The Trials and Tribulations of the Family Office

Get ready to deal with the trappings of wealth and leveraging the next generation's tax exemptions

By Brenda Jackson-Cooper and Linda Kotis

If you're a veteran family office adviser, you've spent decades working with the family's estate-planning counsel to ensure that wealth is passed to succeeding generations as tax efficiently as possible. You faithfully oversee the implementation of annual exclusion gifts, intrafamily loans, and rolling grantor-retained annuity trust (GRAT) programs, and you are well-versed in the benefits of lifetime gifts and leveraged sales to grantor trusts. Due to your efforts and those of the estate-planning team, each member of the senior generation (G1) has taken full advantage of his applicable exclusion amount and generation-skipping transfer (GST) tax exemption.

That's the good news.

The Challenge

The challenge is that G1's remaining assets will be subject to federal (and possibly state) estate tax when they pass to the next generation (G2) at his death (or at the death of his spouse, if a surviving spouse has an intervening life interest). A G1 estate worth $100 million will pay a federal estate tax bill of approximately $40 million (plus state estate tax, if applicable) within nine months of G1's death. Absent the incorporation of charitable giving into G1's testamentary plan (and ignoring for present purposes the benefits that could have been achieved by making additional tax-exclusive lifetime gifts), the $40 million tax bill is unavoidable.

To make matters worse, the assets passing to G2 will be unshielded by GST exemption, i.e., the assets will be GST nonexempt. Absent further planning, when the GST nonexempt assets held in trust for G2[1] later pass to G2's children (G3), there will be a "taxable termination" for GST purposes. The taxable termination will trigger a GST tax equal to forty percent of the value of the GST nonexempt assets. The GST tax on taxable terminations is designed to be a proxy for the estate tax that would have been owed by G2's estate had the assets been owned directly by G2 rather than held in trust for G2's benefit. In other words, the GST tax is designed to ensure that wealth is subject to transfer tax at every generation.

But suppose G2 does not have a taxable estate large enough to use his applicable exclusion amount and GST tax exemption (both of which are indexed for inflation going forward and will be $5,450,000 in 2016). Ideally, G2 would be able to cause trust assets with a value equal to his applicable exclusion amount to be included in his own taxable estate. This would make him the transferor of the assets for GST purposes[2] and therefore allow him to allocate his own GST tax exemption to the trust assets. An allocation of $5,450,000 worth of GST tax exemption not only would reduce the GST tax due at G2's death by $2,180,000 ($5,450,000 x .40) but also would shield the trust assets from further estate and GST taxes as they pass through the generations.

The Solution

A technique known as "springing the Delaware Tax Trap" would allow a G2 beneficiary to use his applicable exclusion amount and GST tax exemption and provides practical guidance for ensuring that G1's estate plan is structured to make the technique available to G2 and more remote generations.

The Delaware Tax Trap is a term estate planners use to refer to Code section 2041(a)(3) (an estate tax provision) and Code section 2514(d) (the parallel gift tax provision). The phrase "springing the Delaware Tax Trap" means triggering either of these sections. The enactment of both provisions was a response to a specific feature of Delaware law that could be used to circumvent the imposition of transfer tax at every generation.

The beneficiary of a trust springs the Tax Trap under section 2041(a)(3) and thereby causes trust assets to be included in his estate for tax purposes when the following factors are present:

1. The terms of the trust confer upon the beneficiary a testamentary limited power of appointment (LPOA). A testamentary LPOA is a power, subject to limitations, that allows the beneficiary to direct how trust assets will be distributed at his death. An LPOA is a common feature generally used to give current beneficiaries some control and to allow for additions to the permissible class of beneficiaries. An LPOA in and of itself has no tax consequences.
2. The beneficiary exercises his testamentary LPOA in writing (either in his last will and testament or a separate instrument).
3. The way in which the beneficiary exercises the LPOA results in the appointee (i.e., the individual in favor of whom the beneficiary exercises the power) having his own power of appointment.
4. The terms of the appointee's power of appointment do not preclude the appointee from exercising his power in a way that extends the perpetuities period applicable to the trust assets, i.e., that postpones the date on which the trust property vests in possession.

The beneficiary of a trust springs the Tax Trap under section 2514(d) and thereby makes a taxable gift of trust assets when all of the factors described above are present, except that the beneficiary holds an *inter vivos* (lifetime) LPOA rather than a testamentary LPOA. An *inter vivos* LPOA is a power, subject to limitations, to direct how trust assets will be distributed during the beneficiary's lifetime. Naturally, the document whereby the beneficiary exercises the power is a written instrument of appointment rather than his last will and testament.

The Availability of the Tax Trap

It is critical that the estate planning team carefully analyze whether springing the Tax Trap is a possibility under the law that governs the trust. A full discussion of the state law variations on the common law Rule Against Perpetuities is beyond the scope of this article, but the laws of states that have abolished the commonlaw Rule Against Perpetuities may not allow for springing the Tax Trap.[3]

Once the estate planning team has confirmed that the law that will govern the continuing trusts created by G1 will allow for springing the Tax Trap, it must ensure that G1's last will and testament, revocable trust or irrevocable *inter vivos* GST nonexempt trust (governing instrument) is drafted appropriately.

Naturally, the governing instrument must confer an *inter vivos* and/or testamentary LPOA on the beneficiary of each continuing trust.[4] The following is an example of such a provision:

> *Upon reaching forty (40) years of age, each Beneficiary shall have the power to appoint during his or her lifetime all or any part of the principal of the GST Nonexempt Trust held for his or her benefit (but not the GST Exempt Trust (if any) held for his or her benefit) to and among one or more of Trustor's descendants (other than the Beneficiary, his or her estate, his or her creditors, and creditors of his or her estate), in trust or otherwise, in any proportion and manner, upon such terms and conditions, and without regard to equality and to the exclusion of any, as the Beneficiary may appoint by a signed writing that is acknowledged before a notary public specifically referring to this power of appointment.*

Although not strictly necessary, it would make sense to include language expressly authorizing the beneficiary to spring the Tax Trap:

The Beneficiary may exercise the lifetime limited power of appointment over the GST Nonexempt Trust conferred on him or her in a manner that confers upon one or more of the permissible objects of such limited power of appointment a second power of appointment that has the effect of starting a new rule against perpetuities or similar rule that limits the period during which property may remain in trust. Trustor cautions the Beneficiary to carefully consider the consequences under Code Section 2514(d) of exercising the lifetime limited power of appointment so as to start a new perpetuities period and envisions that he or she will do so only to the extent that such exercise will reduce the overall impact of estate, gift, and GST taxes on the trust property.

In addition, any perpetuities savings clause in the governing instrument should be crafted so that it does not prohibit a beneficiary from springing the Tax Trap if he affirmatively chooses to do so. The following is an example of how such language might be drafted:

Each trust created under this Agreement shall terminate, unless sooner terminated under the terms of this Agreement, thirty (30) days before the end of the period provided under the applicable Rule Against Perpetuities. The foregoing provision also shall apply to a trust created by the exercise of a power of appointment conferred by this Agreement unless the exercise expressly begins a new Rule Against Perpetuities or similar rule that limits the time that property may remain in trust.

Practical Examples

The examples that follow demonstrate the potential benefit of triggering the Tax Trap during a beneficiary's lifetime or at the beneficiary's death.

For both examples, assume that G1 used all of his applicable exclusion amount and GST tax exemption during his lifetime to benefit his two daughters and their families. Given the financial resources available to them, G1's daughters felt comfortable pursuing careers that are intellectually and emotionally rewarding, but not particularly remunerative. As a result, neither of the daughters has a net worth of more than $2 million. Each daughter currently is married, and each daughter has two children of her own.

At G1's death, his after-tax estate of $90 million was divided evenly between two GST nonexempt trusts—one for each daughter and her family. The daughter for whom the trust is established receives all of the trust's net income. In addition, the trustee, which is a trust company, may distribute principal to the daughter if, in the trustee's view, she needs it to maintain her lifestyle, taking into account other financial resources available to her.

Following the settlement of their father's estate, the daughters come to you for some preliminary advice about the sort of estate-planning strategies they should consider. You mention the potential benefits of the Tax Trap and suggest that they consult with the family's estate-planning counsel. Counsel confirms that the governing instrument was structured with an eye toward allowing the daughters to spring the Tax Trap and that nothing in the governing instrument or applicable law precludes them from pursuing the strategy.

EXAMPLE 1

The elder daughter, who is sixty years old, lives in Manhattan and currently has a net worth of $2 million. She has long received income distributions from a GST exempt trust her father established during his lifetime, and now she receives income distributions from her $45 million GST nonexempt trust. She would like to take steps to preserve the family wealth, but living in Manhattan is expensive, and she is not comfortable with the reduction in income that would result from exercising her *inter vivos* LPOA in favor of her children. The family's estate planner encourages her to take state estate taxes into consideration and points out that exercising the *inter vivos* LPOA to make a gift rather than exercising the testamentary LPOA to cause estate inclusion likely will have a better New York estate-tax result. She ultimately decides not to make gifts but sees the wisdom in springing the Tax Trap under section 2041(a)(3). She amends her last will and testament accordingly. (The use of formula clauses is a discussion beyond the scope of this article, but the estate planner certainly would consider the use of a formula clause to prevent over-inclusion of assets in the taxable estate, especially where state estate tax is a relevant consideration.)

When the daughter dies fifteen years later, her net worth is $3 million. The applicable exclusion amount and the GST tax exemption are $7 million apiece. But for the inclusion of the trust assets in the daughter's taxable estate under section 2041(a)(3), $4 million of her applicable exclusion amount and GST tax exemption would have been wasted. Assuming a GST tax rate of forty percent on taxable terminations, the immediate tax savings are $1.6 million, which means that each of her children receives (in trust) $800,000 more than they otherwise would have received. The fact that the entire $7 million worth of assets will be insulated from further estate or GST taxes (as a result of the daughter's allocation of her own GST exemption) will provide substantial deferred tax savings. (It should, however, be noted, that springing the testamentary LPOA increases the New York estate tax burden.)

EXAMPLE 2

The younger daughter, who is fifty-five years old, lives in a rural area not far from Seattle and currently has a net worth of $1.5 million. She is aware of Washington's high state estate-tax rates and also understands the potential benefit of removing appreciating assets from her taxable estate. Moreover, her husband has few assets of his own and therefore very likely will not have an estate large enough to use his applicable exclusion amount and GST tax exemption. The couple has a very inexpensive lifestyle and consumes only a small fraction of the income distributions received from trusts for the daughter's benefit.

The family's estate planner recommends that the daughter exercise her *inter vivos* LPOA so as to spring the Tax Trap to the extent of $8 million and that her husband consent to split the gift[5] so that each of them uses $4 million of applicable exclusion amount and $4 million of GST tax exemption. The exercise immediately removes $8 million from the Washington state estate-tax base, and because Washington has no gift tax, the $8 million passes completely free of state-level transfer taxes. In addition, any future appreciation in the trust assets that were gifted will not be a part of the daughter's taxable estate. Perhaps most important, there is a $3.2 million reduction in the GST tax on taxable terminations and deferred tax savings that will result from the allocation of the couple's GST tax exemptions to the gifted assets.

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Endnotes

1. This article proceeds on the assumption that G1's estate plan passes wealth to succeeding generations in further trust, not outright, and that the continuing trust created for a beneficiary does not confer a general power of appointment (GPOA) on him, thereby causing inclusion of the trust assets in his taxable estate. Structuring continuing trusts as GPOA trusts is optimal under some circumstances, but in many cases, other considerations (e.g., asset protection, state estate taxes, and the desire to keep family business interests in trust) counsel against GPOA trusts.
2. Code Section 2652(a).
3. *See* A.R.S. § 14-2901, Del. Code Ann. Tit. 25, § 503, R.I. Gen. Laws §34-11-38, and Va. Code Ann. § 55-13.3, cited by Greer, *The Delaware Tax Trap*, ESTATE PLANNING JOURNAL, February 2001. *See* Les Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets,* ESTATE PLANNING JOURNAL, February 2014, for a discussion of state law and the implications for the Delaware Tax Trap.
4. For maximum flexibility, it often makes sense to include both types of LPOAs in the governing instrument.
5. Code Section 2513.