generation so no GST tax, but consider, e.g., child dies after first spouse/parent to die, but before second spouse, so the GST predeceased child exception does not apply, or, if the powerholder wanted to skip generations).

**Note #2** – Alternate Valuation Date - AVD is not addressed above. In theory, an AVD could be addressed to tweak basis further in rare situations. AVD is only available when the estate tax is reduced. I did not address this to simplify administration (and my drafting :-) – to address AVD would require delaying determination of the value of the power of appointment by six months and potentially complicate matters. I may address a variation of this in future iterations or presentations. Example: Jane, a surviving spouse and beneficiary of an OBIT established by her late husband, dies with a $6 million estate of her own (thus, no GPOA over the OBIT) – but the market crashes and 6 months later those same assets are $4.5 million. The OBIT may therefore exploit $0.75 million of Jane’s remaining applicable exclusion amount (assuming no DSUEA, $5.25 AEA), but the language above uses DOD values, which may have some benefit, but would not be optimal. Can a GPOA simply be delayed (probably, see page 28 and Reg 20.2041-3(b)), and can it be applied to assets based on a value 6 months later? Probably - I welcome any comments or suggestions here.

**Note #3** – Indemnifying trustee for administration of assets between the date of death and determination of exercise of power of appointment. When the surviving spouse/powerholder dies, it may be months before the trustee knows the existence of the POA’s exercise, much less the exact value of the surviving spouse’s net estate (and the value of any marital/charitable deductions). If the GPOA applies to a piece of real estate, and the
trustee in good faith sells the real estate after death, then the GPOA should probably apply to cash traced to the sale.

**Note #4** – There is no accounting for debts/liens/encumbrances in the above language. Most bypass trusts are not leveraged, but you may have residence with a mortgage, a margin account, or maybe even intra-family loans to the bypass. Future versions of this language will add provisions to account for “net value after debt” for those situations, which are not an issue when someone has a POA over an entire trust.

None of this language is warrantied or may be relied on in any way – nor is it legal advice that can be relied upon for penalty protection. Any constructive criticism appreciated.

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Thanks to Ohio attorney Brian Layman (www.laymandatri.com) for provided substantial constructive feedback on this clause, and Ohio attorney Andy Richner for providing substantial feedback on Part II of this article.
Sample Language for Exercising LPOA for Bypass (Family) Trust in Order to Trigger the
Delaware Tax Trap to Adjust Basis for Appreciated Assets
(to be included in Will or Living Trust, as directed by original document)

Pursuant to paragraph X of my spouse’s trust dated xx/xx/xxxx, I was granted a testamentary
limited power to appoint the assets of said trust by specifically referring to that power in my
(will, living trust or other deed). I hereby exercise that appointment as follows:

1) I hereby appoint all assets to the [Surviving Spouse’s Trust for a child that grants child a
PEG Power – presently exercisable general power of appointment] excluding the following:

   (i) all property that constitutes income in respect of a decedent (IRD), except
   employer securities previously received in a lump sum distribution from a qualified
   plan containing net unrealized appreciation (NUA) that would also be IRD pursuant to
   IRC §402 and §1014(c). Only such employer securities that have unrealized gains
   post-lump sum distribution are eligible to be an appointive asset pursuant to this
   paragraph, those without unrealized gains post-distribution shall not be;

   (ii) Roth IRA accounts or Roth variants of other retirement plans such as 403(b),
        457(b), or 401(k)s;

   (iii) 529 plans or Coverdell Education Savings Accounts (ESAs);

   (iv) all property that has a cost basis for federal income tax purposes that is greater
        than or equal to the fair market value of the property at the time of my spouse’s
        death;

   (v) all life insurance policy or annuity death benefit proceeds owned by and payable
       to the trust as a result of my spouse’s death.

After eliminating the above described assets from the appointive assets subject to this
paragraph, if such remaining assets’ inclusion in my taxable estate for federal estate tax
purposes would not increase my estate’s federal or state estate tax liability, this
paragraph 1 shall apply to all remaining assets not excluded above that are subject to this
power.

However, should such inclusion otherwise result in federal or state estate tax liability, the
appointive assets subject to this paragraph shall be further limited, and apply or not apply
to each remaining asset of the trust in the following order. This exercise shall apply to
the asset with the largest percentage of difference between fair market value at the time
of my death and the cost basis immediately prior to my death first, cascading in turn to
each subsequent asset with the next largest percentage difference between fair market
value and cost basis (e.g. an asset with basis of $10, FMV of $100 would have a
“percentage of difference” of 90/100, or 90%). Once an asset’s (or group of assets’)
inclusion as appointive assets would otherwise cause an increase in my estate’s federal or
state estate tax liability, my appointment pursuant to this paragraph shall be limited to
that fraction or percentage that will not cause any federal or state estate tax liability.
Upon reaching this limit, all other assets are excluded from this exercise and shall be subject to the exercise in paragraph 2 below.

Property with different cost basis for different lots or purchases shall be considered completely separate property for this purpose (e.g. 100 shares of ABC stock bought at $350/sh shall be considered different from 100 shares bought at $500/sh a year later), and may be divided or fractionalized accordingly.

For purposes of illustrating the intent of this Paragraph 1, if $50,000 could be added to my estate (prior to application of this Paragraph 1) without causing state or federal estate tax, and the asset with the largest percentage difference between cost basis and fair market value is 100 shares of ABC stock with a basis of $35,000 and fair market value of $100,000, then the power of appointment under this paragraph shall extend to only 50 shares from that lot of stock.

2) I hereby appoint all remaining assets of the XXXX trust that were not appointed in Paragraph 1 to the [Surviving Spouse’s Trust that does NOT grant anyone a PEG Power, and the trust that would probably be allocated any GST exemption].
Sample Language for an LPOA in a Bypass (Family) Trust Designed to be Eligible to be Retained Even When Trust is Funded Via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Trigger the Delaware Tax Trap to Adjust Basis for Appreciated Assets

(see discussion in Part IV – remember, limited LIFETIME powers might trigger a gift tax if the powerholder has a mandatory income interest even if DTT is not triggered– if it is done in such a way as to trigger the DTT, it DOES trigger a taxable gift under IRC §2514, regardless of whether a spouse has mandatory income interest – but many spouses couldn’t care less – the income tax benefit of spraying income may far outweigh any gift tax ramifications)

During my spouse’s lifetime and upon my spouse’s death, my spouse shall have the power to appoint, from income or principal, in cash or in kind, all assets of this trust to a trust or trusts for any or all of my descendants that qualifies the transfer as a taxable gift or bequest under IRC §2514(e) or §2041(a)(3), such as a trust for my descendant that grants my descendant a presently exercisable general power of appointment. All other appointees are excluded, specifically my spouse, my spouse’s estate, my spouse’s creditors, and creditors of my spouse’s estate.

In addition, during my spouse’s lifetime, my spouse shall have the power to appoint, from income or principal, in cash or in kind, assets of this trust to any or all of my descendants, but limited to amounts necessary for their health, education or support. This paragraph should not be interpreted to grant my permitted appointees any property interest as a result of being a permitted appointee, and my spouse shall have no fiduciary duty whatsoever to them during my spouse’s lifetime under this paragraph. The above limitations shall serve as a ceiling to limit my spouse’s ability to direct the beneficial enjoyment of property pursuant to Treas. Reg. §25.2518(e)(2) and (e)(5) Example 6.

The above power of appointment is intended to be retained while still qualifying any transfers made to this trust pursuant to my spouse’s disclaimer, pursuant to IRC § 2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2). It shall be interpreted accordingly.
Sample Language for a Partial Release of a Broad LPOA in a Bypass (Family) Trust where the Surviving Spouse Desires to Fund Bypass via Qualified Disclaimer – Still Allowing the Surviving Spouse Dispositive Control in Order to Spray Income and/or Trigger the Delaware Tax Trap at Death to Increase Basis for Appreciated Assets

Example of when to use this: John and Jane have basic AB trusts, with broad LPOAs in the bypass trust. The trusts are mostly unfunded, then John dies. Jane proposes to disclaim her POD/TOD/JTWROS interests, in which case the assets will pour into the Bypass, but retention of a broad LPOA would taint the disclaimer (it would result in a taxable gift, loss of asset protection, full 2036 inclusion, full step down at second death). Jane could disclaim the entire LPOA, losing the tax flexibility to spray income and get a step up in basis at second death, or, for potentially better income tax results, she may execute a partial release as envisioned below. When she then disclaims, the retained LPOA, which can only be exercised in a way to trigger estate/gift tax, should meet the exception in the qualified disclaimer regs cited below.

Pursuant to paragraph X of my spouse’s trust dated xx/xx/xxxx, I was granted a limited [testamentary] power to appoint the assets of said trust by specifically referring to that power in my (will, living trust or other deed). I was granted the power to appoint to ___________________________ [often this will be either to descendants or to anyone but the powerholder, powerholder’s estate or creditors of either], which includes the power to appoint to a trust therefore [usually trusts include this power – if yours does not, check state law (common law under Restatement is favorable), which probably includes it anyway].

[to use if a lifetime power is granted in the original trust] As to my limited power to appoint during my lifetime, I hereby partially release and disclaim the above mentioned power except that I shall retain only 1) the power to appoint to a trust for the permitted appointees that will trigger a federal gift tax under IRC §2514(e) upon transfer and 2) the power to appoint to any of the permitted appointees directly, but limited to amounts necessary for their health, education or support. I hereby release and disclaim the power to appoint during my lifetime beyond the appointees or amounts described above.

[more common – to use if a testamentary power is granted in the original trust] As to my limited testamentary power to appoint upon my death, I hereby partially release and disclaim the above mentioned power except that I shall retain only the power to appoint to a trust for any or all of the permitted appointees that will trigger a federal estate tax under IRC §2041(a)(3) upon transfer. I hereby release and disclaim the power to appoint to any other appointee.

This release/disclaimer is intended to qualify any future or contemporaneously executed disclaimer that would cause a transfer to the trust referenced above, such that the rights retained after release/disclaimer comply with the requirements of IRC §2518 and the exception for retained spousal rights to direct the beneficial enjoyment of property under Treas. Reg. §25.2518(e)(2) and (e)(5) examples 6 and 7. It shall be interpreted accordingly and shall be given effect regardless of whether this release/disclaimer of interests is itself a qualified disclaimer under IRC §2518.
Note – There is no example in the 2518 Regs of whether such a disclaimer is “qualified” (is it “severable”?), which is why I referred to the above as a “release” and/or “disclaimer”, not a “qualified disclaimer”. See 25.2518-3(A)(iii) and examples 9 and 21 in that Reg for disclaiming POAs, which are considered as separate property interests for disclaimer purposes. Whether the above would be “qualified” is irrelevant, at least for the limited purpose of this Release, which is to prepare another disclaimer to be qualified – a release may accomplish the same thing as a qualified disclaimer in some cases without ill effect. For a great example of a clever use of a partial release of a GPOA to qualify a trust as a “see through trust”, see PLR 2012-03033. If a GPOA is released (not a qualified disclaimer), it would be a gift taxable event based on the underlying assets (see IRC 2514(b)) (although it may be delayed by being an incomplete gift if powers are retained as contemplated by a partial release), but a release of an LPOA, or portions of an LPOA, would not be— see Treas. Reg. 25.2514-3(e) example 3 “If in this example L had a power to cause the corpus to be distributed only to X, L would have a power of appointment which is not a general power of appointment, the exercise or release of which would not constitute a transfer of property for purposes of the gift tax.”
Draft of Proposed Opt-In Rule Against Perpetuities Amendment for Adoption in States to Provide Improved Tax, Estate and Asset Protection Planning Options for their Citizens

(portions plagiarized from 25 Del. Code §§ 501, 504, with an opt in feature added)

Ohio Rev. Code proposed §2131.08(H):

Notwithstanding any other provision of this chapter, in the case of a nongeneral power of appointment over property held in trust (the "first power"), and only wherein the instrument exercising the power either

1) specifically refers to this paragraph, or
2) specifically asserts an intention to trigger Section 2041(a)(3) or Section 2514(e) of the Internal Revenue Code of 1986, or
3) specifically asserts an intention to postpone the vesting of any estate or interest in the property which was subject to the first power, 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

then, and only to the extent intended and specified in the instrument, any estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power, irrespective of the manner in which the first power was created or may be exercised, or whether the first power was created before or after the passage of this section [alternatively, “but only if the date of creation of that nongeneral power of appointment is on or after the effective date of this section], shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment.

[Ohio defines non-general power in another statute, otherwise you might add something like “and the first power may not be exercised in favor of the donee, the donee's creditors, the donee's estate or the creditors of the donee's estate”]

Also – You might add “testamentary”, or limit to 2041(a)(3), since there would not be much use in triggering a taxable gift under 2514(e). However, might you have a case of a GST non-exempt trust where someone wants to appoint and use their gift/GST exemption? Perhaps someone more creative than I can find a use, but I can’t see much harm in including the gift possibility as long as the appointment has to affirmatively opt-in.

I don’t think the bracketed language above is necessary, since I don’t think an opt-in statute has the danger of inadvertently causing some calamity based on application to existing LPOAs, but I’m still thinking this over a bit. Comments welcome.
## Comparison of Various Basic Trust Design Options for Married Couples

Companion chart to article, "The Optimal Basis Increase and Income Tax Efficiency Trust" - please consult for explanation of variations (For simplicity, this chart does not compare intervivos SLATs, QTIPs, or other lifetime gifting options, though SLATs may also be adapted) (Some "traditional" bypass or marital trusts may have more features than indicated, this chart compares the "ordinary" common trust for spouse) (Some benefits may be limited/constrained by available applicable exclusion amounts. Assumes beneficiaries are not in top income tax bracket)

<table>
<thead>
<tr>
<th>Key Features</th>
<th>Outright Will or Trust (w/portability)</th>
<th>Traditional Bypass</th>
<th>Traditional QTIP</th>
<th>Traditional GPOA marital</th>
<th>Optimal Basis and Income Tax Efficiency Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basis Treatment at Death of Surviving Spouse</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 &quot;Step up&quot; in basis at 2nd death (QTIP has potential for Rev. Proc. 2001-38 step up denial)</td>
<td>yes</td>
<td>no</td>
<td>probably</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>2 No &quot;Step down&quot; in basis on 2nd death</td>
<td>no</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>3 Avoid potential lesser basis step up when fractional interests (LLC, TIC, etc) fund trust, at 2nd death</td>
<td>n/a</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Basis Treatment at Death of Beneficiary (Child)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 &quot;Step up&quot; in basis on child's death (if dynastic style, protective trust, to extent GST exempt)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>5 No &quot;Step down&quot; in basis on child's death (if dynastic style, protective trust)</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td><strong>Ongoing Income Tax Treatment and Flexibility</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Capital Gains Able to Escape Tax Rate Trap of 43.4% or 23.8% over $11,950 if bene is in lower bracket</td>
<td>n/a</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>7 Ability to spray income to lower tax bracket beneficiaries or possibly even charity</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>8 Ability to spray capital gains as well</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>9 Ability for &quot;above the line&quot; charitable deduction</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>10 Ability for spouse to make lifetime LPOA tax-free &quot;gifts&quot;</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>11 Ability for better tax treatment for special assets (personal residence, small business stock, etc)</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>maybe</td>
</tr>
</tbody>
</table>
### Asset Protection Considerations

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Maybe</th>
<th>Partial</th>
<th>Partial</th>
<th>Partial</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Inherited Principal protected from creditors (assumes not 401(k), IRA, homestead, etc)</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>13</td>
<td>Income from inherited assets protected from creditors</td>
<td></td>
<td>no</td>
<td>maybe</td>
<td>no</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>14</td>
<td>Protection from divorce, remarriage, squandering spousal elective share, ERISA/REA, etc</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>15</td>
<td>Better incapacity/management capability</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>16</td>
<td>Potential Medicaid/govt benefits advantage</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
<td>some</td>
<td>no</td>
</tr>
</tbody>
</table>

### Federal Estate/Gift/GST Tax Features

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Maybe</th>
<th>Partial</th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>Inherited assets escape estate tax at 2nd death</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>18</td>
<td>Allows dynastic GST use at first death (reverse QTIP)</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>19</td>
<td>No need for timely filed 706/portability to exploit 1st decedent spouse’s $5.25m estate/GST exclusion</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>20</td>
<td>Can save millions in add’l estate tax in event of simultaneous death if one spouse’s estate &gt; $5.25m</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>21</td>
<td>Surviving spouse can remarry w/o jeopardizing first spouse’s use of exclusion (losing DSUE)</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>22</td>
<td>Enables disclaimer funding while still keeping POA</td>
<td>n/a</td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
</tbody>
</table>

### State Estate & Income Tax Features

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Maybe</th>
<th>Partial</th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>Inherited assets escape state estate tax at 2nd death (to extent of exclusion, if not separate state QTIPed)</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>24</td>
<td>Ability to spray income to beneficiary in low tax bracket or low tax state</td>
<td></td>
<td>no</td>
<td></td>
<td>yes</td>
</tr>
<tr>
<td>25</td>
<td>Ability to shelter trust income from state income tax for trust income not K-1’d to beneficiary</td>
<td></td>
<td>no</td>
<td>maybe</td>
<td>maybe</td>
</tr>
</tbody>
</table>

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