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NOTICE TO SUBSCRIBERS

Getting a Stepped-Up Income-Tax Basis and More by Springing — or Not Springing —The Delaware Tax Trap the Old-Fashioned Way

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[1] This article is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought.

INTRODUCTION

Estate planning attorneys throughout the United States long have fretted about the poorly understood aspect of the federal tax laws known as the Delaware tax trap ("the Trap"), which is codified in §2041(a)(3) and §2514(d). Although practitioners have had a vague notion that triggering the Trap might be beneficial in certain situations, they have been scared to death that a client's exercise of a power of appointment might inadvertently subject a trust to federal estate or gift tax.[2] Would a malpractice action be far behind? As a result, the goal has been to avoid triggering the Trap at all cost.

[2]*See*825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations*; 850 T.M., *Generation Skipping Transfer Tax*; Les Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets*, 41 Est. Plan. 3 (Feb. 2014). *See also* Howard M. Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law* (Mar. 2012), www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf.

Times change.

It is true that planners still must avoid stumbling into the Trap for many trusts. For example, it would be disastrous for a client to spring the Trap in a trust that is not subject to federal generation-skipping transfer tax (GST tax) because it was irrevocable on September 25, 1985 (Grandfathered Trust) or that is exempt from GST tax as the result of allocation of GST exemption (Exempt Trust) if the client already has enough assets to exhaust his or her federal estate tax exemption, which is a lofty $5.43 million in 2015.[3] This is because springing the Trap would subject assets to a 40% federal transfer tax that otherwise would pass free of tax for one or more additional generations.

[3]Rev. Proc. 2014-61, *2014-47 I.R.B. 860*, §3.33.

Similarly, given that the federal estate tax exemption and the GST exemption are equal at $5.43 million, that the federal estate tax rate and the GST tax rate are equal at 40%, and that a stepped-up income tax basis is available under §1014 for assets owned at death and under §2654(a)(2) for assets subject to a taxable termination, the decision to spring or not to spring the Trap for a trust that is neither grandfathered nor exempt for GST tax purposes (Nonexempt Trust) often will be tax neutral. But, it would be disadvantageous to trigger the Trap if doing so would subject trust assets to a state death tax.[4]

[4]*See* Richard B. Covey & Dan T. Hastings, *States With a Death Tax in Effect as of January 1, 2015*, Prac.

Drafting App. A at 1203537 (Apr. 2015); *McGuireWoods LLP State Death Tax Chart* (Jan. 26, 2015), available at www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.

Nevertheless, following enactment of the American Taxpayer Relief Act of 2012,[5] clients sometimes might benefit by forgoing continued immunity from GST tax in order to obtain a stepped-up income tax basis. Thus, a client might want to spring the Trap for a Grandfathered Trust or an Exempt Trust to obtain a stepped-up income tax basis under §1014 to the extent the client has available federal estate tax exemption. Unused GST exemption might then be allocated to those trust assets.

[5] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 112th Cong., 2d Sess., approved Jan. 2, 2013.

Although commentators have developed ways to trigger the Trap by exercising nongeneral powers of appointment to confer presently exercisable general powers of appointment, they recognize that there is a crucial risk with this technique, i.e., the donee of the presently exercisable general power might exercise it and take the money.[6] Instead, I will focus on the original approach, viz., the successive exercise of nongeneral powers of appointment.

[6] *See*825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations*; James M. Kane, *Income Tax Planning Using the Delaware Tax Trap*, LISI Est. Plng. Newsltr. #2295 (Mar. 30, 2015), www.leimbergservices.com; Jonathan G. Blattmachr & Jeffrey N. Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the "Delaware Tax Trap,"* 24 Real Prop., Prob. & Tr. J. 75 (Spring 1989); Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using the "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. Tax'n 242 (Apr. 1988).

Accordingly, I will use the following definitions:

- First Power — a nongeneral lifetime or testamentary power of appointment granted by a Will or an inter vivos trust instrument.
- Second Power — a second or further nongeneral lifetime or testamentary power of appointment conferred by a First Power.

This article will:

- Review the Trap's history
- Describe how to spring and not to spring the Trap
- Discuss when to spring and not to spring the Trap
- Summarize how the Trap works under current Delaware law
- Note how the Trap works under the laws of some other states
- Identify related issues.

HISTORY

The Delaware Statute

Under Delaware statutory law, the exercise of a power of appointment usually begins a new perpetuities period.[7] The predecessor to this provision, which was enacted in 1933, provided:[8]

[7]Del. Code Ann. tit. 25, §501.

[8] *38 Del. Laws 198, §1* (1933).

Every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of a power of appointment, irrespective of whether such power is limited or unlimited as to appointees, irrespective of the manner in which such power was created or may be exercised, and irrespective of whether such power was created before or after the passage of this Act, 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; and no such estate or interest shall be void on account of any such rule unless such estate or interest would have been void had it been created at the *date of the exercise* of such power of appointment otherwise than through the exercise of a power of appointment. (Emphasis added.)

The above provision offered the possibility, through the exercise of nongeneral powers of appointment in successive generations, of having a perpetual trust without the imposition of federal transfer tax.

Illustration: Fred died in 1934. In his Will, he created a trust for his daughter Alice for her life, giving her a First Power. At Alice's death in 1959, the trust was not subject to federal estate tax because she held only a nongeneral power of appointment. By her Will, she exercised her First Power to create a trust for her son George, giving him a Second Power. Under the Delaware statute, the determination of whether Delaware's traditional rule against perpetuities was violated was measured from the date of Alice's death not from the date of Fred's death. Under this regime, assets could remain in trust perpetually and no federal estate tax would be due other than at Fred's death.

Congress's Response

To prevent this from happening, the predecessor to §2041(a)(3) was enacted in 1951.[9] Under it, a trust is subject to federal estate tax at the death of the donee of a First Power who:[10]

[9] The corresponding federal gift-tax provision is §2514(d).

[10]§2041(a)(3). *See* Reg. §20.2041-3(e)(1).

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

The legislative history makes clear that the Delaware statute was Congress's target:[11]

[11] *S. Rep. No. 82-382* (1951).

In at least one state [i.e., Delaware] a succession of powers of appointment, general or limited may be created and exercised over an indefinite period without violating the rule against perpetuities. In the absence of some special provision in the statute, property could be handed down from generation to generation without ever being subject to estate tax.

The Treasury Regulations

The determination as to whether the donee springs the Trap is based on:

- The instrument that created the First Power
- The instrument that exercises the First Power to create a Second Power
- Applicable local law.[12]

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[12] Reg. §20.2041-3(e)(1)(ii).

Consequently, even if state law provides that the exercise of a First Power to create a Second Power starts a new perpetuities period and even if the instrument granting the First Power does not limit its exercise, the donee may avoid invoking §2041(a)(3) by including appropriate limitations in the instrument exercising the First Power to create the Second Power. To avoid triggering the Trap, instruments exercising First Powers over Grandfathered Trusts in Delaware typically include language such as the following:

I further direct that any power of appointment conferred upon any person under the provisions of this instrument may not be exercised in any manner which would vest an interest in trust beyond the expiration of twenty-one (21) years after the death of the last survivor of my spouse and my issue living on [date original trust became irrevocable]. If any such power is so exercised, I direct that it be declared void ab initio.

The regulations illustrate the application of the Trap as follows:[13]

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[13] Reg. §20.2041-3(e)(2) (Citation omitted.)

If … the decedent appoints the income from the entire [$100,000] fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the 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.

Case Law

The only reported case that considered §2041(a)(3) is *Estate of Murphy v. Commissioner*,[14] in which the Tax Court held that the exercise of a First Power to create a Second Power did not spring the Trap because, under applicable Wisconsin law, the exercise of a nongeneral power of appointment did not commence a new perpetuities period. The IRS acquiesced in the result.[15] The Action on Decision explained that:[16]

[14] 71 T.C. 671 (1979).

[15] 1979-2 C.B. 2.

[16] *AOD 1979-87* (May 1979).

Section 2041(a)(3) refers to the creation of a power which under state law can be validly exercised so as to postpone vesting or suspend ownership "for a period ascertainable without regard to the date of the creation of the First Power." Since the Wisconsin rule measures the period from the creation of the first nongeneral power, the statute by its very words cannot apply. This conclusion is supported by Treas. Reg. §20.2041-3(e)(1)(ii). While an argument can be made that Congress intended to tax all creations of successive powers where vesting or ownership/power of alienation are affected, without regard to state law, such an argument ignores the very language of the Code and regulation. The regulation itself indicates that postponing of vesting and suspension of ownership/alienation power are mutually exclusive conditions of includability which are governed by the particular applicable state law. Finally, under Wisconsin law, ownership has not been suspended because the trustee was given the power to sell trust assets. The regulation, as it is written, appears to say that because local law is phrased in terms of the suspension of ownership/power of alienation, and if there is no such suspension under that local law, then section 2041(a)(3) cannot apply.

HOW TO SPRING AND NOT TO SPRING THE TRAP

Introduction

As noted above, §2041(a)(3) provides for estate taxation if a trust beneficiary:

[E]xercises 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.

Hence, for a trust to be includable in the gross estate of the donee of a First Power created after October 21, 1942, the donee must:

- Exercise the First Power
- Exercise the First Power to create a Second Power
- Exercise the First Power to create a Second Power that, under applicable local law, can be validly exercised to do one of the following for a period ascertainable without regard to the date of the creation of the First Power:
    - Postpone the vesting of any estate or interest in such property; or
    - Suspend the absolute ownership or power of alienation of such property.

Conversely, the donee of a First Power will not fall into the Trap if the donee:

- Does not exercise the First Power

- Exercises the First Power but does not create a Second Power
- Exercises the First Power to create a Second Power that is tied to the date of creation of the First Power.

Beginning of Measuring Period

From the foregoing, it is apparent that the key to whether the exercise of a First Power to create a Second Power springs the Trap is whether the duration of trusts created by the Second Power will be based on the date of creation of the First Power or on the date of its exercise. If tied to the date of creation, the Trap should not be sprung; if tied to the date of exercise, the Trap should be sprung. I summarize where some states stand on this issue below.

End of Measuring Period

Some commentators suggest that the Trap makes it impossible for donees to exercise First Powers to create Second Powers over trusts created in states, such as Delaware, that allow perpetual trusts without adverse tax consequences. This concern was articulated in a 2009 article in the following way:[17]

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[17] Spica, *A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute Is Too Clever by Half (of Infinity)*, 43 Real Prop., Tr. & Est. J. 673, 682 (Winter 2009).

To avoid the Trap, it is necessary to specify a period during which vesting may be postponed, or absolute ownership or the power of alienation suspended, that begins on the date of the Second Power's exercise and ends on a date that cannot be ascertained without regard to the date of creation of the First Power. *Such a period must be finite*. (emphasis added).

As a result, several states set a maximum period (ranging from 360 years to 1,000 years) for the duration of trusts created by the exercise of nongeneral powers of appointment.[18]

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[18] See below for some examples.

Several comments are in order:

- The fixed-period requirement appears nowhere in the authorities summarized above. This isn't surprising because perpetual trusts were not generally available when the authorities were developed, but the fact remains that a fixed period is not required by the tax laws or regulations. The primary authority cited by the author of the above article is an earlier article, which also cites meager sources.[19]
- The argument assumes that §2041(a)(3) requires the existence of a “fixed period” to avoid its application. In fact, by its terms, §2041(a)(3) only applies to a Second Power that can be exercised to suspend vesting for one type of period — a “period ascertainable without regard to the date of the creation of the first power.” If the Second Power can be exercised to suspend vesting indefinitely and if this is not a “period,” the section literally does not apply.
- Even if avoidance of §2041(a)(3) does require a “period” to demonstrate such period was ascertainable with regard to the date of the creation of the first power, Delaware, and other

perpetual trust states, do have such a period — an indefinite one. The notion that a period may be indefinite is consistent with dictionary meanings of the word. For example, the *Oxford English Dictionary*[20] defines "period" as both "an indefinite portion of time" and as "any specified portion or division of time."

• It is difficult to distinguish, in any practical sense, among states that permit perpetual trusts and states with 1,000-year periods or states with 360-year periods with their definite periods of such inordinate length that they might as well be indefinite. Note that the foregoing fixed periods greatly exceed the IRS's "safe harbor" period (the common-law rule against perpetuities, 90 years, or the shorter of such periods) in the regulations for the exercise of nongeneral powers of appointment over Grandfathered Trusts,[21] which apply to any exercise of a power and not just to an exercise of a First Power that creates a Second Power.[22] The regulations suggest that if an ending period is essential to avoid the application of §2041(a)(3), the IRS will require such ending period to be no longer than the traditional period or 90 years. In informal discussions in 2003, IRS representatives confirmed this view with me. At that time, the IRS declined to issue a revenue ruling or private letter ruling on the Trap.

• Given that the determination of whether the Trap is triggered is based, in part, on the instrument exercising the First Power,[23] such instruments should place a maximum fixed period on trusts created by the exercise of Second Powers if the drafting attorney shares this concern.

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[19] Greer, *The Alaska Dynasty Trust*, 18 Alaska L. Rev. 253, 276 (Dec. 2001).

[20] *Oxford English Dictionary* (24th ed. 1985).

[21] Reg. §26.2601-1(b)(1)(v)(B)(2).

[22] *See* Reg. §26.2601-1(b)(1)(v)(B)(2).

[23] Reg. §20.2041-3(e)(1).

WHEN TO SPRING AND NOT TO SPRING THE TRAP

Grandfathered Trust

The Trap is of particular concern for a donee who is exercising a First Power over a Grandfathered Trust because, if the power is exercised inadvertently, he or she might subject an otherwise tax-free trust to estate or gift tax. For example, if the donee exercises a nongeneral power of appointment over a $5 million Grandfathered Trust so as to spring the Trap, his or her estate would owe $2 million of federal estate tax ($5 million times 40%) that should not have been due. Nonetheless, the Trap rarely will be of concern for Grandfathered Trusts for at least two reasons.

First, just three states (Idaho, South Dakota, and Wisconsin) allowed perpetual trusts before September 26, 1985. Therefore, most Grandfathered Trusts expressly require all trusts (including those established through the exercise of powers of appointment) to terminate at the end of the common-law period.

Second, the GST tax regulations allow a donee exercising a nongeneral power of appointment over a Grandfathered Trust (whether or not he or she creates a Second Power) to extend the trust until the expiration of the common law rule against perpetuities, the passage of 90 years, or the end of the shorter of those periods.[24] If a donee complies with these regulations, he or she probably has no Trap concern.

[24] Reg. §26.2601-1(b)(1)(v)(B)(2).

On several occasions, the IRS ruled that exercises of First Powers over Grandfathered Trusts to create Second Powers would not cause the trusts to lose their tax-favored status.[25]

[25]*See*PLR 201029011, PLR 200535009, PLR 200243048, PLR 200206045, PLR 200124006, PLR 199912021, PLR 9351016.

Nonetheless, as noted above, a client might intentionally trigger the Trap in a Grandfathered Trust to the extent that he or she has unused federal estate tax and GST tax exemption.

Exempt Trust

The Trap can pose a significant problem for Exempt Trusts. Thus, if the donee of a nongeneral power of appointment over a $5 million Exempt Trust exercises the power in a way that springs the Trap, the estate again would owe $2 million of federal estate tax that should have been avoided. Currently, over half the states authorize perpetual or very long trusts, and many Exempt Trusts take advantage of these statutes. Exempt Trusts typically also confer First Powers that enable donees to modify trust terms over time to adapt to changing circumstances. Assessing the potential impact of the Trap is crucial to this planning.

As discussed above, the donee of a First Power over an Exempt Trust should not create federal gift or estate tax liability if he or she does not exercise the First Power to create a Second Power or includes appropriate limiting language in the Will or instrument by which the power is exercised.

In a 2002 private letter ruling,[26] the IRS concluded that a donee's exercise of a First Power to create a Second Power did not cause an Exempt Trust to lose its zero inclusion ratio because all resulting trusts had to terminate within the common-law perpetuities period determined from the date of creation of the original trust.

[26]PLR 200219034.

Placing a fixed limitation on the duration of trusts created by the exercise of First Powers over Exempt Trusts puts a state that is trying to attract trust business at a serious competitive disadvantage. The problem is that once an Exempt Trust is established in one of those states, it cannot be moved to a state with a longer perpetuities period without adverse transfer-tax consequences, which will discourage wealthy families who want to preserve flexibility from creating the trust there in the first place.[27] This is particularly true for states that set relatively short fixed periods.

[27]*See* Reg. §26.2601-1(b)(4)(i)(E)*Ex.* 4.

Theoretically, the Trap might be triggered in a state that still follows the common-law rule against perpetuities.

Illustration: Parent creates a trust for the lifetime benefit of Child, remainder to Grandchild, and grants

Child the power to appoint trust property either outright or in further trust to Grandchild. As part of this power, Child can grant Grandchild a nongeneral power of appointment. The trust is subject to the laws of a jurisdiction under which Grandchild's exercise of a nongeneral power of appointment starts a new perpetuities period running. If Child exercises the First Power by creating a trust for Grandchild and granting Grandchild a Second Power, the property of Grandchild's trust will be includible in Child's estate under §2041(a)(3) because Child has exercised the First Power by creating a Second Power that may be exercised so as to suspend absolute ownership of trust property without reference to the date of the trust created by Parent.[28]

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[28]*See*825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations*.

Therefore, the Trap must be considered by a donee exercising a First Power in almost every state. Given the prevalence of the issue, attorneys drafting new trusts or instruments exercising powers of appointment should include language to alert donees and their attorneys to the concern.

As mentioned above, though, it might be desirable to trigger the Trap over an Exempt Trust if a client has unused exemptions.

Nonexempt Trust

The Trap provides an interesting planning option for a Nonexempt Trust given the substantial increase in the federal estate tax exemption ($5.43 million in 2015).[29] An individual's total tax liability sometimes might be lower if trust assets are subject to estate tax and sometimes might be lower if they are subject to GST tax. Various mechanisms have been suggested to minimize a trust beneficiary's total transfer tax liability, but they usually depend upon the inclusion of a formula in the original trust instrument or the exercise of discretion by a trustee who might possess less than complete information.

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[29]Rev. Proc. 2014-61, *2014-47 I.R.B. 860*, §3.33.

The Trap might provide the ideal mechanism because it gives the donee the ability to choose between estate tax and GST tax in light of circumstances as they are at the time of the choice. Thus, if the donee's tax liability will be lower if the trust is subject to estate tax (which might be the case if the estate is below $5.43 million and if a stepped-up income tax basis is desirable), he or she may exercise a First Power to trigger the Trap. Conversely, if the donee's tax liability will be lower if a trust is subject to the GST tax (which might be the case if he or she lived in a state that has a death tax), he or she may refrain from exercising a First Power or exercise it in a way that does not spring the Trap.

CURRENT DELAWARE LAW

Rule Against Perpetuities

The common law rule against perpetuities has been abolished in Delaware. The basic rule is as follows:[30]

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[30]Del. Code Ann. tit. 25, §503(a).

No interest created in real property held in trust shall be void by reason of the common-law rule against perpetuities or any common-law rule limiting the duration of noncharitable purpose trusts, and no interest created in personal property held in trust shall be void by reason of any rule, whether the common-law rule against perpetuities, any common-law rule limiting the duration of noncharitable purpose trusts, or otherwise.

Trust interests in personal property may be perpetual, but trust interests in real property must be distributed "at the expiration of 110 years from the later of the date on which a parcel of real property or an interest in real property is added to or purchased by a trust or the date the trust became irrevocable."[31]

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[31]Del. Code Ann. tit. 25, §503(b).

The 110-year limitation may be circumvented by contributing a parcel of real property to an entity because, "real property does not include any intangible personal property such as an interest in a corporation, limited liability company, partnership, statutory trust, business trust or other entity, regardless of whether such entity is the owner of real property or any interest therein."[32]

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[32]Del. Code Ann. tit. 25, §503(e). The subsection addresses what happens if such an entity ceases to exist.

Powers of Appointment

Delaware law generally measures violations of the rule against perpetuities from the date of exercise — rather than from the date of creation — of powers of appointment. The basic rule is:[33]

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[33]Del. Code Ann. tit. 25, §501. Rules are set for releasing powers of appointment. *See*Del. Code Ann. tit. 25, §502.

Every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of a power of appointment, irrespective of:

(1) Whether such power is nongeneral or general as to appointees;

(2) The manner in which such power was created or may be exercised;

(3) Whether such power was created before or after the passage 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. No such estate or interest shall be void on account of any such rule unless the estate or interest would have been void had it been created at the date of the exercise of such power of appointment otherwise than through the exercise of a power of appointment.

Regarding the above rule, another section provides:[34]

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[34]Del. Code Ann. tit. 25, §503(c).

[T]rusts created by the exercise of a power of appointment, whether nongeneral or general, and whether by will, deed or other instrument, shall be deemed to have become irrevocable by the trustor or testator on the date on which such exercise became irrevocable.

The law is mindful of not falling into the Trap through the exercise of First Powers over Grandfathered Trusts and Exempt Trusts in most situations. Accordingly, the general rule is reversed for these trusts as follows:[35]

[35]Del. Code Ann. tit. 25, §504(a).

Notwithstanding any other provision of this chapter, and except as otherwise provided in subsection (b) of this section, in the case of a power of appointment over property held in trust (the "first power"), if the trust is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto 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, then every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power, irrespective of:

(1) The manner in which the first power was created or may be exercised, or

(2) Whether the first power was created before or after the passage 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 creation of, and not at the time of the exercise of, the first power. For purposes of applying the foregoing rule, if any part of an estate or interest in property created through the exercise of the first power includes another power of appointment (the "second power"), then the second power of appointment and any estate or interest in property (including additional powers of appointment) created through the exercise of the second power shall be deemed to have been created at the time of the creation of the first power. (citation omitted).

Elsewhere, it is provided:[36]

[36]Del. Code Ann. tit. 25, §503(c).

Notwithstanding the foregoing, in the case of a power of appointment described in §504 of this title as a "first power," and subject to §504(a), trusts created by the exercise of the power of appointment, whether by will, deed or other instrument, shall be deemed to have become irrevocable by the trustor or testator on the date on which the first power was created.

But, the law recognizes that it might be desirable to spring the Trap over Grandfathered Trusts and Exempt Trusts:[37]

[37]Del. Code Ann. tit. 25, §504(b). The law addresses the manner in which powers of appointment may be exercised. *See*Del. Code Ann. tit. 25, §505.

Subsection (a) of this section shall not apply to the exercise of a first power or second power over property held in a trust that is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto if the instrument of exercise of any such power makes express reference to subsection (a) of this section and expressly states that subsection (a) of this section shall not apply to the exercise of the power or makes express reference to §501 of this title and expressly states that §501 of this title shall apply to the exercise of the power.

STATUS OF THE TRAP IN SOME OTHER STATES

Leading Trust States

Introduction

A January 2014 article identifies the best trust states as follows:[38]

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[38] Daniel G. Worthington & Mark Merric, *Which Trust Situs is Best in 2014?*, 153 Tr. & Est. 53, 53 (Jan. 2014) (footnote omitted). The authors did not issue a comparable ranking in 2015.

In our view, the four top-tier jurisdictions for 2014 (listed by the year they adopted their perpetuities legislation) remain South Dakota, Delaware, Alaska and Nevada. We rank New Hampshire in fifth place.

As described above, the donee of a First Power over a Delaware trust can exercise the power to spring the Trap and get a stepped-up income-tax basis. This option does not appear to be available in Alaska, Nevada, New Hampshire, or South Dakota.

Alaska

A testator or trustor may create a perpetual Alaska trust,[39] but trusts created via the exercise of nongeneral powers of appointment are limited to 1,000 years.[40] The donee of a First Power over an Alaska Trust cannot spring the Trap because the duration of trusts created by First Powers and Second Powers relates back to the creation of the First Power under the following provision:[41]

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[39]Alaska Stat. §34.27.075.

[40]Alaska Stat. §34.27.051(a).

[41]Alaska Stat. §34.27.051(c).

If a nongeneral power of appointment is exercised to create a new or successive nongeneral power of appointment … , all property interests subject to the exercise of that new or successive nongeneral … power of appointment are invalid unless, within 1,000 years from the time of creation of the original instrument or conveyance creating the original nongeneral power of appointment that is exercised to create a new or successive nongeneral … power of appointment, the property interests that are subject to the new or successive nongeneral … power of appointment either vest or terminate.

Nevada

A Nevada statute[42] allows trusts created by Wills, inter vivos trust instruments, and exercises of nongeneral powers of appointment to last for 365 years, but the statute probably is unconstitutional because §4 of Article 15 of the Nevada Constitution provides that, "No perpetuities shall be allowed except for eleemosynary purposes," and because, in 2002, Nevada voters disapproved a ballot initiative to repeal this prohibition.[43] In this regard, a late 2014 article observes:[44]

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[42] *Nev. Rev. Stat. §111.1031(1)(b)*, §111.1031(3)(b).

[43] Robert H. Horowitz & Steven J. Sitkoff, *Unconstitutional Perpetual Trusts*, 67 Vand. L. Rev. 1769, 1773 (Nov. 2014).

[44] *Id.* at 1803. *Accord* Jonathon Blattmachr, Mitchell Gans & Lipkin, *What If Pepetual Trusts are Unconstitutional?* LISI Est. Plng. Newsltr. #2263 (Dec. 18, 2014), available at www.leimbergservices.com.

[W]e conclude that legislation authorizing perpetual or long-enduring dynasty trusts is constitutionally suspect in a state with a constitutional prohibition of perpetuities ….

A Nevada practitioner contends that a 1941 decision of the Supreme Court of Nevada — *Sarrazin v. First Nat'l Bank of Nevada*[45] — and a 2015 decision of the same court — *Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc* .[46] — mean that the constitutional limitation no longer is relevant.

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[45] 111 P.2d 49 (Nev.1941). *See* Steven J. Oshins, *The Rebuttal to Unconstitutional Perpetual Trusts*, LISI Est. Plng. Newsltr. #2265 (Dec. 22, 2014), available at www.leimbergservices.com.

[46] *Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc.* , 345 P.3d 1040 (Nev.2015). *See* Steven J. Oshins, *Unconstitutional Perpetual Trusts — Not So Fast Says the Nevada Supreme Court*, LISI Est. Plng. Newsltr #2297 (Apr. 6, 2015), available at www.leimbergservices.com.

The *Sarrazin* case was decided long before Nevada adopted a 365-year period for trust interests. Its entire description of the law of perpetuities in Nevada is as follows:[47]

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[47] *Sarrazin*, 111 P.2d at 51.

Section 4 of article XV of the constitution of Nevada reads: "No perpetuities shall be allowed except for eleemosynary purposes." There is no Nevada statute defining the rule against perpetuities. The common-law rule is usually stated thus: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." *Other than the constitutional provision above quoted, there have not been called to our attention any other provisions, either constitutional or statutory, invalidating interests which vest too remotely, or forbidding restraints on alienation.* (citations omitted; emphasis added).

The above emphasized sentence is dictum at best because the court concluded that all interests in the trust in question would vest within the common law rule against perpetuities period.[48]

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[48] 111 P.2d at 53.

The *Bullion Monarch Mining* case involved the applicability of Nevada's rule against perpetuities to "commercial mining agreements for the payment of area-of-interest royalties."[49] Not surprisingly, the court held that it did not.[50] In the course of the opinion, the court discussed a 1974 case — *Rupert v. Stienne*[51] — as endorsing statutes that depart from the common law. Nevertheless, *Rupert*, which dealt with the "old common-law rule of interspousal immunity,"[52] did not involve a common law rule that had been codified in Nevada's constitution.

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[49] *Bullion Monarch Mining*, 345 P.3d at 1041.

[50] 345 P.3d at 1044.

[51] *Rupert v. Stienne* , 528 P.2d 1013 (Nev.1974).

[52] *Bullion Monarch Mining*, 345 P.3d at 1042.

A decision of the Supreme Court of Nevada validating 365-year trusts might be helpful. It has been suggested that the court would uphold the statute in the interest of supporting Nevada's business development efforts. That would be a regrettable basis for such a decision if the law is to the contrary.

The best way to resolve the uncertainty would be for the voters to repeal the constitutional prohibition.

In any event, the following statute[53] prevents the donee of a First Power over a Nevada trust from triggering the Trap:

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[53] *Nev. Rev. Stat. §111.1033(3)*.

For purposes of NRS 111.103 to 111.1039, inclusive, a nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created.

New Hampshire

In New Hampshire, a trust may be perpetual if the governing instrument expressly exempts it from the application of the rule against perpetuities and if the trustee or another person has the power to sell, mortgage, or lease trust property for any period beyond the period that would be required for an interest in the trust to vest in order to be valid under the rule against perpetuities.[54] Given that New Hampshire has no statute regarding the beginning date for measuring the validity of the exercise of a power of appointment or when a First Power becomes irrevocable, the Trap cannot be sprung in New Hampshire because, under the common law, the duration of trusts created by powers of appointment dates back to the creation of the original trust.[55]

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[54] N.H. Rev. Stat. Ann. §564-B:4-402A, §564:24, §547:3-k.

[55] 850 T.M., *Generation-Skipping Transfer Tax*.

South Dakota

South Dakota permits trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment to be perpetual.[56] Nevertheless, the donee of a First Power over a South Dakota trust cannot spring the Trap as a result of the following statute:[57]

[56] S.D. Codified Laws §43-5-8.

[57] S.D. Codified Laws §43-5-5.

If a future interest or trust is created by exercise of a power of appointment, the permissible period is computed from the time the power … is created if the power is not a general power.

States Where Trap Cannot Be Sprung

Introduction

As just discussed, it appears that the Trap cannot be sprung in Alaska, Nevada, New Hampshie, or South Dakota. Below are other states where the technique also is not available.

Connecticut

Connecticut follows the Uniform Statutory Rule Against Perpetuities (USRAP). Thus, a trust created by a Will or inter vivos trust instrument[58] or by the exercise of a power of appointment[59] must vest at the expiration of the common-law rule against perpetuities or at the expiration of 90 years after creation. The Trap cannot be triggered because the date of creation relates back to the creation of the original trust under the following statute:[60]

[58]Conn. Gen. Stat. §45a-491(a).

[59]Conn. Gen. Stat. §45a-491(c).

[60]Conn. Gen. Stat. §45a-492(c).

For purposes of sections 45a-490 to 45a-496, inclusive, a … power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the … power of appointment in the original contribution was created.

New Jersey

In New Jersey, trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment may be perpetual[61] but the donee of a First Power over a New Jersey trust cannot spring the Trap by reason of the following statute:[62]

[61]N.J. Rev. Stat. §46:2F-9.

[62]N.J. Rev. Stat. §46:2F-10(a)(3).

If a future property interest or trust is created by 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 exercisable in favor of the donee, the donee's estate, the donee's creditors or the creditors of the donee's estate, whether or not it is exercisable in favor of others, and even if the general power is exercisable only by will; in the case of other powers the permissible period is computed from the time the power is created ….

New York

Trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment in New York are subject to the common law rule against perpetuities.[63] A donee exercising a First Power over a New York trust cannot trigger the Trap pursuant to the following statute:[64]

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[63] N.Y. Est. Powers & Trusts Law §9-1.1

[64] N.Y. Est. Powers & Trusts Law §10-8.1(a).

Where an estate is created by an instrument exercising a power of appointment, the permissible period of the rule against perpetuities begins:

(1) In the case of an instrument exercising a general power which is presently exercisable, on the effective date of the instrument of exercise.

(2) In all other cases, at the time of the creation of the power.

Another State Where Trap Can Be Sprung (Pennsylvania)

In Pennsylvania, trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment may be perpetual.[65] A donee exercising a First Power over a Pennsylvania trust may trigger the Trap under the following statute:[66]

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[65]20 Pa. Cons. Stat. §6107.1(b)(1).

[66]20 Pa. Cons. Stat. §6107.1(b)(3).

If a power of appointment is exercised to create a new power of appointment, any interest created by the exercise of the new power of appointment is invalid if it does not vest within 360 years of the creation of the original power of appointment, unless the exercise of the new power of appointment expressly states that this provision shall not apply to the interests created by the exercise.

RELATED ISSUES

Fiduciary Powers

The regulations under §2041 define “power of appointment” expansively.[67] Consequently, attorneys advising trustees regarding trust modifications, exercises of decanting powers,[68] and changes of trust situs (as well as donees exercising First Powers) must be mindful of §2041(a)(3) and §2514(d). Nevertheless, the provision's legislative history indicates that they do not apply to powers exercised by trustees:[69]

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[67] Reg. §20.2041-1(b)(1).

[68]*See*PLR 200744020 (exercise of decanting power over grandfathered trust did not fall within §2041(a)(3)).

[69] *S. Rep. No. 82-382* (1951).

The existing statute contains a provision which was intended to cover this situation, but it is too broadly worded. Under it, for example, the exercise of an otherwise exempt power might be taxed if it were exercised by giving a trustee discretionary power to invade principal.

Creditor Rights

The practitioner should be aware of any creditor issues relating to the exercise of First Powers. Under Delaware law, for example, the exercise of a nongeneral power of appointment does not cause trust assets to be subject to creditor claims.[70] The exercise of a general power — lifetime or testamentary — only subjects trust assets to the claim of a creditor in favor of whom the power is exercised.[71]

[70] *See*Del. Code Ann. tit. 12, §3536(d)(1) *§3536(d)(2)*.

[71] Del. Code Ann. tit. 12, §3536(d)(1)§3536(d)(2).

Tax Payment

The planner should pay close attention to how federal estate tax will be paid if a donee triggers the Trap and how GST tax will be paid if a donee does not spring the Trap over a Nonexempt Trust. Charging all taxes to the residue of the probate estate will be ill-advised in almost every case. If the donee of a First Power triggers the Trap and thereby generates federal estate tax, §2207 is available. It provides:[72]

[72] §2207.

Unless the decedent directs otherwise in his will, if any part of the gross estate on which the tax has been paid consists of the value of property included in the gross estate under section 2041, the executor shall be entitled to recover from the person receiving such property by reason of the exercise, nonexercise, or release of a power of appointment such portion of the total tax paid as the value of such property bears to the taxable estate. If there is more than one such person, the executor shall be entitled to recover from such persons in the same ratio. In the case of such property received by the surviving spouse of the decedent for which a deduction is allowed under section 2056 (relating to marital deduction), this section shall not apply to such property except as to the value thereof reduced by an amount equal to the excess of the aggregate amount of the marital deductions allowed under section 2056 over the amount of proceeds of insurance upon the life of the decedent receivable by the surviving spouse for which proceeds a marital deduction is allowed under such section. (Emphasis added.)

Similarly, if a taxable termination occurs in a Nonexempt Trust, §2603(b) is available. It provides:[73]

[73] §2603(b) (emphasis added).

Source of tax. *Unless otherwise directed pursuant to the governing instrument by specific reference to the tax imposed by this chapter* [§2601 et seq.], the tax imposed by this chapter [§2601 et seq.] on a generation-skipping transfer shall be charged to the property constituting such transfer. (Emphasis added.)

The tax clause in the client's Will should be coordinated with the above tax-recovery provisions.

Incapacity of Testator/Trustor

In many ways, the Trap is an ideal way to minimize the payment of federal taxes because it puts the decision as to whether to subject assets to federal estate tax or to GST tax in the hands of the person who is best able to make that determination. That might involve reviewing the situation periodically and signing appropriate estate planning documents, which grows difficult if the donee of a First Power becomes incompetent. With that in mind, donees of First Powers might want to include provisions in durable powers of attorney authorizing attorneys-in-fact to amend exercises of powers of appointment (which might be as minimal as specifying whether the duration of trusts will be measured from the creation rather than from the exercise of powers or vice versa) or might want to include language in instruments of appointment authorizing court-appointed guardians to make appropriate decisions. It also might be prudent to include language in new trusts authorizing trustees to make appropriate distributions.

CONCLUSION

Flexibility is essential in the estate planning world. For decades, estate planning attorneys did their utmost to prevent trusts from being classified as grantor trusts for federal income tax purposes. Now, grantor trusts are the norm. Similarly, planners, who long have abhorred the Trap, now should add it to their planning palette. I hope that this article has alerted planners to the Trap's perils and possibilities.[74]

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[74] In a future article, I hope to explore the circumstances, if any, in which the Trap option can be made available through the exercise of a merger or a decanting power, a nonjudicial settlement agreement, a change of situs, or a court proceeding.

Florida Homestead Law: A Client's Benefit Can Be an Advisor's Nightmare

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INTRODUCTION

A recent Florida case, *Stone v. Stone*,[1] reminds estate planning advisors of how unique, complicated and confusing Florida homestead laws are. These laws not only baffle and surprise practitioners outside of Florida whose clients need advice on the Florida homestead law, but also stymie the Florida courts interpreting these laws. This Article explains Florida's homestead laws, raising issues that advisors outside of Florida should be aware of, providing a review of these laws for Florida practitioners and giving practical pointers for all practitioners on Florida homestead matters. Practitioners who are not admitted to practice law in Florida generally should engage Florida counsel in estate planning matters as appropriate in order to give their clients the benefit of Florida experience and to avoid any appearance of unauthorized practice of law.[2]

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[1] 157 So. 3d 295 (Fla. Dist. Ct. App. 2014), *reh'g denied* No. 4D11-4541, 2015 BL 76161 (Fla. Dist. Ct. App.Mar. 16, 2015).

[2] For more information about the rules governing the unauthorized practice of law including Model Rule 5.5 of the American Bar Association Model Rules of Professional Conduct, see generally 801 T.M., *Conflicts, Confidentiality, and Other Ethical Considerations in Estate Planning*.

Florida homestead law has three parts: (1) restrictions on devise; (2) exemptions from real property tax and limitations on annual increases in property tax values; and (3) protection from creditors. Those three aspects of Florida homestead may be boiled down in their most basic and general sense as follows: A Florida resident may not freely choose who receives such resident's homestead at death, if the decedent is survived by a spouse or minor child; each Florida resident may exempt up to the first $50,000 in the appraised value of his or her homestead from real property tax and furthermore, the value of the homestead may not increase more than 3% a year, unless there is a change of ownership; and most creditors may not force a sale of a Florida homestead. Only a Florida resident and his or her heirs qualify for some or all of these three homestead benefits.

The homestead laws are intended to not only benefit the individual Florida resident, but also his or her family in certain situations. The public policy underlying these three Florida homestead benefits is to promote the stability and welfare of the state by securing to the householder a home, so that the homeowner and his or her family may live beyond the reach of financial misfortune and demands of creditors.[3] As explained in more detail below, there are certain exceptions to the creditor protection.

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[3] *See* *McKean v. Warburton* , 919 So. 2d 341 (Fla.2006).

WHAT IS FLORIDA HOMESTEAD?

The start of the analysis of obtaining the Florida homestead real property benefits is determining if the home qualifies as “homestead.” When determining qualification for homestead, there are three elements: (1) acreage; (2) residency; and (3) ownership. “Homestead” property is a real property interest in a home limited to a certain acreage, depending on the location of the home, deemed to be owned by a Florida resident and occupied by such resident or his or her heirs.

Acreage

The Florida Constitution provides the acreage criteria for homestead:

A homestead, if located outside a municipality, to the extent of one hundred sixty acres of contiguous land and improvements thereon, which shall not be reduced without the owner's consent by reason of subsequent inclusion in a municipality; or if located within a municipality, to the extent of one-half acre of contiguous land upon which the exemption shall be limited to the residence of the owner or the owner's family.[4]

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[4] Fla. Const. art. X, §4(a)(1).

Accordingly, Florida protects a home located as follows: if the home is outside of a municipality, the homestead may consist of up to 160 acres and, inside a municipality, up to one-half acre. The protected area cannot be reduced if the location of the home becomes a municipality after homestead status is in effect, unless the owner consents to the reduction.

Residency

The Florida homestead real property benefits are for Florida residents. To qualify as a Florida resident, one must have a home in the state with the intent to reside in Florida permanently.[5] Specifically, an individual must have legal, beneficial or equitable title in the home and in good faith make the property his or her permanent residence. As there are many factors in the determination of Florida residency, including having a home and living in the state, which are weighed differently depending on the circumstances, establishing Florida residency will not be discussed in detail in this Article. Another element to residency is occupancy of the home by the Florida resident or his or her heirs. Occupancy is generally considered to be a prerequisite for obtaining the homestead benefits, prohibiting vacant lots and homes under construction from attaining homestead status.

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[5]*See* *Hillsborough Inv. Co. v. Wilcox* , 13 So. 2d 448 (Fla.1943).

Ownership

The last part of the general requirements for qualifying for Florida homestead real property tax benefits is deemed ownership of the home. As the specifics of this homestead requirement and the other two requirements vary depending on the homestead benefit being analyzed, the variations in the qualifications for homestead among the three homestead real property benefits are detailed in the discussions below.

HOMESTEAD DESCENT AND DEVISE

Law

Florida Statutes §732.401 provides for the descent of homestead property. If not properly devised, a Florida homestead will pass by intestacy. If not devised as authorized by law, however, and if the decedent's spouse and one or more descendants survive the decedent, the surviving spouse takes a life estate in the homestead, with a vested remainder to the descendants living at the decedent's death, per stirpes.[6] Alternatively, the surviving spouse may elect to take the homestead as a 50% tenant in common with the remaining undivided 50% interest vesting in the descendants living at the decedent's death, per stirpes.[7] The Florida legislature implemented this election for the surviving spouse to alleviate any burden caused by the costs and responsibilities of being a life tenant.[8]

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[6]Fla. Stat. §732.401(1).

[7]Fla. Stat. §732.401(2).

[8] Staff of Fla. S. Comm. on the Jud., Bill Analysis and Fiscal Impact Statement for Bill CS/SB 1544 (Mar. 29, 2010); *see* Jeffrey A. Baskies, *The New Homestead Trap: Surviving Spouses Are Trapped by Life Estates They No Longer Want or Can Afford*, 81 Fla. Bar J. 69 (June 2007).

The Florida Constitution provides the restriction on devise of a homestead as follows:

The homestead shall not be subject to devise if the owner is survived by spouse or minor child, except the homestead may be devised to the owner's spouse if there be no minor child. The owner of homestead real estate, joined by the spouse, may alienate the homestead by mortgage, sale or gift and, if married, may by deed transfer the title to an estate by the entirety with the spouse.[9]

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[9] Fla. Const. art. X, §4(c).

Florida Statutes §732.4015 fleshes out the restrictions on homestead devise, stating that when the homestead owner is survived by a spouse and no minor children, the owner may devise the homestead to the owner's spouse.[10] For purposes of the restrictions on devise of homestead, "owner" includes the grantor of a written revocable trust and "devise" includes a disposition by trust of that portion of the trust estate which, if titled in the name of the grantor of the trust, would be the grantor's homestead.[11]

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[10]*See* Fla. Stat. §732.4015(1).

[11]*See*Fla. Stat. §732.4015(2).

Thus, constitutionally, a Florida resident decedent may not choose who will receive his or her primary residence at death if the residence qualifies as homestead property and the decedent is survived by a minor child. If the decedent is survived by a spouse and no minor child, the decedent may devise the homestead to his or her spouse, but no one else. The Florida Statutes extend the restrictions on devise to include a grantor who owns the homestead through a revocable trust and a bequest provided under revocable trust agreement. The statutory rules acknowledge that the grantor's lifetime beneficial interest, even if the grantor is not the legal owner because someone else is the trustee of the grantor's revocable trust, still qualifies the ownership for the purposes of the restrictions on homestead devise.[12]

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[12]*See*Fla. Stat. §732.4015(2)(a).

Notably, except for the joinder of the spouse when transferring the homestead (whether or not the transferor owns the home individually or jointly), the homestead transfer restrictions do not apply during the life of the owner of the homestead.[13]

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[13]*See* Fla. Stat. §732.4017.

Joint Ownership

As for a jointly owned home, the restrictions on devise of homestead do not apply to a home owned as tenants by the entirety or as joint tenants with right of survivorship.[14] Those interests pass by operation of law to the surviving joint tenant or tenants. On the other hand, the restrictions on devise of homestead do apply to a tenant in common interest in homestead real property.

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[14]*See*Fla. Stat. §732.401(5).

Similarities and Differences of Homestead Qualifications

General

The rules for the qualification of homestead for purposes of descent and devise are similar to the general requirements stated above. For the restrictions on homestead devise, the determination of homestead qualification is made as of the death of the owner.

Probate

If, upon the decedent's death, there is a question of whether a home qualifies as Florida homestead property, the decedent's Personal Representative may petition the probate court to determine if the home qualifies as homestead and to whom the property passes. This petition may cause an estate that was not being probated to be opened for probate. The homestead is not a part of the Florida probate estate, but a Personal Representative may take possession of the homestead to preserve and protect it until the probate court determines homestead status.[15] This determination of homestead provides assurance that the home will pass appropriately at death, though it is too late to change the homestead owner's estate planning documents if the court determines that the homestead had been invalidly devised.

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[15] *See* Fla. Stat. §733.608(2).

Practical Considerations for Restrictions on Homestead Devise

As an invalid devise may result in the homestead passing to unintended beneficiaries, or to intended beneficiaries, but in a manner that was not intended by the client, advisors should pay careful attention to any planning for transfer of a Florida homestead.

Identity of Homestead

There are various techniques for avoiding the potentially adverse effects of the Florida restrictions on homestead. As a threshold issue, an estate planner for a Florida client needs to determine whether the client's primary home is his or her homestead. This determination may be as easy as reviewing on the internet the property tax records from the property appraiser's office for the client's county of residence because these public tax records show whether the client received the homestead real property tax exemption. The attorney should also make his or her own determination of homestead based on discussions with the client as to whether the client's home qualifies for homestead, independent of what the tax records show, because individuals may qualify for the real property tax exemption when, technically, they may not be entitled to receive that benefit.

Drafting Provisions for Homestead

After determining that the home is homestead property, the estate planner may choose not to provide any provisions for the transfer of the homestead where the client may be survived by a spouse or minor child, allowing Florida's laws of homestead descent to dictate the transfer of the property on the client's death. Alternatively, for a married client with no minor child, the attorney may choose to affirmatively provide in the client's will or revocable trust agreement that the homestead passes outright to the surviving spouse.

Waiver of Spousal Homestead Rights

If the estate planner decides that Florida's restrictions on homestead devise will inhibit the estate plan or does not want to take the chance of violating those rules, the planner may use a marital agreement, homestead waiver or irrevocable trust to avoid any adverse consequences. Notably, all three of these techniques rely on the Florida Statutes, though the use of a homestead waiver that is not a valid marital agreement has been questioned by some Florida practitioners.

Marital Agreements

Florida Statutes §732.702(1) allows a surviving spouse to waive rights to homestead, “wholly or partly, before or after marriage, by written contract, agreement, or waiver, signed by the waiving party in the presence of two subscribing witnesses." Accordingly, a typical pre- or post-marital agreement requires full financial disclosure by both parties who should be represented by independent counsel, and may be used by a couple to avoid the homestead devise restrictions with respect to each other, but the agreement will not affect any minor child's interest in the homestead.

Homestead Waiver

As the typical marital agreement is an extensive endeavor and may be much more than the client wants, attorneys have used a document commonly known as a "homestead waiver," which is typically only a few pages. Some attorneys do not think that a homestead waiver, which is an abbreviated marital agreement, will suffice for the waiver of the spousal right to homestead because the waiver is not often carried out in the same manner as a typical premarital agreement or postmarital agreement. The homestead waiver, however, may be acceptable to some Florida estate planners so long as there is some sort of financial disclosure, acknowledgement that the parties knew of their respective rights to consult independent counsel and the document is executed in the same manner as a marital agreement. If a waiver includes these features, Florida Statutes §732.702(1) would also be satisfied.

Joint Deed: Stone v. Stone

Unfortunately, judicial interpretation of Florida Statutes §732.702(1) has led to a disagreement in the courts whether the homestead restrictions on devise may also be waived in a deed executed by both spouses.[16] In a 2011 case, the Third District Court of Appeals ruled that a husband's joint execution of a warranty deed with his wife, transferring the homestead to his wife, constituted a waiver of his spousal rights to the homestead.[17] Common practice had been for real estate deeds to provide that the transferor was transferring the property with "all the tenements, hereditaments and appurtenances thereto." Thus, a deed containing this language that transfers a home from one spouse to another or from joint name to one of their names has been construed to be a waiver of homestead rights by the transferring spouse because "hereditaments" means anything capable of being inherited.

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[16]*See* *Stone v. Stone*, 157 So. 3d at 304.

[17]*See* *Habeeb v. Linder* , No. 3D10-1532, 2011 BL 33451 (Fla. Dist. Ct. App.Feb. 9, 2011).

Many advisors believe that the court's finding of a spousal homestead waiver from a deed executed by both spouses was without merit. In the end the opinion was effectively vacated when the appeal was withdrawn,[18] leaving the Circuit Court's holding that the deed constituted a homestead waiver in place.

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[18]*See* *Habeeb v. Linder*, 64 So.3d 1275 (Fla. Dist. Ct. App. 2011) (appeal withdrawn, causing original opinion to be vacated).

However, last November, the Fourth District Court of Appeals agreed with the original conclusion of the Third District in *Stone v. Stone*, holding that a joint deed from husband and wife to each of them as tenants in common waived their spousal homestead rights to the home.[19] This recent case confirmed advisors' fears of possible inadvertent waivers of spousal homestead rights through deeds signed by both spouses without even a mention of "waiver" where the deeds use the archaic term "hereditaments." Even though many estate planners disagree with this ruling by the court, the ruling has not been overturned yet.

[19] *See Stone v. Stone*, 157 So. 3d at 304.

Homestead Trust

The last option for an estate planner to avoid Florida's restriction on the devise of homestead is for the client to transfer the property during his or her lifetime to an irrevocable trust. Florida Statutes §732.4017 permits the owner of homestead property to transfer the homestead during his or her life to an irrevocable trust without restrictions on post-death devise, even if the client reserves the right to a lifetime beneficial interest in the property that qualifies for the homestead real property tax exemption discussed below. The client may also have a reversion or possibility of reverter without being subject to the restrictions on homestead devise. Essentially, this type of trust would allow the client to continue to qualify for the homestead benefits discussed below while avoiding the restrictions on devise, and the homestead could revert back to the client when the restrictions on homestead cease to apply (e.g., the owner no longer has a spouse or minor child), or the trust could continue after the client's death for the beneficiaries that he or she chooses.

As the homestead waiver may still have its doubters, the full marital agreement or irrevocable homestead trust may be the safest techniques for avoiding any adverse consequences of Florida's restrictions on homestead devise.

REAL PROPERTY TAX EXEMPTIONS

Unlike the surprise that Florida clients may have on the restrictions on devise of homestead, many clients are acutely aware of the real property tax benefits of homestead. To be eligible, one must be a permanent Florida resident and must apply for the exemption.

Law

Ad Valorem Tax

The Florida Constitution grants the legal or equitable title owner (as of January 1) of a Florida home, who either lives at that home or whose legal or natural dependents live at the home, an exemption from the ad valorem tax for $25,000 of the assessed value of the home.[20] Further, Florida Statutes §196.031(1)(b) authorizes up to an additional $25,000 of exemption from tax (other than school district levies) for homes with an assessed value greater than $50,000.

[20] Fla. Const. art. VII, §6.

This part of the Florida homestead law extends the benefit to home owners who have equitable title in the home, meaning that the holder of a life estate or beneficiary of a trust who has a lifetime beneficial interest in the trust qualifies as an “owner” for the real property tax exemption. Furthermore, a lessee who has a leasehold interest in a bona fide lease of a residence for at least 98 years is deemed to have equitable title for homestead purposes.[21] With the public policy of providing stability to families in mind, the real property homestead exemption benefits a home owner who allows his or her dependents to live at the home, even if the owner is not living there.

[21] *See* Fla. Stat. §196.041(1).

If an owner qualifies for the ad valorem tax exemption, then he or she also should qualify for the homestead benefit commonly known as the “Save Our Homes Cap.” The Florida Constitution prohibits changes in the annual assessment of the homestead exceeding the lower of 3% of the prior year's assessment or the percent change in the Consumer Price Index of the prior year.[22] This cap was implemented to prevent Florida residents from being adversely affected by skyrocketing housing prices because the value of each home in Florida is reassessed every year for real property tax purposes.

[22] Fla. Const. art. VII, §4(d).

The cap, however, does not apply when there is a change in ownership and, on January 1 of the year following the change in ownership, the home will be reassessed at full value for real property tax purposes. Excepted from being considered a “change in ownership” are four types of transfers: (1) from the owner with legal title to the home to the same owner with equitable title to the home (e.g., transfers to a life estate for the original owner or a trust in which the original owner has a lifetime beneficial interest in the home); (2) between spouses, or ex-spouses due to a dissolution of the marriage, as long as the transferee spouse is otherwise eligible and timely files for the exemption; (3) by operation of the homestead descent and devise laws, to the surviving spouse or minor child; and (4) from the owner to someone who is a permanent resident and legally or naturally dependent on the owner.[23] Although the above exceptions are not considered changes in ownership, a transferee may still need to timely file for the exemption.

[23] Fla. Stat. §193.155(3)(a).

Lastly, the owner can transfer the tax benefit from the Save Our Homes Cap up to $500,000 of the underassessment, which is the amount by which the just value exceeds the assessed value, to another homestead established within two years of selling a homestead.[24] The owner obtains the transfer by timely filing an application for the homestead exemption, which is discussed below.

[24] *See* Fla. Const. art. VII, §4(d)(8).

Other Exemptions

In addition to the ad valorem tax exemption and Save Our Homes Cap, Florida offers partial exemptions to widows, the blind, the disabled and veterans. The details of these exemptions are beyond the scope of this Article.

Joint Ownership

As for a jointly owned home, there are some intricacies to note.[25] If the home is owned as tenants by the entirety or as joint tenants with rights of survivorship, so long as one of the owners resides in the home, the owners will qualify for the homestead real property tax benefits. Differently, tenants in common will only receive the homestead real property tax benefits in proportion to the percentage ownership of any tenant in common who resides in the home.[26] The tenant in common who does qualify for homestead will receive the ad valorem tax benefit in proportion to his or her ownership in the home and his or her interest cannot increase more than the Save Our Homes Cap.

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[25]*See*Fla. Stat. §196.031(1)(a).

[26]*See id.*

Similarities and Differences of Homestead Qualifications

To obtain these homestead real property tax benefits, the owner must apply with his or her county tax collector or property appraiser's office between January 1 and March 1 of the year that the house qualifies on January 1 as homestead property. The qualification for these homestead benefits is similar to the general requirements stated in “What Is Florida Homestead,” above. Importantly, qualifying for this homestead benefit does not depend on the person having legal title to the home, nor does it depend on the person living in the home. As mentioned above, the homestead qualification for the real property tax benefits extends to a lifetime beneficial interest in a home and permits the owner's dependents to live in the home without the owner. Thus, the qualification for this homestead benefit depends on who owns and resides in the house on January 1 and ultimately comes down to the homestead application being approved by the local county.

Practical Considerations for Real Property Tax Benefits

Homestead Application

Unlike the restrictions on homestead devise, clients often know about and want to qualify for the homestead real property tax benefits. Florida has made it easy for its residents to qualify for the homestead real property tax benefits. So long as the Florida resident qualifies on January 1 of the year in which he or she is applying for the benefits, and the application is filed by March 1 and accepted, the resident receives these tax benefits.

The homestead application is only a few pages long. The applicant must provide certain personal information and proof of residency, such as a Florida driver's license, Florida vehicle tag number, Florida voter registration number or declaration of Florida domicile, if any. Filing the application for these tax benefits is often very accessible and a quick process with short lines, if any. During the application period, there are kiosks established at various public places, such as shopping malls, which also serve as a reminder for new Florida residents. A knowing and willful lie on the application is a misdemeanor of the first degree punishable by imprisonment up to one year in addition to a possible fine of up to $5,000.

After qualification for and acceptance by the local government of the Florida homestead real property tax benefits, the client does not need to file an application again until there is a change in ownership. A transfer of the homestead from a homestead owner to his or her revocable trust may be thought of as a change of ownership, but as mentioned above, this is not the type of change in ownership that triggers loss of the homestead tax benefits.

The owner does need to inform the county of the new form of ownership in the revocable trust, however. Notification requirements can vary by county. For example, some counties may require the owner to re-apply for the tax benefits, while other counties may simply request a letter of instruction. Added to the application or letter of instruction will be either copies of relevant pages of the trust agreement or a certificate of trust, stating that the trustee has the legal ownership of the home and the original, individual owner still has the requisite beneficial ownership. Copies of the relevant pages of the trust agreement or the certificate of trust would also be needed for the initial application for homestead if a trust owned the home initially. Some counties provide a certificate of trust form on their tax collector or property appraiser's website. Notably, Florida counties have different forms for the application for homestead and certificate of trust, along with different requirements, necessitating obtaining these forms and confirming the requirements with the particular county of residence of the owner.

Sample language for the settlor meeting the requirements of homestead ownership through a trust is as follows:

If the trustee shall own a residence in the State of Florida which would qualify as the settlor's homestead if the settlor owned such residence, the settlor shall have the right to use, possess and occupy such residence in such manner as will qualify the settlor's rights as an “equitable title to real estate” pursuant to Section 196.041 of the Florida Statutes.

Obviously, there are many ways to draft this provision, which can be made more generic by not referencing Florida or its statutes and may allow the settlor to more easily qualify his or her home for real property tax benefits in another state if the settlor changes residency. This language may be used in irrevocable trusts for the settlor. Furthermore, this language may be adapted to allow for a homestead which continues to be held in a trust or passes to a trust for a surviving spouse or surviving dependent to not trigger a change of ownership and continue the homestead benefit for those beneficiaries.

Qualified Personal Residence Trust

A specific estate planning technique that requires particular attention is a transfer of the homestead to a qualified personal residence trust (“QPRT”). The first issue arises upon the contribution of the homestead to the QPRT. This initial issue is solved by using language similar to the sample provided above. The second issue would arise if the settlor wanted to continue to use the home after the end of the QPRT term, when the beneficial interest in the home passes from the settlor to the remainder beneficiaries.

If the settlor enters into a lease of the homestead property for at least 98 years before the expiration of the QPRT term and has that lease recorded, he or she will continue to qualify for Florida's homestead and the Save Our Homes Cap benefit.[27] In a 2008 case, the lease was found to be an equitable title in the home because the settlor was considered to have use of the home for life.[28] Although this lease technique satisfies the homestead requirements, if fair market rent is not paid (which may be very hard to determine), then the settlor may be deemed to have retained an interest in the home under IRC §2036. Thus, the purpose of the QPRT may be defeated by the 98-year lease.

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[27] *See* *Higgs v. Warrick* , 994 So. 2d 492 (Fla. Dist. Ct. App.2008).

[28] *See id.*

As the real property homestead tax exemptions can be very beneficial to a Florida client, estate planners advising Florida clients on transfers of homestead property should take extra precaution and, as mentioned above, if not licensed to practice law in Florida they should engage Florida counsel to advise on homestead matters.

CREDITOR PROTECTION

Many Florida advisors refrain from using Florida homesteads in lifetime gifting techniques because of not only the potential adverse real property tax consequences, but also the potential loss of the homestead protection from creditors. Although the homestead creditor exemption is best left to asset protection or bankruptcy specialists, estate planners often find themselves involved in advising about this aspect of Florida homestead.

Law

The Florida Constitution provides the creditor protection for homestead:

There shall be exempt from forced sale under process of any court, and no judgment, decree or execution shall be a lien thereon, except for the payment of taxes and assessments thereon, obligations contracted for the purchase, improvement or repair thereof, or obligations contracted for house, field or other labor performed on the realty, the following property owned by a natural person.[29]

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[29] Fla. Const. art. X, §4.

This creditor protection receives extensive coverage in the national news, providing the public with general knowledge about the protection, but also misleads the public because much of the details about the law are left out of the coverage. The Florida Constitution carves out exceptions for creditors relating to the taxes and assessments on the homestead property, and the purchase, building and improvements of the homestead.

Similarities and Differences of Homestead Qualifications

Along with the general requirements to qualify for Florida homestead discussed in “What is Florida Homestead?” above, there are some other notable qualification requirements for purposes of homestead creditor protection. Unlike the homestead real property tax benefits, the creditor exemption is not examined as of January 1 of the year in question, but rather when the creditor attempts to assert its rights over the home. Again, this homestead benefit is for an owner who is a Florida resident, which Federal bankruptcy courts have held does not occur until the owner has resided in the state for at least the past 180 days.[30] Similar to the other homestead benefits, the creditor protection inures to the benefit of the debtor's family as well and the owner need not live in the home to obtain this benefit.[31] The debtor may own the home directly or indirectly, in the same forms as are eligible for the other homestead real property benefits discussed above, despite the Florida Constitution referring to a “natural person” — though individual ownership may be the best option for qualifying for creditor protection.[32]

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[30] *See* *In re Whitehead* , 278 B.R. 597 (Bankr. M.D. Fla.2002).

[31] *See* *Friscia v. Friscia*, 161 So. 3d 513 (Fla. Dist. Ct. App. 2014).

[32] *See* *In re Alexander* , 346 B.R. 546 (Bankr. M.D. Fla.2006); *but see* *Crews v. Bosonetto* , 271 B.R. 403 (Bankr. M.D. Fla.2001) (finding that a home owned in a revocable trust does not qualify for the protection from creditors).

Florida's homestead creditor protection has been extended to many types of homes. Florida Statutes

§222.05 provides:

Any person owning and occupying any dwelling house, including a mobile home used as a residence, or modular home, on land not his or her own which he or she may lawfully possess, by lease or otherwise, and claiming such house, mobile home, or modular home as his or her homestead, shall be entitled to the exemption of such house, mobile home, or modular home from levy and sale.

The Florida Statutes mention various types of homes (e.g., mobile homes) and deemed ownership through a lease qualifying for the homestead creditor protection. There are even decisions by the courts ruling that a motorboat qualifies for homestead because the debtor lived in the boat as his or her home, which had permanent connection with utilities.[33] Not surprisingly, motorboats have also been found not to be the type of permanent home that Florida wants to protect from creditors.[34] Accordingly, advisors of Florida clients interested in asset protection should be open to many ideas about what qualifies for Florida's homestead creditor protection.

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[33] *See In re Mead*, 255 B.R. 80 (Bankr. S.D. Fla.2000).

[34] *See In re Hacker*, 260 B.R. 542 (Bankr. M.D. Fla.2000).

Similar to the homestead real property tax benefits, the homestead creditor protection qualification will remain in effect until the homestead is abandoned.

Practical Consideration for Homestead Creditor Protection

To reiterate, the homestead creditor protection is a matter best dealt with by attorneys specializing in asset protection or bankruptcy. The estate planner, however, may become involved before those specialists and may need to ensure that Florida clients do not inadvertently discard the homestead creditor protection through transfers of the homestead. Many of the same practical considerations discussed with respect to the homestead real property tax benefits and the Save Our Homes Cap benefit would also apply to the homestead protection from creditors. Specifically, when a homestead is transferred in whole or in part by adding another person to the deed, estate planners should analyze whether creditor protection continues to apply in the hands of the transferee or whether the document transferring the homestead waives the homestead creditor protection.

CONCLUSION

The surprising confirmation of a homestead waiver by joint deed from *Stone v. Stone* reiterates the unique and ever-changing characteristics of Florida homestead law. Unquestionably, advising a Florida resident client whose property qualifies for homestead treatment on estate planning matters involving the transfer of homestead property or other homestead protections necessitates frequent review of the current Florida homestead law and fastidious planning for transferring the homestead.

LEADING PRACTITIONER COMMENTARY

Tax Court Rules that Fixed Percentage Specified in Net Income with Make-up Charitable Remainder Unitrust (NIMCRUT) Must Be Used to Value Interests in Trust for Purposes of Determining Whether Trust Meets 10% Remainder Requirement

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Background

A charitable remainder trust allows a donor to take an income, estate and/or gift tax charitable deduction for an amount transferred in trust, where the income of the trust (expressed as a percentage of the trust's initial or yearly fair market value) is paid to the donor (and/or others designated by him) for a specified term or for life, and the remainder is paid to charity at the end of the term. The charity's remainder interest in the trust must be equal to at least 10% of the value of the assets placed in the trust. The amount of the deduction is limited to the actuarial value (determined under §7520 from IRS tables) of the remainder interest at the time of the contribution.[1]

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[1] *See generally*§664 and applicable Treasury regulations.

There are a number of types of *inter vivos* and testamentary charitable remainder trusts. The two standard variations are the charitable remainder annuity trust (CRAT) in which the donor and/or other noncharitable beneficiaries receive a fixed dollar amount (sum certain), which may be expressed as a percentage of the initial fair market value of the assets, and the charitable remainder unitrust (CRUT), in which the donor and/or other noncharitable beneficiaries receive a stated percentage of the value of the trust's assets determined annually. In either case, the stated percentage — either initial or annual — of the value of the trust's assets that is used to calculate the payout must be no less than 5% and no more than 50%.

Subcategories within the CRUT category include: (a) the income only unitrust (NICRUT), which pays the noncharitable beneficiary the *lesser* of the net income of the trust (as defined in the trust instrument, which must not be inconsistent with state law) or a fixed percentage of the fair market value of the assets of the trust, determined yearly; and (b) the net-income-with-makeup charitable remainder unitrust (NIMCRUT), which includes an optional "make-up" provision allowing any amount not distributed in a year in which the trust had no income (or income that was less than the stated unitrust percentage) to be "made up" in later years if the trust produces income in excess of the unitrust percentage in those years. The NIMCRUT may be appropriate for unitrusts with assets which are not readily marketable or which will produce little or no income in the earlier years of the trust.

***Estate of Schaefer v. Commissioner*[2]**

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[2] 145 T.C. No. 4 (July 28, 2015).

On February 21, 2006, Arthur Schaefer (Decedent) created and funded (with nonvoting LLC interests) two trusts: Arthur E. Schaefer Charitable Remainder Unitrust Number 1 (Trust 1) and Arthur E. Schaefer Charitable Remainder Unitrust Number 2 (Trust 2) for the benefit of his two sons during the trusts' noncharitable terms.

The trust agreements provide for quarterly distributions to the income beneficiaries during the "Unitrust Period" of the lesser of the net trust accounting income for the taxable year or a percentage, equal to 11% for Trust 1 and 10% for Trust 2, of the net fair market value of the trust assets, valued annually. At the end of the Unitrust Period the remainder of the principal and income in each trust is to be distributed to a charitable organization.

Decedent died in Wisconsin on March 9, 2007, a little over a year after the trusts were established. His estate did not claim a charitable contribution deduction for any portion of the trusts on its Form 706. Instead, the estate reduced the amounts reported on Schedule G, *Transfers During Decedent's Life*, by the amounts it deemed to be charitable.

The IRS issued a notice of deficiency, in which it explained that the estate was not allowed a charitable contribution deduction for the values of the remainder interests of the trusts because the trusts did not meet the requirement that the value of the charitable remainder interest be at least 10% of the net fair market value of the property on the date of contribution, and the estate had not shown any other basis upon which the charitable remainder interests in the trusts should be discounted.

After pre-trial stipulations of fact, the only remaining issue was whether the trusts met the 10% remainder requirement. The parties agreed that the estate was not entitled to the charitable contribution deduction if the values of the charitable remainder interests in Trust 1 and Trust 2 were calculated on the basis that 11% or 10%, respectively, of the net fair market value of the assets is distributed each year. However, they also agreed that the estate was entitled to the charitable contribution deduction if the values of the charitable remainder interests were calculated on the basis that an amount equal to each trust's net income, determined using the (lower) §7520 rate, was distributed each year.

The text of §664(e), while reasonably specific on how to value a charitable remainder interest of a standard CRUT, is, in the view of the Tax Court, ambiguous, or silent, concerning how to value the remainder interest under the NIMCRUT exception. Thus, the estate argued that NIMCRUT distributions should be determined, not under the general rule, but under an exception to this rule that would require the remainder interest to be valued by using the §7520 rate to determine the trust's expected income, so long as the §7520 rate is above 5% of the net fair market value of the assets.

Given this ambiguity, the court consulted the legislative history to §664(e), which, in the Senate report, [3] "makes clear that where there is a net income provision, the distribution amount or rate set forth in the trust instrument is to be used for valuation purposes even though distributions may be limited by net income."[4]

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[3]§664(e), which governs valuing a remainder interest in a CRAT or a CRUT, was enacted as part of the Tax Reform Act of 1969, Pub. L. No. 91-172. The underlying House bill containing the provisions for CRATs and CRUTs did not include a provision allowing for distributions to be limited to net income. H.R. 13270, 91st Cong., §201 (1969) (as passed by the House, August 7, 1969). A Senate amendment included both §664(d)(3), which allowed for distributions to be limited to net income, and §664(e), which provided for valuing the remainder interest of the trust.

[4] *S. Rept. No. 91-552*, at 89–90 (1969), 1969-3 C.B. 423, 481.

The regulations,[5] stated the court, are less clear. The court pointed out, however, that "[i]ndependent of the regulations," the IRS has issued administrative guidance on the subject of valuing a remainder interest in a NIMCRUT on several occasions.[6] That administrative guidance "asserts that the remainder interest of a NIMCRUT is valued using the fixed percentage stated in the trust instrument, regardless of the fact that distributions are limited to trust income," and even in Rev. Rul. 72-395, with reference to a sample provision, explained that "notwithstanding the … [net income makeup provision], the computation of the charitable deduction will be determined on the basis that the regular unitrust amount will be distributed in each taxable year of the trust." Similarly, Rev. Proc. 2005-54 states: "For purposes of determining the amount of the charitable contribution, the remainder interest is computed on the basis that an amount equal to the fixed percentage unitrust amount is to be distributed each year, without regard to the possibility that a smaller or larger amount of trust income may be the amount distributed."

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[5] Reg. §1.664-4(a)(3) and §1.664-3(a)(1)(i)(a).

[6] *See*Rev. Rul. 72-395, 1972-2 C.B. 340, §7.01; Rev. Proc. 2005-54, 2005-2 C.B. 353, §6.09.

While the court noted that it is not bound by revenue rulings or procedures, they are entitled to deference when thoroughly reasoned and consistently adhered to over a long period of years. In this case, "the guidance has withstood the test of time."

Conclusion

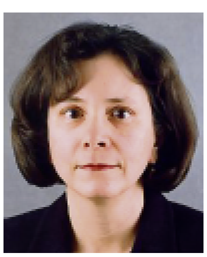
The court determined that:

With regard to the statute before us, the legislative history and the administrative guidance point us to only one conclusion — that the value of the remainder interest of a NIMCRUT must be calculated using the greater of 5% or the fixed percentage stated in the trust instrument. Accordingly, the estate must use an annual distribution amount of 11% or 10% of the net fair market value of the trust assets when valuing the remainder interests of Trust 1 and Trust 2, respectively. Because the parties have previously stipulated that the estate would not be entitled to a charitable contribution deduction if the remainder interests are valued using this method, respondent's determination denying the charitable contribution deduction is sustained.

The Schaeffer trusts therefore failed the 10% test and no deduction for the value of the remainder was allowable.

We note that most estate planning actuarial software (such as, e.g., NumberCruncher) assumes that the IRS's position is the correct one in providing values for interests in charitable remainder trusts. It is unclear, however, whether the estate in *Schaefer* used such software.

Tax Court Rules that "Investor Control" Doctrine Is Still Relevant to Taxation of Private Placement Variable Life Insurance Arrangement



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In *Webber v. Commissioner* ,[1] the Tax Court ruled that, under the "investor control" doctrine, taxpayer Jeffrey T. Webber was the actual owner of assets held in segregated accounts underlying certain life insurance policies, and that, accordingly, the dividends, interest, capital gains, and other income received by the special purpose company set up to hold the accounts were directly includible in Webber's gross income under §61. However, the Court refused to impose the accuracy-related penalties assessed by the government, finding that the taxpayer had reasonably relied on professional tax advice.

[1] 144 T.C. No. 17 (June 30, 2015). Unless otherwise specified, all "Section" or "§" references refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

Background

Taxpayers that hold life insurance or annuity contracts are entitled to certain benefits under the Internal Revenue Code (the "Code") that arguably make them more tax-favored than many other types of investments.

Under §72(e), the earnings — or "inside buildup" — of a life insurance contract are, in most cases, not taxable until actual receipt. If amounts are withdrawn from the contract, they are taxable only after the policyholder's investment in the contract has been recovered (commonly referred to as the "basis first" rule). In addition, §101(a) provides that amounts received under a life insurance contract by reason of the death of the insured are not includible in gross income unless the contract has been transferred "for a valuable consideration."

Under §72(b), an "exclusion ratio" is used to determine how much of an "amount received as an annuity" is included in gross income. While income inherent in an annuity contract is taxed ratably over the period that it is received, income on a deferred annuity contract is not taxed as it is earned.

Therefore, investing through the medium of life insurance or annuities allows for the deferral (or in the case of life insurance held until death, the elimination) of tax on income that would be taxed currently to the investor (as interest, dividends, or capital gain) in the absence of the insurance/annuity "wrapper."

Qualification as Life Insurance or Annuity Contract

In order to be entitled to the benefits described above, the product in question must qualify as a "life insurance contract" or as an "annuity contract."

Under §7702 the term "life insurance contract" is defined as a contract "which is a life insurance contract under the applicable law." In addition to qualifying as life insurance under local law, the contract must meet one of two tests — the "cash value accumulation" test or the "guideline premium and cash value corridor" test. Certain common law characteristics of life insurance also may have to be present in order for a contract to qualify as a life insurance contract.

There is no similar statutory definition of "annuity contract." However, applicable Treasury regulations provide that an annuity contract is generally a contract issued by an insurance company that is "considered to be [an] annuity contract[] in accordance with the customary practice of life insurance companies."[2]

[2] Reg. §1.72-2(a)(1).

Variable Contracts and the "Diversification" Rules

In addition to meeting the requirements of a life insurance or annuity contract, a "variable contract" (other than certain pension plan contracts) must meet the "diversification requirements" of §817(h), which was added to the Code in 1984. If a variable contract fails to meet the diversification requirements, it is not treated as a life insurance or annuity contract — resulting in taxation of the "inside build-up" on the contract to the holder — for any period during which the investments made by the accounts are not adequately diversified. Although considerably more complicated, a contract will be deemed to be adequately diversified if it invests in at least five different "investments" that are not available other than through the purchase of a life insurance or annuity contract in the stipulated percentages.[3]

[3]§816(d); Reg. §1.817-5(b).

The "Investor Control" Doctrine

The "investor control" doctrine predates the 1984 enactment of the diversification rules under §817. It was developed, beginning in 1977,[4] in a series of revenue rulings issued in response to the marketing of variable life insurance and annuity products that allowed the contract owner to retain too much control over the investment assets underlying the contract to be consistent with the insurer's ownership of the contract. While some considered that the 1984 legislation replaced the investor control doctrine with the relatively bright-line diversification rules codified in §817, it was clear that the Internal Revenue Service believed that the doctrine still retained its validity.[5]

[4]*See, e.g.,* Rev. Rul. 77-85, 1977-1 C.B. 12, Rev. Rul. 80-274, 1980-2 C.B. 27, Rev. Rul. 81-225, 1981-2 C.B. 1, Rev. Rul. 82-84, 1982-1 C.B. 11. Rev. Rul. 81-225 was modified, with respect to certain retirement plan accounts, by Rev. Proc. 99-44, 1999-2 C.B. 598, which clearly re-stated the IRS's position that "[s]atisfying the diversification requirements … does not prevent a contract holder's control of the investments of a segregated asset account from causing the contract holder, rather than the insurance company, to be treated as the owner of the assets in the account." *See also* *Christoffersen v. United States* , 749 F.2d. 513 (8th Cir.1984), *rev'g*578 F. Supp. 398 (N.D. Iowa1984).

More recently, the IRS issued Rev. Rul. 2003-91, 2003-2 C.B. 347, and Rev. Rul. 2003-92, 2003-2 C.B. 350, dealing with the diversification rules — and, to some extent, the investor control doctrine — in the context of non-registered partnerships (or hedge funds). Rev. Rul. 2003-92, *clarifying and amplifying* Rev. Rul. 81-225.

[5] Final regulations concerning diversification standards were issued in 1989. T.D. *8242*, 1989-1 C.B. 215. Following their issuance, the IRS continued to issue both public and private rulings invoking the "investor control" doctrine to determine ownership of assets in segregated asset accounts. *See, e.g.,*Rev. Rul. 2003-91, Rev. Rul. 2003-92; PLR 201105012, PLR 200420017, PLR 9433030. *See also*CCA 200840043. In PLR 9433030, the IRS explained: "[T]he final regulations do not provide guidance concerning the extent to which policyholders may direct the investments of a segregated asset account without being treated as the owners of the underlying assets."

Facts

Jeffrey T. Webber ("Taxpayer") was a venture-capital investor and private-equity fund manager, who established a grantor trust that purchased "private placement" variable life insurance policies[6] insuring the lives of two elderly relatives from a Cayman Islands insurance company (hereinafter sometimes "Lighthouse"). Taxpayer and various family members were the beneficiaries of these policies. The grantor trust moved from Alaska to the Bahamas to Delaware during the period at issue.

[6] Private placement life insurance policies are marketed chiefly to high-net-worth individuals who qualify as accredited investors under the Securities Act of 1933. *See*15 U.S.C. §77b(a)(15); 17 C.F.R. §230.501(a).

The premium paid for each policy was placed in a separate account underlying the policy. The assets in these separate accounts, and all income earned thereon, were segregated from the general assets and reserves of the insurer pursuant to Cayman Islands' law, and inured exclusively to the benefit of the two insurance policies.

The money in the separate accounts was used to purchase investments in startup companies with which Taxpayer was intimately familiar and in which he invested personally and through funds he managed. Taxpayer effectively dictated both the companies in which the separate accounts would invest and all actions taken with respect to these investments. "Taxpayer expected the assets in the separate accounts to appreciate substantially, and they did."

According to the Tax Court, Taxpayer's objectives were to avoid income tax on the income and capital gains realized by the investments in the account, and, upon the deaths of the insureds, to avoid all income and estate taxation.

Lighthouse permitted the policyholder to select an investment manager from a Lighthouse-approved list. The Court noted that:

As drafted, the Policies state that no one but the Investment Manager may direct investments and deny the policyholder any "right to require Lighthouse to acquire a particular investment" for a separate account. Under the Policies, the policyholder was allowed to transmit "general investment objectives and guidelines" to the Investment Manager, who was supposed to build a portfolio within those parameters. The Trusts specified that 100% of the assets in the separate accounts could consist of "high risk" investments, including private-equity and venture-capital assets. Lighthouse was required to perform "know your client" due diligence, designed to avoid violation of antiterrorism and money-laundering laws, and was supposed …. to ensure that the Separate Account investments [were managed] in compliance with the diversification requirements of Code Section 817(h)."

On the advice of his attorney, Taxpayer never communicated — by e-mail, telephone, or otherwise — directly with Lighthouse or the Investment Manager. Instead, he relayed all of his directives, invariably styled "recommendations," through his legal advisors in a series of over 70,000 e-mails to them. For the most part these e-mails "recommended" investments in start-up companies in which Taxpayer was also invested or which he controlled:

The Investment Manager did no independent research about these fledgling companies; it never finalized an investment until [the attorney] had signed off; and it performed no due diligence apart from boilerplate requests for organizational documents and "know your customer" review. The Investment Manager did not initiate or consider any equity investment for the separate accounts other than the investments that [Taxpayer] 'recommended.' The Investment Manager was paid $500 annually for its services, and its compensation was commensurate with its efforts.

Opinion

On these facts, the Tax Court found that Taxpayer's life insurance arrangement violated the "investor control" doctrine, in that Taxpayer, as opposed to the insurer, had sufficient "incidents of ownership" over the policies in the separate account to make him the "owner" of the assets underlying the policies for tax purposes:

The critical "incident of ownership" that emerges from these [IRS's above-cited] rulings is the power to decide what specific investments will be held in the account… [as well as] the powers to vote securities in the separate account; to exercise other rights or options relative to these investments; to extract money from the account by withdrawal or otherwise; and to derive, in other ways, what the Supreme Court has termed "effective benefit" from the underlying assets. [Citation omitted.]

In summary, the IRS's rulings enunciating the investor control doctrine consistently over a period of nearly 40 years deserve deference,[7] and were not supplanted by the diversification rules under §817(h). The final regulations issued under §817 "do not provide guidance concerning the extent to which policyholders may direct the investments of a segregated asset account without being treated as the owners of the underlying assets."[8]

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[7] *See* *Skidmore v. Swift & Co.* , 323 U.S. 134 , 140 (1944).

[8] The Tax Court also rejected Taxpayer's alternative arguments, including arguments based on the doctrine of "constructive receipt" and §7702(g), which sets forth specific circumstances when a policyholder will be deemed to be taxable on the income and gains underlying a policy.

The Tax Court refused to impose accuracy-related penalties under §6662, however, finding that Taxpayer reasonably relied on the (orally-delivered) advice of professional tax counsel. The Court also noted that "the outer limits of the [investor control] doctrine were not definitively marked when Mr. Lipkind [the attorney] rendered his advice in 1998."

The Webber case should (assuming that it is upheld on any appeal) put an end to the argument that the diversification rules and associated regulations were meant to supplant the much older investor control doctrine. It also should be an object lesson in how not to leave an evidentiary trail (over 70,000 e-mails!) indicating that one has in fact exercised such control over the investment of the assets in a separate account.