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In the April issue...

BY JENNIFER L. BUNKER

In this month's newsletter, Robert J. Kolasa provides a detailed analysis of achieving stepped-up basis for credit shelter trusts using PEG Powers and provides example Trust language. Additionally, James M. Lestikow discusses the meaning of "reasonable" trustee's fees.

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Stepped-up basis for credit shelter trusts using PEG powers under Illinois law

BY ROBERT J. KOLASA

Taking into account the 2016 stratospheric estate tax exclusions ($5.45 million for federal purposes; $4 million for Illinois), estate taxes have effectively been repealed for many Illinois residents whose assets do not approach these limits. Yet, credit shelter trusts ("CSTs") are routinely established (or were established in the past, when estate exclusions were much lower) for this same client group. This becomes dangerously counterproductive from an income tax viewpoint for surviving spouses not subject to estate taxes. CST assets generally do not receive stepped-up basis upon the survivor's death, while the same assets owned directly by the surviving spouse do attain stepped-up basis.[1]

Thankfully, there is a credible solution to the above problem if the CST grants the surviving spouse a testamentary special power of appointment. This article discusses how the survivor may in some

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Stepped-up basis for credit shelter trusts using PEG powers

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scenarios exercise such power to create a new (i.e., appointive) trust for remainder CST beneficiaries (typically the children). If the appointive trust grants the children certain “PEG Powers” (defined below), the appointment should generate favorable basis step-up for CST assets upon the survivor’s death.

The Delaware Tax Trap

The technique we are examining to achieve CST basis step-up is §2041(a)(3)[2] of the Internal Revenue Code (“I.R.C.”), commonly known as the “Delaware Tax Trap” (referred to herein as the “Trap”).

I.R.C. §2041(a)(3) includes in the gross estate the value of all property:

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

A full understanding of the above statute can be extremely complex as it is intertwined with the common law rule against perpetuities,[3] as modified by state law.[4] Congress enacted the Trap as an anti-abuse rule (it is now a planning opportunity), attacking a change to Delaware’s former perpetuities law which is discussed below.

The Trap deals with the distinction between general and special powers of appointments, so it is vital to understand these terms. A general power of appointment (“GPA”) is defined under I.R.C. §2041(b)(1) as a power of appointment which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. A special power of appointment (“SPA”), sometimes labeled a “limited “ or “nongeneral” power, is one which is not a GPA and permits appointment to a designated class other than the decedent, his estate, his creditors, or the creditors of his estate. The value of property subject to a GPA is included in the decedent’s gross estate under I.R.C. §2041(a)(2), whereas no estate tax inclusion is generally associated with the decedent’s retention of SPAs.

Illinois courts have adopted the classical definition of the common law rule against perpetuities which generally provides that “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.”[5] A corollary is that where an appointment is made under a SPA or testamentary GPA, under the “relation back” doctrine the perpetuities period is measured from the date the original power was created and not when it was exercised (as if the powerholder were “filling in blanks” in the donor’s instrument).[6] An example best illustrates these rules.

Assume that upon his death in 1990, D establishes a trust for the benefit of his son (S) for life, remainder to S’ descendants, with S having a testamentary SPA over trust assets. S exercises the SPA upon his death in 2010, creating an appointive trust for the life of his child (G) (unborn at D’s death), remainder to G’s descendants, with G having a successive testamentary SPA over trust assets. G then dies in 2030 and

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exercises the power in the same way for G's descendants and so on ad infinitum.

To determine if the appointed interests are valid, the perpetuities testing period relates back to D's death in 1990. Thus, it is construed as if D had died and left the trust property to S for life, then to G for life, then to G's descendants for life, etc.[7] The SPA held by S and the appointive trust for G passes the perpetuities test as it vests within 21 years of the death of S, a person living in 1990. However, the successive SPA held by G[8] and the appointive trusts for G's descendants and future generations will fail, because such interests may not vest within 21 years of any person living in 1990.

Delaware's former perpetuities statute, as originally enacted in 1933, ingeniously reversed the above common law rule by providing that the validity of successive powers are determined by reckoning the period of perpetuities from the date the power is exercised, rather than from the date the original power was created.[9] This means a new perpetuity period based on each SPA exercise (2010, 2030 and later periods for each exercise in our example). Thus, the perpetuities rule is never violated as there is always a current life in being upon exercise, with the resulting appointive trusts never vesting in any generation. From the IRS' perspective at the time, this was abusive as property after the death of the original grantor could be tied up in trust *forever* without estate taxes.[10]

In 1951, Congress countered the above planning by enacting the Trap, which applies to multiple powers of appointment (i.e., the original "first" power and successive "second" power). Under its annoyingly obtuse language, the Trap exacts the penalty of estate or gift tax if the perpetuity testing period for the successive "second" power of appointment does not relate back to the date of creation of the original "first" power. In testing powers of appointment under the former Delaware perpetuities law, one looked at the date of subsequent SPA exercises without taking into account the creation of the first power (1990 in our example). If such law applied, the Trap would trigger estate taxes on trust property for every SPA exercise creating a successive power, because the perpetuity testing period for the successive (second) powers would not match the 1990 creation date of the original (first) power.

The only reported case on the Trap is Murphy v. Comm'r, 71 T.C. 671 (1979), *acq.* AOD 1979-87. In that case, the decedent held a testamentary SPA (first power) over trust assets, which she exercised to create an appointive trust for the benefit her husband. The husband was also granted a testamentary SPA (second power) over the appointive trust. The IRS contended that the Trap was triggered at the decedent's death by her exercise of the first SPA, which created a successive second SPA which (arguably) could be exercised outside the perpetuities period. Note that the requirement of the Trap did not require the husband to actually exercise his second power (it is enough that the power *could* be exercised in the prohibited fashion). The Tax Court ruled against the IRS based on the Wisconsin statute, which measured the perpetuities period from the time the first power was created.[11]

Using PEG Powers to "Trip the Trap"

The term "PEG Powers" is an acronym for a GPA which is "presently exercisable" without restrictions.[12] Under the law of most states (including Illinois), the validity of PEG Powers created by testamentary SPAs are determined by reckoning the perpetuities period from the date the power granting the PEG power is exercised (i.e., the death of the SPA powerholder), not when the original SPA was created.[13] The theory is that since the donee of a PEG Power can appoint to himself, the donee in substance is the owner of the property and appointments should be treated as the disposition of owned property.[14]

In the typical planning scenario, the surviving spouse as beneficiary of a CST would exercise a testamentary SPA to create a new appointive trust over which the CST remainder beneficiaries (typically the children) are granted PEG Powers, enabling the appointment of trust assets to themselves, creditors or descendants as the children deem appropriate. The Trap is triggered because of the mismatch between the perpetuities testing periods for the testamentary SPA (date of creation of the SPA, which is the original first power), and the PEG Power (date of creation of the PEG Power, which is the successive second power).

Beware that planning with PEG Powers can backfire and generate estate taxes if trust assets exceed the surviving spouse's available estate tax exclusions (because the Trap effectively converts the SPA to a GPA, thereby triggering estate tax inclusion in the surviving spouse's estate).

In selecting property subject to PEG Powers, efficient tax planning dictates that highly appreciated assets are the ideal candidates, as they benefit the most from basis step-up (versus non-appreciated, loss and IRD assets). While PEG Powers may be granted over specific appreciated assets, problems relate to whether such assets will still be owned by the CST at the survivor's death, or whether their values may generate estate taxes due to inclusion in the spouse's estate.

Formula PEG Powers would seem to be the best shot to achieve income tax optimization by guaranteeing that the basis increase results in the most income tax savings without estate taxes. Such drafting formulas are readily available (see Exhibit A for an example),[15] and typically are part of a two-pronged formula allocation: (1) a "capping" rule, limiting the amount of the appointive assets so that no estate taxes are incurred in the survivor's estate; and (2) an "ordering rule," limiting the appointive assets to those with the greatest appreciation.[16] Numerous IRS private letter rulings have blessed formula-based GPAs in analogous contexts.[17]

In drafting CSTs, consider giving the spouse a testamentary SPA to have the planning option of springing the Trap (and achieving step-up basis) through appointive trusts granting PEG Powers to trust remaindermen. For CSTs without powers of appointments, practitioners should examine whether SPAs can be added under Illinois law,[18] or consider moving the trust situs to a new jurisdiction which supports the addition of such powers. The boilerplate provisions of the trust document should also be examined to make sure that unintended "anti-Trap" saving clauses do

not prevent the Trap from being sprung in the first place. Surprisingly, CSTs established through disclaimer planning may be able to adopt this strategy if the disclaiming spouse retains a testamentary SPA for the narrow purpose of creating PEG Powers.[19]

In some instances, it may not be worthwhile to engage in planning with PEG Powers because of other considerations. Granting youthful or spendthrift beneficiaries PEG Powers may not be the wisest course given the possibility of the appointive assets being diminished by bad behavior, or subject to creditor attacks.[20] Additionally, assets subject to PEG Powers are included in the beneficiary's estate, which may not be estate tax efficient if the beneficiary already has sufficient assets meriting estate tax planning, or if the CST is part of a dynasty trust which opted out of the rule against perpetuities for multi-generational planning.[21] Although the recommended planning is acceptable in most jurisdictions, prudence dictates that the mobile client in a new state check out the vagaries of local law to ensure that this strategy still works.

Using the Trap as a sword to achieve basis step-up in CSTs should be viewed as a moderately safe estate planning technique.[22] Without IRS objections, practitioners for many years have utilized the Trap for generation skipping transfer tax scenarios to grant the beneficiary of the non-exempt generation-skipping trust a general power of appointment (effectively allowing the beneficiary to choose between generation-skipping transfer tax and estate taxes at death).[23]

Paying Illinois Estate Taxes for CST Basis Step-up?

For federal estate tax purposes, CST basis planning with PEG Powers is generally limited by the surviving spouse's available inflation-indexed ($5.45 million) federal exclusion, which may be doubled through estate tax portability. Any unused federal exclusion effectively acts as a "free basis" coupon for appreciated CST assets. However, for Illinois residents, taxpayers must take into account the $4 million Illinois exclusion as a limiting factor in exercising PEG Powers.

For Illinoisans, planning with PEG Powers is always productive when the surviving spouse's assets (plus includible CST assets) are less than $4 million, since income tax gain is avoided on CST assets without estate taxes. When the Illinois taxable estate (plus adjusted taxable gifts) exceed $4 million, the incremental Illinois estate taxes caused by including CST assets in the spouse's estate need to be compared with the income tax savings of the stepped-up basis for such assets.

The accompanying table shows multiple scenarios for a $2 million CST with $1 of appreciation, paired with a surviving spouse having assets ranging from $2 to $6 million. An important assumption is that the surviving spouse has sufficient federal estate tax exclusion (supplemented through estate tax portability) to avoid federal estate taxes. The table shows varying combined federal and Illinois income tax rates from 20.25% to 48.65%.

Under the table, for a surviving spouse with $6 million of assets, the incremental Illinois estate tax for including an additional $2 million of CST assets in his or her estate is $224,563. Likewise, the income tax savings due to the stepped-up basis on such assets range from $202,500 to $486,500, depending on the income tax rate. Incurring Illinois estate taxes seems to be beneficial in all cases, except for the first 20.25% tax bracket (i.e., the $240,500 to $486,500 of avoidable income taxes are less than the $224,563 Illinois estate tax). This analysis contemplates an eventual sale of CST assets by the trust and ignores possible distribution of assets to beneficiaries who may be taxable in lower brackets.

For CST assets sold at capital gain tax rates (unless capital gains are taxable to trust beneficiaries),[24] the applicable trust income tax rate should be 29.05%.[25] Such rate bracket may make the exercise of PEG Powers and the payment of incremental Illinois estate taxes (to achieve stepped-up basis) attractive in some scenarios presuming the spouse can avoid federal

PAYING ILLINOIS ESTATE TAXES TO SAVE INCOME TAXES?

A. PEG Powers Exercise to Increase Basis of CST Assets

(IL Estate taxes, with no income taxes on $1M CST gain)

Spouse's Assets	$2,000,000	$3,000,000	$4,000,000	$6,000,000	$8,000,000
CST Assets ($1M Gain)	$2,000,000	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Taxable Estate	$4,000,000	$5,000,000	$6,000,000	$8,000,000	$10,000,000
Federal Estate Taxes*	$0	$0	$0	$0	$0
IL Estate Taxes	$0	$285,714	$456,071	$680,634	$926,923
Incremental IL Estate Taxes due to PEG Powers	**$0**	**$285,714**	**$456,071**	$224,563[26]	**$246,289**

* No federal estate taxes due to estate tax portability.

B. No PEG Powers Exercise

(No IL Estate taxes, with income taxes on CST $1M gain)

	15% Capital Gains Rate		*20% Capital Gains Rate*		*Top Rate*
Federal Rate	15%	15%	20%	20%	39.60%
Illinois Rate[27]	5.25%	5.25%	5.25%	5.25%	5.25%
3.8% Medicare surtax	N/A	3.8%	N/A	3.8%	3.8%
Total Rate	20.25%	24.05%	25.25%	29.05%**	48.65%
Income Taxes on $1M CST gain	**$202,500**	**$240,500**	**$252,500**	**$290,500**	**$486,500**

**Assumed income tax rate for CST selling appreciated assets.

estate taxes. This technique becomes more viable if the CST gains are taxable as ordinary income or otherwise subject to higher income tax rates (such as real estate subject to depreciation recapture), or the assumed CST appreciation becomes greater. While not applicable in all cases, nothing substitutes for "crunching the numbers" to determine if this planning can be productive.

Conclusion

Due to the heightened estate tax exclusions, many CSTs do not save estate taxes and generate additional income taxes because of the loss of stepped-up basis at the surviving spouse's death. One solution to this problem is for the surviving spouse to exercise a formula testamentary special power of appointment granting PEG Powers to trust beneficiaries over appointive trust assets. Under Illinois law, such exercise generally triggers the arcane provisions of the Delaware Tax Trap, resulting in stepped-up basis and eliminating the income tax gain on appreciated CST assets. In some cases, it may be productive to utilize this technique and pay Illinois estate taxes to avoid the higher income taxes on trust assets. ■

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1. CST assets generally get stepped-up basis at the death of the first spouse to die, but not upon the survivor's death. The same assets received outright by a surviving spouse achieves a "double" step-up at both the first to die, and the survivor's death. I.R.C. §1014(a).

2. The Trap also can be sprung to generate taxable gifts through the lifetime exercise of prohibited powers under I.R.C. §2514(d). For income tax purposes a lifetime violation of the Trap is less beneficial than a testamentary violation, because in the former case there is no stepped-up basis of appointed assets (other than for gift taxes added to basis under I.R.C. §1015(d)). However, for generation skipping transfer tax ("GST") purposes the exercising powerholder springing the Trap becomes the new transferor for gift and GST purposes, thereby permitting the beneficial allocation of the new transferor's unused GST exemption to the trust.

3. An excellent source explaining the common law rule against perpetuities is Professor Leach's recitation in Leach, *Perpetuities in a Nutshell*, 51 Harv. L. Rev. 638 (1938). A more recent exposition reviewing the common law rule and various legislative changes (including an analysis of the Trap and GST concerns) can be found in Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 Alb. L. Rev. 261 (Winter 1981).

4. In 1969, Illinois modified the common law rule against perpetuities. See 765 ILCS 305/1 et. seq. A good explanation of the statute is found in Piwowarczyk, *Illinois v. The Rule Against Perpetuities*, 3 The John Marshall J. of Prac. and Proc. 386 (1971).

5. *Quinlan v. Wickman*, 233 Ill. 39, 84 N.E. 38 (1908). The Illinois rule deals with the voiding of future interests which do not vest within the applicable perpetuities period. Alternately, some states (such as Wisconsin; see *Murphy v. Comm'r*, *supra*) have enacted statutes voiding future interests if the power of alienation (i.e., power of sale) is suspended longer than the permissible perpetuities period. Although this "anti-alienation rule" is distinct from the traditional rule against perpetuities dealing with vesting, the IRS (see Treas. Reg. §20.2041-3(e)(1)(ii)) labels these different regimens as alternative versions of the rule against perpetuities. An Illinois qualified perpetual trust ("QPT") "electing out" of the rule against perpetuities is often said to have adopted an anti-alienation rule because of the requirement of 765 ILCS 305/3(a-5)(ii), that such trusts not restrict the trustee from selling property beyond the perpetuities period. While extremely technical, this argument is made to create a perpetuities "period" so the Trap is not always triggered upon the creation of the second power (*supra* note 21 and Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68, 73-74 (February 2001)). However, the rule against perpetuities (whether defined by vesting or alienability) traditionally voids nonqualifying interests, while the consequence of an Illinois trust not adopting a power of sale is that such trust is not eligible to constitute a QPT. Without the voiding of disqualifying interests, it is hard to see how the Illinois statute constitutes an anti-alienation rule in the first place.

6. Leach, *supra* note 3, at 653; 3rd Rest. Prop §27.1, Comments d(1), j & j(1), §19.19 Comment g, §17.4, Comments f(1) & f(2); UPC §2-902, Comment a; Illinois cases in accord are *Northern Trust Co. v. Porter,* 368 Ill. 256, 13 N.E. 2d 487 (1938) and *Breault v. Feigenholtz*, 250 F. Supp. 551 (N.D. Ill., 1965). See also Margolin and Weinstein, *Dynasty Trusts and the Rule Against Perpetuities*, 87 Ill. B.J. #3 (March 1999), footnotes 18 and 19 for other authorities supporting this point.

7. Under the so called "second-look doctrine," facts and circumstances existing at the time the appointment is made are taken into account in determining the validity of the appointment. See Leach, *supra* note 3, at 654; *Northern Trust Co. v. Porter, supra* note 6 at 491 and *Breault v. Feigenholtz, supra* note 6, at 557.

8. A power of appointment given to an unborn person is invalid unless the time of exercise is specifically restricted to the perpetuities period. Leach, *supra* note 3, at 652.

9. See Bloom, *supra* note 3, and Greer, *supra* note 5, for a thorough analysis of the prior Delaware statute and how the Trap was crafted by the government in response.

10. IRS concerns regarding the abuses of perpetual trusts were somewhat mitigated by the enactment of the generation-skipping transfer tax in 1976. Also, Illinois (765 ILCS 305/3-4) and many other states have since adopted "dynasty trust" statutes permitting trusts to last in perpetuity, or for a very long stated period. See the ACTEC study prepared by Howard Zaritsky entitled "The Rule Against Perpetuities: A Survey of State (and D.C.) Law" at <http://www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf> for an exhaustive analysis of the differing laws (through March 2012) relating to the rule against perpetuities and the Trap.

11. The Wisconsin's rule against perpetuities is based on an "anti-alienation rule" (*supra* note 5), which if not violated allows the creation of perpetual trusts. The IRS in its AOD accepting the Tax Court's decision reasoned that since the trustee was given the power to sell trust assets, I.R.C. §2041(a)(3) could not apply as there was no suspension of the power of alienation. This argument seems equally applicable to Illinois QPTs.

12. A power of appointment is not "presently exercisable" when not exercisable until the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified period of time. 3rd Rest. Prop §17.4.

13. The "relation back" doctrine is generally not followed for a successive "second" PEG Power, with perpetuities testing measured from the date the original "first" power is exercised to create the PEG Power (not the creation of the first power). See Leach, *supra* note 3, at 654; citations to 3rd Rest. Prop. & UPC, *supra* note 6; Bogert, *Trusts and Trustees* (2nd ed.), §213, p 206-207; Blattmachr, *Adventures in Generation Skipping, or How We Learned to Love the "Delaware Tax Trap,"* 24 Real Prop. Prob. & Tr. & Est. L.J., 75, 83-84 (1989-1990), Zaritsky, *supra* note 10, at 9; Northern Trust Co. v. Porter, *supra* note 6, at 490, discussing this point for appointments by "deed" (a PEG Power).

14. Leach, *supra* note 3, at 654; Northern Trust Co. v. Porter, *supra* note 6 at 490; 3rd Rest. Prop §27.1, Comment d (1).

15. Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)*, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436964; Akers, *Estate Planning: Current Developments and Hot Topics, Appendix C* (December 2014), at <http://files.shareholder.com/downloads/BESS/0x0x794539/99079655-B378-4934-B653-336E1E04DCD6/Hot_Topics_Current_Developments.pdf>.

16. Given the difference in income tax rates, in springing the Trap one might adjust the formula clause to give preference to basis step-up for higher taxable assets such as collectibles and

depreciable assets.

17. Morrow, *supra* note 15, footnote #55.

18. Consider adding SPAs under the Illinois decanting (760 ILCS 5/16.4) or virtual representation (760 ILCS 5/16.1) statutes.

19. Treas. Reg. §25.2518-2(e)(5) Ex. 7, permits the disclaiming spouse to retain a "5 and 5" withdrawal power (a PEG Power) over a CST receiving disclaimed property. This suggests that for disclaimer planning a testamentary SPA may be retained in the CST for the narrow purpose of triggering the Trap. See Morrow, *supra* note 15, at 60-62.

20. In a non-bankruptcy context, Illinois seems to follow the common law rule that creditors cannot reach assets over which a donee holds an unexercised PEG Power not created by the donee. *Gilman v. Bell*, 99 Ill. 144 (1881), 2d § Rest. Prop § 13.4. The 3rd Rest. Prop. at §22.3 (which may become Illinois law, if our legislature adopts a version of the Uniform Trust Code taking this position) voices a different view, providing that creditors can reach trust property to the extent there is insufficiency in the powerholder's property. PEG Powers most likely would be exercisable by a bankruptcy trustee for the benefit of the donee's creditors under 11 U.S.C.A. § 541.

21. Most commentators believe that 765 ILCS 305/3(a-5)(ii) is an "anti-alienation rule" and that successive PEG Powers should spring the Trap for QPTs as there is an ascertainable perpetuities "period" (but see note 5 and the *Murphy v. Comm'r AOD*, *supra* note 11, for contrary arguments). Without an anti-alienation rule, different results apply under the Illinois statute depending on one's interpretation of the law. One view is that the Trap is always sprung anytime a SPA is exercised creating a successive power since the perpetuity period for the "second" power cannot be ascertained by referring back to a (non-existent) period for the "first" power (if true, this is actually a planning opportunity as it enables the Trap to be sprung with successive SPAs not requiring estate tax inclusion for the powerholder). Fear of this argument explains why nine states have rejected outright repeal and embraced extended perpetuity periods, such as 500 or 1,000 years. Zaritsky, *supra* note 10, at 7. The contrary position is that the Trap is not sprung because the perpetuities periods are the same (a period of "forever"), implying that the Trap can never be sprung for QPTs, either because (i) same periods are always ascertainable to each other; or (ii) the Trap's statutory requirement to "postpone" vesting (or "suspend" alienability), cannot by definition be accomplished for perpetual trusts which last forever. In any event, the lack of relevant rulings or cases makes the analysis unclear and suggests that the IRS is disinclined to enter into this wildly confusing dispute. See Greer, supra note 5; Spica, *A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute is Too Clever by Half (of Infinity),* 43 Real Prop. Prob. & Tr. & Est. L.J. 673 (Winter 2009); Nenno, *Terrors of the Deep: Tax Dangers When Exercising Powers over Trusts - The GST Regulations and the Delaware Tax Trap,*34 Tax Management Estates, Gifts, and Trust Journal, No. 1 (1/8/2009); Horn, *Flexible Trusts and Estate for Uncertain Times*, Ch. 19 (ABA 2014).

22. What if PEG Powers are granted to CST beneficiaries who would otherwise receive outright distributions at the surviving spouse's death? Can the IRS disregard such PEG Powers as "illusory" because they have no economic effect? Treas. Reg. §20.2041-1(d) seems to prevent this argument. If still a concern, consider drafting the appointive trust to have a non-outright dispositive scheme.

23. See Blattmachr, *supra* note 13; Pennell, Blattmachr, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes,* 68 J. Tax'n 242 (1988); Nenno, *supra* note 21, at 9.

24. Treas. Reg. §1.643(a)-3(b) permits three methods to allow capital gains to be treated as part of the DNI deduction and taxable to beneficiaries. Also, capital gains realized in the year of trust termination are included in DNI.

25. 20% capital gain rate, plus 3.8% Medicare surtax, plus 5.25% Illinois rate. The 20% capital gain rate and 3.8% Medicare surtax generally apply to 2016 trust incomes over $12,500.

26. $680,634 Illinois estate taxes on $8M taxable estate (without federal estate taxes), less $456,071 Illinois estate taxes on $6M taxable estate.

27. Illinois 3.75% income tax rate, plus 1.5% trust replacement tax.

EXHIBIT A

Exercise of Testamentary SPA Triggering the Delaware Tax Trap.

Formula Clause Eliminating Estate Taxes and Achieving Stepped-up Basis for Assets with Greatest Appreciation*

SIXTH: *EXERCISE OF POWER OF APPOINTMENT*. Pursuant to Section ___ of the Jane Doe Living Trust dated xx/xx/xxxx ("Jane Doe Living Trust"), I am given a testamentary power of appointment as to the Family Trust established under Article ___ of such instrument (the "Family Trust"). I hereby exercise this testamentary special power of appointment upon my death as follows:

[OPTION #1 - APPOINT ASSETS TO NEWLY FORMED STAND ALONE TRUST]

SECTION 1: *Exercise of Power*. Subject to the limitations of Section 2 and 3 below, I hereby appoint the assets of the Family Trust which would otherwise (but for this appointment) be distributed for the benefit of my surviving children** (the "appointive property"), to the ABC Appointive Trust created by me on today's date for the benefit of such children, granting each surviving child a presently exercisable general power of appointment.

[OPTION #2 - APPOINT ASSETS TO TRUST CREATED BY REFERENCE]

SECTION 1: *Exercise of Power*. Subject to the limitations of Section 2 and 3 below, I hereby appoint the assets of the Family Trust which would otherwise (but for this appointment) be distributed for the benefit of my then living children** (the "appointive property"), to be allocated in equal shares to separate trusts for each of my then living children. Each such separate trust shall be identical to trusts administered under the separate trust withholding provisions of Article __ of the Jane Doe Living Trust, which terms are incorporated by reference herein, except that each such separate trust shall grant the child the following additional power under its terms:

> During the child's lifetime, the child shall have a presently exercisable general power to appoint any or all assets of this trust to his or her creditors, to him or herself or to any of my descendants in such amounts or under such terms as the child deems appropriate.

SECTION 2: _Assets Subject to Power of Appointment_. Subject to the limitations of Section 3 below, the assets potentially subject to this power of appointment shall only be those assets of the Family Trust whose tax basis would increase in value pursuant to Section 1014 of the Internal Revenue Code ("Code") if included in my gross estate under Code Section 2041(a)(3), subject to the following ordering rules.

A. The power shall apply to the asset with the largest percentage of difference between fair market value at the time of my death and the cost basis immediately prior to my death first, cascading in turn to each subsequent asset with the next largest percentage difference between fair market value and cost basis (e.g. an asset with basis of $10, fair market value of $100 would have a "percentage of difference" of 90/100, or 90%).

B. *[OPTIONAL PARAGRAPH GIVING PREFERENC*E TO DEPRECIABLE PROPERTY]

In applying paragraph A., depreciable assets shall be deemed to have a percentage of difference 50% higher. To illustrate, if the trust owns (i) a depreciable building with a basis of $100,000 and fair market value at the time of my death of $200,000; and (2) stock with a basis of $75,000 and fair market value at the time of my death of $100,000, the percentage of difference for purposes of this paragraph shall be: 75% for the depreciable building (50% times 1.5); (ii) and 25% for the stock; respectively. Accordingly, the power of appointment shall apply first to the depreciable building and then to the stock. For purposes of this paragraph, entities taxed as a partnership that hold depreciable assets shall be considered depreciable assets, regardless of whether an election is made under IRC Code Section 754.

SECTION 3: _Power of Appointment Limited to Exercise Resulting in no Federal [or State***] Estate Taxes_. Should the exercise of the power of appointment specified hereunder result in federal [or state***] estate tax liability due to the appointive property being included in my estate pursuant to Code Section 2041(a)(3), the appointive property subject to this power of appointment shall be further limited, and apply or not apply to each remaining asset of the trust not previously excluded as potential appointive property above in the order specified in Section 2 so that that the total appointive property does not rise to a level to generate any federal [or state***] estate tax liability. Once an asset's (or group of assets') inclusion as appointive property would otherwise cause an increase in my federal [or state***] estate tax liability, the power to appoint them shall be limited to that fraction or percentage that would not cause any federal [or state***] estate tax liability. Upon reaching this limit, all other assets are excluded from this power of appointment. Property with different cost basis for different lots or purchases shall be considered completely separate property for this purpose, and may be divided or fractionalized accordingly.

SECTION 4: Statement of Intent. It is my intention that the foregoing exercise of my power of appointment shall trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Family Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in my federal [or state***] estate tax liability. This article shall be administered and interpreted in a manner consistent with this intent. Any provision of this article which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

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*Adapted from forms developed by Ed Morrow, *supra* note 15.

**If predeceased children cause the appointive property to be insufficient to obtain the required stepped-up basis for trust assets, consider granting PEG Powers to grandchildren.

***Consider deleting if income tax benefit of stepped-up basis exceeds state estate taxes.