Springing the Delaware Tax Trap Under

North Carolina Law to Obtain an Income Tax Basis Step-Up

By: Graham D. Holding, Jr. and Paul M. Hattenhauer

The significant increase in the federal estate tax exclusion amount, $11,400,000 for 2019, has caused estate planners to look at techniques to have assets in an irrevocable trust included in the taxable estate of the beneficiary in order to provide a basis step-up for appreciated assets under I.R.C. Section 1014.

Inclusion of the assets in the beneficiary's gross estate may be desirable to obtain the income tax savings of the basis step-up when, for example, a spouse-beneficiary holds a nongeneral power of appointment over a traditional bypass trust, or a beneficiary has a nongeneral power of appointment over a trust exempt from the federal generation-skipping transfer tax, and the spouse or beneficiary has sufficient remaining federal estate tax exemption left to prevent a portion or all of the assets of the trust from being subject to estate tax.

There are four ways to cause trust assets to be included in the beneficiary's taxable estate: (i) the Delaware Tax Trap, (ii) the use of an independent trustee's power of distribution, (iii) a contingent general power of appointment, and (iv) a trust protector or independent trustee's power to create a general power of appointment. Lester Law and Howard M. Zaritsky, "Basis After the 2017 Tax Act – Important Before, Crucial Now," 1-84 (*Fundamental Program Focus Series, Univ. of Miami Heckerling Institute on Estate Planning*) (2019)).

The objective of this article is to analyze whether and under what circumstances the Delaware Tax Trap can be used under North Carolina law to cause inclusion of the trust assets subject to a nongeneral power in the beneficiary's gross estate.

The Delaware Tax Trap – I.R.C. Section 2041(a)(3)

Historically, the rule against perpetuities typically provided that a trust was void if it caused a suspension of the power of alienation or vesting of an interest for longer than a permissible period, usually lives in being plus twenty-one years.

Under a former Delaware statute, the permissible period for measuring an interest created by a nongeneral power of appointment was the date of the exercise of the power of appointment. *See* 38 Del. Laws 198, § 1 (1933). This allowed for indefinite successive exercises of nongeneral powers of appointment within the permissible period, thereby avoiding a violation of the rule against perpetuities and the imposition of estate tax for generations. See the discussion in **Estate of Murphy v. Comm'r,** 71 T.C. 671 (1979), *action on dec.*, 1979-87 (May 30, 1979).

Congress responded by enacting I.R.C. Section 811(f)(4), the predecessor of I.R.C. Section 2041(a)(3), to prevent successive exercises of nongeneral powers of appointment from avoiding the rule against perpetuities. Although I.R.C. Section 2041(a)(3) was originally enacted to prevent estate tax avoidance through successive exercises and creation of nongeneral powers of appointment, it also applies to the creation, by the exercise of a nongeneral power, of a presently exercisable general power of appointment which under the law of most states begins a new permissible perpetuities period without regard to the creation of the original power. *See* Jonathan G. Blattmachr and Jeffrey N. Pennell, "Using Delaware Tax Trap to Avoid Generation-Skipping Taxes," 68 *J. TAX'N* 242 (1988).

Under I.R.C. Section 2041(a)(3) assets subject to a beneficiary's nongeneral power of appointment will be included in the beneficiary's gross estate at the beneficiary's death if the beneficiary:

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

Thus, I.R.C. Section 2041(a)(3) requires inclusion of trust assets in a beneficiary's gross estate if (i) the beneficiary exercises the power of appointment (the "first power") to create a transfer into a second trust, (ii) the terms of the second trust give someone else a new power of appointment (the "second power"), and (iii) the second power can be exercised to postpone the vesting or suspension of ownership or power of alienation of property for a period ascertainable without regard to the date of the creation of the first power. *See* Howard M. Zaritsky, "Obtaining a Basis Adjustment for an Irrevocable Trust," *PROB. PRAC. REP.*, Oct. 2014, at 5.

To include assets in the beneficiary's gross estate, I.R.C. Section 2041(a)(3) only requires that the second power *can be* exercised to postpone the vesting or suspension of ownership or the power of alienation of trust property. There is no requirement that the second power *actually* be exercised in this manner.

The fact that a beneficiary's exercise of a nongeneral power of appointment may inadvertently cause inclusion of assets in the beneficiary's gross estate under I.R.C. Section 2041(a)(3) has led to the name "Delaware Tax Trap" for I.R.C. Section 2041(a)(3). The Delaware Tax Trap is "sprung" or "triggered" when it causes inclusion of assets in the beneficiary's gross estate.

Murphy v. Commissioner and the I.R.S. Action on Decision

In **Estate of Murphy v. Comm'r**, 71 T.C. 671 (1971), *action on dec*. 1979-87 (1979), the only reported case on I.R.C. Section 2041(a)(3), the I.R.S. attempted to include under I.R.C. Section 2041(a)(3) trust assets in the decedent's estate where the decedent exercised a nongeneral power of appointment over a Wisconsin trust by appointing assets to a trust for her husband and granting him a nongeneral power of appointment.

Wisconsin by statute eliminated the common law rule against perpetuities. The applicable statute, which remains in effect, instead provided that a trust is void if it suspends the power of alienation for longer than the permissible period of 30 years. Wis. Stat. Ann. Section 700.16(1)(a). The statute also provided:

> If a . . . trust is created by the exercise of a power of appointment, the permissible period is computed from the time the power is exercised if the power is a general

> power . . .; in the case of other powers, the permissible period is computed from. . . the time the power is created. Wis. Stat. Ann. Section 700.16(1)(c)

Although in **Murphy**, the I.R.S. contended that I.R.C. Section 2041(a)(3) applied if the exercise of the first power postponed vesting, suspended absolute ownership, *or* suspended the power of alienation, the Tax Court ruled that I.R.C. Section 2041(a)(3) only required an examination of the applicable rules of state law which under Wisconsin law provided rules for the suspension of the power of alienation.

The Tax Court then held that because the decedent's power was not a general power it was governed by the second clause of Wisconsin statutes section 700.16(1)(c) and therefore not taxable under I.R.C. Section 2041(a)(3) because the permissible period is measured from the date that the first power of appointment was created. I.R.C. Section 2041(a)(3) applies whenever the permissible period is ascertainable "without regard" to the date of creation of the first power.

Wisconsin law also provided that there is no suspension of the power of alienation if the trustee has the power to sell assets. Wis. Stat. Ann. Section 700.16(2), (3). The **Murphy** Tax Court did not base its decision on that provision although its opinion did make note of it. The I.R.S. acquiesced to the Tax Court conclusion in an Action on Decision and agreed that I.R.C. Section 2041(a)(3) cannot apply because the Wisconsin rule measured the permissible period for suspension of the power of alienation from the creation of the first nongeneral power. The I.R.S. A.O.D. then went further stating:

> Finally, under Wisconsin law ownership had not been suspended because the trustee was given a power to sell assets. The regulation, as it is written, appears to say that because local law is phrased in terms of its suspension of ownership/power of alienation, and there is no such suspension under local law, then section 2041(a)(3) cannot apply.

North Carolina Law Applicable to the Delaware Tax Trap

In 2007 North Carolina enacted N.C.G.S. 41-23, repealing the common law rule against perpetuities as applied to trusts and replacing it with a prohibition against the suspension of the power of alienation of property. The drafters of N.C.G.S. 41-23 based it on the Wisconsin statutes which were the subject of the **Murphy** decision and which are substantially similar to N.C.G.S. 41-23.

N.C.G.S. 41-23(a) provides that a trust is void if it suspends the power of alienation beyond the permissible period of suspension as follows:

> A trust is void if it suspends the power of alienation of trust property, as that term is defined in G.S. 36C-1-103, for longer than the permissible period. The permissible period is no later than 21 years after the death of an individual then alive or lives then in being plus a period of 21 years.

N.C.G.S. 41-23(c) provides for when the permissible period is computed if a trust is created by the exercise of powers of appointment as follows:

> If a trust is created by exercise of a power of appointment, the permissible period under subsection (a) of this section is computed from the time the power is exercised if the power is a general power even if the power is only exercisable as a testamentary power. In the case of other powers, the permissible period is computed from the time the power is created….

N.C.G.S. 41-23(e) provides, however, that the provisions for voiding a trust that suspends the power of alienation beyond the permissible period do not apply as follows:

> Notwithstanding subsection (a) of this section, there is no suspension of the power of alienability by a trust or by equitable interests under a trust if the trustee has the power to sell, either expressed or implied, or if there exists an unlimited power to terminate the trust in one or more persons in being.

It is not clear whether "the trustee has the power to sell" within the meaning of N.C.G.S. 41-23(e) if the trustee could do so only at the direction of a third party, but, nevertheless, there may be no suspension under N.C.G.S. 41-23(d), which provides that the power of alienation is suspended only when no person, *alone or in conjunction with others*, can convey ownership of property. [Emphasis added.]

If a beneficiary is given a presently exercisable general power of appointment over the entire trust principal, this could be the equivalent of having "an unlimited power to terminate the trust" within the meaning of N.C. G.S. 41-23(e). Arguably, the beneficiary would not have unlimited power to terminate the trust if the exercise of the power was subject to the consent of a third party.

Springing the Delaware Tax Trap Under North Carolina Law

Under G.S. 41-23(c) if a nongeneral power of appointment is exercised to create a transfer to a second trust granting a general power of appointment to a beneficiary, whether presently exercisable or exercisable as a testamentary power, the permissible period of suspension of the power of alienation is measured from the time the general power is exercised and not from the date of the creation of the nongeneral power. Accordingly, the Delaware Tax Trap would appear to be sprung because the general power can be exercised to postpone the power of alienation for a period ascertainable "without regard to the creation of the first power."

One commentator has concluded, however, that in states like Wisconsin and North Carolina that have adopted an alienation rule the Delaware Tax Trap cannot be sprung because there is no suspension of the power of alienation when the trustee has the power to sell. *See* Robert J. Kolasa, "Problems in Springing the Delaware Tax Trap," *TR. & EST.* 12, April 2018, at 12. The commentator stated that the I.R.S. embraced this position in the A.O.D. to Murphy "by concluding that the Trap couldn't be sprung because the power of sale meant the power of alienation wasn't suspended." As noted above, G.S. 41-23(e) provides for no suspension of the power of alienation if the trustee has the power to sell and also if a person has the unlimited power to terminate the trust.

The conclusion that the Delaware Tax Trap cannot be sprung because of the trustee's power to sell assumes, incorrectly, that the trustee will always have the power to sell. If a nongeneral power of appointment is exercised to create a transfer to a second trust granting a general power of appointment, the exercise of the general power of appointment could provide that the trustee of the trust created by it does not have the power to sell and no one has the unlimited power to terminate the trust.

If the general power is exercised to create a second trust in which the trustee does not have the power to sell and no one may terminate the trust, the rules of N.C.G.S. 41-23 providing for a permissible period for suspension of the power of alienation would apply and the Delaware Tax Trap would be sprung because the exercise of the general power could postpone the suspension of the power of alienation for a period measured from the time of the exercise of the power and not from the creation of the nongeneral power. As noted above, to spring the Delaware Tax Trap, I.R.C. Section 2041(a)(3) does not require that the second power be actually exercised in a way to postpone the suspension of the power of alienation, only that it can do so.

Since the primary focus of I.R.S. Section 2041(a)(3) is on whether the exercise of the second power can suspend the power of alienation, the authors do not think that it is necessary that the trustee of the trust created by the exercise of the first power not have the power of sale or that no one has the unlimited power to terminate the trust. Such a provision would prevent the exercise of the first power from granting a presently exercisable general power of appointment which would be the equivalent of the power to terminate the trust.

Commentators have noted that postponement of vesting could be further extended by newly created powers of appointment, in each case creating new presently exercisable general powers of appointment – "all kicked in" by the exercise of the original nongeneral power of appointment. *See* Blattmachr & Pennell, *supra*. This would also be the result under North Carolina law with respect to the postponement of the suspension of the power of alienation if there were successive exercises of testamentary general powers or, possibly, presently exercisable general powers of appointment subject to a third party's consent.

Conclusion

Under North Carolina law, if a beneficiary of an irrevocable trust has a nongeneral power of appointment and exercises it by a transfer to a second trust granting another beneficiary a general power of appointment, whether presently exercisable or testamentary, the Delaware Tax Trap will be sprung causing the assets of the original trust to be included in the beneficiary's estate for federal estate tax purposes, and therefore, under I.R.C. Section 1014 providing a stepped-up basis for appreciated assets in the trust.

Although the details of the technique are beyond the scope of this article, it may be possible for a beneficiary to spring the Delaware Tax Trap by exercising a nongeneral power of appointment to appoint trust property to an existing irrevocable trust that gives some person a nongeneral power of appointment. This technique is apparently available in states which, like North Carolina, have adopted section 2(c) of the Uniform Statutory Rule Against Perpetuities. *See* N.C.G.S. 41-16(c); Les Raatz, "USRAP Surprise Trigger of Delaware Tax Trap," *TR. & EST.*, May 2015, at 22.

Graham D. Holding, Jr. is Of Counsel with Robinson, Bradshaw & Hinson, P.A. in Charlotte. His principle areas of practice are Estate Planning, Estate and Trust Administration and Tax Law. He

is a member of the Estate Planning and Fiduciary Law and Tax Sections of the North Carolina Bar Association and a Fellow of the American College of Trust and Estate Counsel. He received his B.A. degree from the University of North Carolina at Chapel Hill in 1958 and his J.D. degree from the University of Virginia in 1964.

Paul M. Hattenhauer is a partner with Culp Elliott & Carpenter, PLLC, and chair of the firm's estate planning practice group. He is a member of the Estate Planning and Fiduciary Law Section of the North Carolina Bar Association, and is a board certified specialist in Estate Planning and Probate Law. He received his B.S. degree from Saint John's University (Minnesota) in 1988, his J.D. degree from the University of Minnesota in 1991, and his LL.M. degree from the University of Miami in 1994.