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Estate & Succession Planning Corner

When Tax and Property Laws Collide a Loss of General Skipping Tax Exemption May Result

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Tax law generally tracks property law. Respect for state property law was enshrined in the Supreme Court's decision in *H.J. Bosch Est.*[1] That decision said that tax authorities could not override local property law by creating their own "federal" version of such law: "it is incumbent upon federal courts to take state law from state court decisions when federal tax consequences turn on state law."[2] Thus, the IRS must follow the property law of the state governing a transaction as long as such law reflects an actual or presumed ruling by the state's highest court.

The tension in the *Bosch* approach, and in fact the tension in any approach that relies on common or statutory state law, is that such laws have the potential to create a *per se* adverse tax result for taxpayers: a trap for the unwary. That tension was recently highlighted in the intersection of two seemingly disparate areas of law: the generation skipping transfer ("GST") tax, specifically, the exemption of trusts from application of that tax, and the relatively recently adopted Uniform Powers of Appointment Act (the "Uniform Act"), now the law in more than eight states[3].

LTR 201814001[4] addressed a possible adverse tax result when it considered the GST tax consequences of the judicial construction of a trust that was established prior to September 25, 1985 (a "GST grandfathered trust"). The construction involved a determination of the meaning of the term "descendants." In LTR 201814001, the issue was whether the term descendants includes adopteds or only descendants by blood. Resolution of the issue was critical to a determination of whether the otherwise GST grandfathered trust would remain exempt from GST tax. Without a judicial resolution, a gift could be deemed made resulting in a loss of grandfathered exempt status.

How would a gift arise? If adopteds were in the class of descendants contrary to state law then their inclusion as trust beneficiaries would mean that a gift could be deemed made by blood descendants to adopteds. Similarly, were the converse the case, and adopteds were excluded in contravention of their rights under state law, then those adopteds could be deemed to have made a gift to the blood descendants. LTR 201814001 notes that under Reg. §25.2511-1(c) "any

transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax."

By its very nature, a gift subject to tax is an addition or deemed addition to a trust, and as such, a gift can result in the loss of GST exemption for an otherwise GST grandfathered trust. Thus, the regulations under Code Sec. 2601 explain the circumstances when a judicial modification of a trust will not cause a trust to lose its exempt status. Specifically, Reg. §26.2601-1(b)(4)(i)(c) provides a judicial construction will not affect the GST exempt status of a grandfathered trust if "(1) the judicial action involves a bona fide issue and (2) the construction is consistent with applicable state law that would be applied by the highest court in the state."

LTR 201814001 resolved the issue of whether adopteds were included in the meaning of the word "descendants" concluding that based upon the intent of the settlor of the trust at the time of the trust's creation, a controlling fact under state law, adopteds were *not* included within the class of descendants, even though under current state law "absent contrary intent by the settlor, the word 'children' would be read to include adopted persons." The conclusion of the IRS in LTR 201814001 is consistent with Example 3 of Reg. §26.2601-1(b)(4)(i)(E). That example addressed construction of the term issue in a GST grandfathered trust: specifically whether issue was to be determined per stirpes or per capita. In the example, the trustee filed a trust construction suit. In reaching Treasury's conclusion that the trust would not be subject to GST tax, Example 3 states: "…the court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state."[5]

The GST grandfathered trust rules have certain unstated assumptions about state law and the forum court for a trust construction lawsuit: namely that the law and the forum for construction are known and determined as of the date of creation of the trust. What then if state law and the forum could be selected at any point in time by an individual or entity with no fiduciary duties? How would such a circumstance affect GST grandfathered and exempt trusts?

The Uniform Law Commissioners took just such an approach in the Uniform Powers of Appointment Act (the "Uniform Act"). Persons, be they individuals or entities, who hold powers of appointment are called powerholders and those powerholders exercise their rights to appoint the trust estate of a trust in a nonfiduciary capacity.[6] The Uniform Act defines a power of appointment as a "power to direct a trustee to distribute income or principal to another."[7]

It is Section 103 of the Uniform Act that upends common law and the assumptions about trust construction that are embedded in the grandfathered GST trust regulations. Section 103 addresses the laws governing powers of appointment and while it states that "the creation, revocation, or amendment of the power is governed by the law of the donor's domicile at the relevant time,"[8] it adopts the novel notion that instead of looking to the donor's domicile "the exercise, release or disclaimer of the power … is governed by the law of the powerholder's domicile at the relevant time."[9] By reversing the common law rule that the exercise of a power is governed by the laws of the donor's domicile, the Uniform Law Commissioners have endorsed the possible "gaming" of a powerholder's exercise of a power of appointment and have created traps for the unwary.

Specifically, the Uniform Act would allow a powerholder, who by definition has no fiduciary duties, to forum shop. Consider the matter of the definition of descendants. Assume for a moment that the powerholder has the power to appoint among descendants. Depending upon the powerholder's domicile at the time of exercise, the term descendants may or may not include adopteds or with today's artificial reproductive technologies may or may not include individuals born a year or more after the death of a parent. By enabling the powerholder to forum shop, the Uniform Act allows a GST grandfathered trust to be modified in a way that can result in a change in the value and timing of beneficial interests in trust.

The ease of forum shopping is highlighted when an entity is a powerholder since the state governing the laws of an entity is a matter of filing papers with a secretary of state and can be readily and easily changed by reincorporation from one state to another or by merger. The Commissioners seem comfortable with forum shopping and its consequences, since acceptance of forum shopping is reflected in the comments to Section 103: "… acts of the powerholder should be governed by the law of the powerholder's domicile because that is the law the powerholder … is likely to know."[10] Indeed, "the Act applies to all powers of appointment whenever created, to judicial proceedings concerning powers of appointment commenced on or after its effective date, and unless the court otherwise orders, to judicial proceedings in progress on the effective date."[11] Thus, under the Uniform Act, a powerholder has carte blanche to forum shop to seek the application of a particular law intended to produce a particular result.

The only brake on forum shopping is that the rules of construction under the Uniform Act do not apply

if "there is a clear indication of a contrary intent in the terms of the instrument."[12] Left unclear is what meaning, if any, to ascribe to the tax intent of the settlor/grantor. If the grantor states he wishes the trust being established to be GST exempt, does that mean that the rules of his state prohibiting the inclusion of adopted descendants would trump the rules of the powerholder's state allowing the inclusion of adopted descendants? For a modern Uniform Act, it is a serious error of omission to fail to include consideration of the GST tax. The net result of this omission is to create a trap for the unwary; a trap that could have been avoided had the Uniform Act not sought to upend hundreds of years of American common law. Practitioners operating in states that adopt the Uniform Act will need to pay particular attention to the exercise of a nongeneral power of appointment so as not to create an unintended shift in beneficial interest.

ENDNOTES

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1 *H.J. Bosch Est.*, SCt, 67-2 USTC ¶12,472, 387 US 456, 87 SCt 1776 (1967).

2 *Id.* at 67.

3 Colorado, Missouri, Montana, Nevada, New Mexico, North Carolina, Utah and Virginia have enacted the Uniform Act.

4 Released April 6, 2018.

5 Reg. §26.2601-1(b)(4)(1)(E).

6 *See* prefatory note to Uniform Powers of Appointment Act.

7 Uniform Powers of Appointment Act, Section 102, Comment to Paragraph (13).

8 *Id*., Code Sec. 103.

9 *Id*.

10 *Id*., Comment paragraph (2).

11 Comments to Article 6, Section 603.

12 Section 603(4).