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Powers of Appointment: More (Taxwise) Than Meets the Eye

(Part II of a Two-Part Article)

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It was once said that "the power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out"[1]. This author would add that it might also be one of the trickiest and sometimes most confusing, at least from a federal tax standpoint. In fact, it may be the very flexibility and efficiency of the power that gives rise to the many tax issues, and when one thinks about it in light of our tax system, this is understandable. For instance, what are the tax consequences in the following situation?

Donor transfers property to a trust under which he retains a special testamentary power of appointment. He also grants donee a special lifetime power over corpus. Neither powerholder is a beneficiary of the trust. Donee exercises the lifetime power unconditionally appointing the corpus to X. We know this is not a gift by donee, since he never owned the corpus, but is it a gift by donor? How can it be if donor had no control over donee's exercise of the power? Did you

know that for tax purposes a donor's reserved testamentary power of appointment is not treated as a power of appointment at all?

This discussion will present an overview of the federal tax consequences of the grant, exercise, and release of general and special powers of appointment (created after October 21, 1942) in various circumstances. It is not exhaustive of every possible situation, however, and only touches upon generation-skipping issues, so the reader is cautioned to research the consequences of the more unusual situations in greater detail.

General Power of Appointment Retained By the Donor

When a person makes a transfer, whether in trust or otherwise, and reserves the power to recover the property, as through the exercise of a general power, he has not, in the eyes of the tax law, relinquished dominion and control over the property. Thus, he has made no completed taxable gift of the property.[2] Since the donor has not made a completed gift, the income and losses relating to the property will pass through to the donor of the power.[3] On the donor's death, if he continues to hold the power, the full value of the property subject to the power will be included in the donor's estate, but not under the Internal Revenue Code (IRC) section governing powers of appointment. Rather, the property is included under the code sections relating to retained control over a transfer.[4] This is because IRC sections 2041 and 2514 ("powers of appointment") are concerned only with powers granted to the decedent or donee by another person.[5] For this reason, an exercise or release of the power within three years of the donor's death will result in estate tax exclusion of the date of death fair value of the property subject to the exercise or release,[6] instead of simply the adjusted lifetime taxable gift.

Special Power of Appointment Retained by the Donor

A special power, sometimes referred to as a non-general power, may not benefit the powerholder and may have a narrow choice of objects (e.g., issue of the donor, or a sibling of the donor), or it may be very broad (e.g., anyone in the world except the powerholder, his creditors, his estate, or the creditors of his estate). In any event, whether narrow or broad, when it is created through a

reserved power by the donor it is not treated as a power of appointment under IRC section 2041 but rather as a retained power under sections 2036 or 2038 for estate tax purposes. As with the retained general power, the donor has not made a completed gift.[7] Accordingly, the income and losses relating to the property subject to the power will pass through to the donor/powerholder,[8] since he continues to be regarded as the owner of the property for tax purposes.

Interestingly, the only section of the IRC specifically stating that a transfer that is subject to the transferor's retained power to control beneficial enjoyment will cause the income or losses on that property to be passed through to the powerholder, deals with a transfer to a trust (under the so-called "grantor trust" rules).[9] Nevertheless, it would be naïve to assume on this basis that the concept and tax result applies only to transfers to trusts and would not apply to non-trust transfers (e.g., a power reserved in a deed). If that were so, it would permit a donor who made a transfer with a reserved power to temporarily and repeatedly shift taxable income among an unlimited number of recipients without ever making a completed gift. For instance, Dan could deed his income-producing property to son no. 1, reserving a special lifetime power of appointment in the deed. Four months later Dan could revocably exercise the power in favor of son no. 2. Three months after that, Dan could revocably exercise the power in favor of son no. 3, and so on, and so on. If we buy into the "no trust- no tax" argument, Dan would have shifted the taxable income among his chosen donees at will without ever having made a completed gift! I don't think so.

Of course, there would be a completed gift when the donor/powerholder irrevocably exercises or releases the power.[10] As with the retained general power, the full value of the property subject to the special power will be in the donor/power-holders estate on his death.[11] And a release or exercise of the power within three years of death will bring the full value in the estate.[12]

General Power of Appointment Granted to Another

When a general power of appointment is granted to a third party and the donor has otherwise given up all dominion and control, a completed gift has been made.[13] Even this result may be clouded, however, if, for example the third party has a concurrent general power with the donor.

In that event, there may be no completed gift until the donee/powerholder exercises his power. For instance, say that George creates a trust reserving the right to withdraw the income and corpus. The trust also contains a provision allowing his brother Jeb to withdraw the income and corpus. Until Jeb makes a withdrawal there is no completed gift. (In the meantime, George will be taxed on the trust income as explained below)[14].

If the donee/general powerholder dies, the full value of the property subject to the power will be includable in his estate, unless the power falls under one of the exceptions to the general power.[15] One of the most common and useful exceptions is where the exercise of the power is governed by an "ascertainable standard", such as health, education, maintenance, and support. This is deemed to place adequate limitations on the powerholder with the result that he does not have a carte blanche "to consume the property, and his actions are reviewable by a court". [16] This is probably so even though the standard may be subject to the powerholder's "sole and absolute discretion", since a trustee's exercise of discretion is always reviewable by a court. The other exceptions include powers that are exercisable only with the consent of the donor or with the consent of an adverse party (someone whose interest would be adversely affected by the exercise of the power).

Note that in order to be treated as a general power for tax purposes it is not necessary that the power be exercisable in favor of <u>all</u> of: the powerholder, his creditors, his estate, and the creditors of his estate. IRC 2041 recites these in the alternative, so the inclusion of any one of them will make the power a general power. Further, in some cases, the inclusion can be even more subtle, such as where it permits payments to or for a <u>dependent</u> of the powerholder. If the power can be exercised to make a payment that would discharge a powerholder's legal obligation of support, then it would be deemed to be payable to his creditors and therefore includible in his estate on his death.[17] To avoid this exposure, especially in a trust, the language governing the power could provide that the power could not be exercised in a way that would have the effect of discharging the powerholder's legal obligation of support.

The possibility of inadvertently giving a person a general power of appointment and producing potentially disastrous tax consequences often arises where a beneficiary of a trust is also

appointed the sole trustee. The powers of a trustee to make discretionary distributions to the beneficiaries can be a general power if the trustee is also a beneficiary and therefore can make unrestricted distributions to himself. As noted below, however, there is a relatively simple way to avoid this trap for the unwary.

A sole general powerholder over property will be treated as the owner of the property for income tax purposes, and so all income and losses on the property subject to the power will pass through to the powerholder. As noted above, however, the IRC section dealing with this relates to a power held under a trust.[18] Nevertheless, few, if any, would argue that the sole holder of a general power of appointment over property should not or would not be taxed on the income, since for every other tax purpose he is unquestionably treated as the owner (except where an ascertainable standard applies, as discussed later). That is, the property subject to the power is in his estate on death; he can make a gift of it by exercising or releasing the power; he could receive consideration for exercising the power, and he can of course, simply appoint the property outright to himself or his creditors.

The question of who is taxed on the income may be more appropriate when there is more than one general powerholder, such as where the donor and the donee both hold a general power. In the case of a trust where the grantor and another party both hold a general power, the nod is given to the grantor of the trust (the donor of the power) and the trust income is taxed to him.[19] Of course, if the donee exercised his power that can change the result, as it can if the concurrent powers are held outside a trust. For instance, if George deposits $10,000 in a bank account in joint names between himself and his sister Georgia, in a state where each joint tenant has the right to withdraw the whole of the account, there is no gift to Georgia and no income will be taxed to her until she exercised her right of withdrawal over the account.[20] The issues relating to a grant of a power to another also arise when a donee is given a withdrawal power over property, such as in the case of a so-called “Crummey” power[21], or a “five or five” power.[22] In both cases, as a general rule, the powerholder is deemed to be the owner of the property or the trust, to the extent of the power, for income and capital gains tax purposes.[23]

For estate and gift tax purposes, the same rule generally applies, but an exception to the gift tax occurs when the donee's power is limited to the greater of five percent or $5,000, non-cumulative, each year (the so-called "five or five" power).[24] The benefit of this power is that it allows a donee to have the equivalent of a general power of appointment over a portion of the property while limiting the portion that will be treated as a gift if he does not exercise the power.

For example, Dad establishes a trust for Daughter. The trust provides that each year Daughter may withdraw the greater of $5000 or five percent principal of the trust. To the extent she does not make such a withdrawal in a given year the power lapses. Say that the trust principal is $500,000, so that Daughter could withdraw $25,000 during the year. The "five or five" power exception provides that a lapse of the power is not considered to be a gift by Daughter, even though the effect of the lapse is as if she withdrew the $25,000, then immediately recontributed it to the trust. However, the exception does not apply for estate tax purposes, so that Daughter's death in the year that the trust principal is $500,000 would result in the inclusion of $25,000 in Daughter's estate.

Another exception, and one far more usable for estate planning purposes, applies when the donee's power is limited by an "ascertainable standard". Even though a donee may have the power to consume property or use it to pay his creditors, it will not be treated as a general power if its exercise is subject to a "reasonably measurable standard" in terms of his needs for health, education, or support (or any combination of them)".[25] This exception would allow, for example, a settlor to name his spouse as sole trustee of a family trust (or so-called, "credit shelter" trust), or would allow a child to be the sole trustee of a generation-skipping trust, even though the spouse or child trustee/powerholder was also a discretionary beneficiary of that trust, so long as the trustee's discretion was governed by an ascertainable standard.[26]

If the power is not governed by such a standard and the powerholder is the trustee (or even if the powerholder is not the trustee but has the power to remove the existing trustee and appoint herself as the trustee), then the full value of the trust property subject to the trustee's discretionary power will be included in the powerholder's estate, or, if exercised (or released) during the powerholder's lifetime, will constitute a taxable gift.[27] <u>Note</u> that if only one word in

the prescribed standard does not meet the requirements then the exception is lost. Many practitioners seem to enjoy walking dangerously close to the line by using phrases such as "support in reasonable comfort" or "support in her accustomed manner of living". While those are certainly acceptable standards,[28] it is frightening to think that a mere "typo" leaving out the word "support" in these cases could lead to an estate tax disaster (and perhaps a malpractice suit).

Special Power of Appointment Granted to Another

If the donee/powerholder has only a special power she is not deemed to be the owner of the property subject to the power, and so as a general rule, the property subject to the power will not be included in the powerholder's estate, and an exercise or release of the power will not constitute a taxable gift (at least not by the powerholder unless the powerholder's interest in the property is reduced by the exercise of the power as noted below). This arrangement can be very helpful where, for instance, the donor desires some flexibility in his plan to allow for changing needs and circumstances of beneficiaries in the future. For instance. By giving a spouse the lifetime and/or testamentary power to appoint corpus among the donor's issue, the spouse could, without any gift or estate tax consequences, exercise her discretion to change the shares of the children or other issue in the future to accommodate their respective needs or changing tax circumstances.

An interesting question arises when the property is subject to a special power in both the donor and the donee, and the donee exercises the power. This is not, as noted earlier, treated as a gift by the donee (except as explained below), because the donee never owned the property. Is it a gift by the donor? It would have to be, on the basis that the donee is merely acting as the agent of the donor who has now lost dominion and control over the property; otherwise, a person would be able to make a completed lifetime transfer of property without consideration from one individual to another while completely by-passing the gift tax. A way to avoid the exposure to a gift in this case would be to provide in the language granting the special power that any exercise of the power by the donee would continue to be subject to the donor's originally reserved special power and that the document exercising the power would have to so state.

Practitioners should also be mindful of the situation where the special powerholder is also an income beneficiary of the trust property over which the power is held. In that event an exercise of the power could result in a gift. For example, say that Jason creates a trust providing an income interest for the benefit of his spouse, Adrienne, and on her death to their children. He grants Adrienne the lifetime and testamentary power to appoint the principal to their issue. If Adrienne exercises her lifetime power and appoints principal to a child, the exercise of the power will constitute a gift by Adrienne of the present value of the income lost by Adrienne as a result of the reduction of principal.[29]

One would think that the above problem could be circumvented by making the special power subject to an ascertainable standard. While it appears this argument is supportable, the IRS has rejected it, stating that the transfer of the income interest was nevertheless a gift.[30]

For income tax purposes, the existence of a special power will not affect the powerholder, but it is very likely to affect the donor of the power, and it can also hold traps for the unwary. For instance, if the powerholder is the grantor's spouse, and if the spouse was living with the donor at the time of the transfer, any powers held by the spouse are treated as being held by the donor.[31] Further, IRC section 674 of the "grantor trust" rules deals in large part with powers of appointment, is very complicated, and contains numerous exceptions resulting in different income tax consequences. As a general rule, however, if the donor (grantor) had the power (remember, this would include a power held by the donor's spouse) to control the beneficial enjoyment of the corpus or income, he will be taxed on the trust income. The same result will apply if the power is held by a third party who does not have an adverse interest in the trust. And if the power is held by a trustee and the trustee is not an independent party as defined by IRC section 672, then once again the donor will be taxed on trust income. One of the several exceptions applies if the power extends only to trust beneficiaries and is limited to a "reasonably definite external standard"; in that event the donor will not be taxed on the income.[32]

With all these special rules and exceptions, it is easy to see how unexpected and probably unwanted tax results can apply. For instance, take the case where a broad special lifetime power

is granted to, say, the donor's brother, over a trust for the benefit of donor's children. Since this arrangement does not fall under any of the exceptions to section 674, the donor will be taxed on all income from the trust, despite the fact that he has no direct or indirect control over the beneficial enjoyment of the trust and made a completed gift when he transferred property to the trust. Interestingly, this arrangement can actually produce a tax advantage in the right circumstances. That is, although the income of the trust is taxed to the donor, it cannot be paid to him, and in the typical case, both the income and the trust corpus are excluded from the donor's estate. As a result, the "after tax" income will accumulate or pass tax free to the trust (or the beneficiaries) and the donor's estate will be reduced by the tax paid on the income, at no gift tax cost.

Joint Powers

The use of joint powers can be very helpful where one wants to make a completed transfer for tax purposes and yet prevent the donee/general powerholder from having unrestricted control over the transferred property, or protect the transferred property from the creditors of the powerholder.[33] A joint power is one which must be exercised by all of the joint power holders (unless otherwise noted, this discussion will contemplate only two joint power holders). On the death of one of the joint power holders, the power would lapse, unless the language creating the power directs otherwise.

As simple as a joint power may appear to be, the estate and gift tax considerations can be tricky. For instance, whether the power is general or special as to either powerholder will depend on whether either powerholder is a permissible appointee or a taker in default. If one of the power holders is a permissible appointee[34] and the other is a "non-adverse" party, then the power is a general power as to the permissible appointee and a limited power as to the non-adverse party. (An adverse party is one whose interest in the property would be adversely affected in a significant way by the exercise of the power.[35])

To illustrate, Don grants a joint power to Dave and Doug jointly, which may be exercised by both in favor of Dave. On Dave's death any un-appointed property will pass to Doug (thus,

Doug is a "taker in default"). In this case, Dave's power is a limited one because Doug is an adverse party. If Doug were not a taker in default, then Dave's power would be a general one, because it could be exercised in Dave's favor without the consent of an adverse party. This is so even though Doug could prevent Dave from exercising the power by refusing to join in. The consequence of that, of course, would be that on Dave's death the property subject to the power would be included in Dave's estate and any exercise of the power during Dave's lifetime would be a taxable gift. The disadvantageous tax results could be avoided if the power was subject to an ascertainable standard as discussed above. Further, if the power is only exercisable with the consent of the donor, it will be considered a limited power, but then the property would be included in the donor's estate on his death.[36]

If both the joint power holders are permissible appointees, then the property is treated for tax purposes as if it were jointly held property. That is, each of the joint power holders would be treated as the owner of a proportionate share of the property for income, gift, and estate tax purposes. If one of the joint power holders (of two) deceased, only half the property would be included in his estate.[37] Remember, this does not affect the disposition of the property. If the joint power remains unexercised, the property will pass to the vested owners or the takers in default, as the case may be.

To illustrate, say that Xavier deeds property to Xeno, but in the deed he grants Jack and Jill the joint power to appoint the property to anyone, including themselves. On Jack's death, one-half the property will be included in his estate. On Jill's subsequent death, none of the property will be included in her estate because after Jack dies she can no longer exercise the power. In any event, absent an exercise, the property remains in the hands of Xeno, the vested owner.

Hybrid Power – The "Delaware Tax Trap"

Powers that fall under this category can in a sense, be treated as either general or special, depending upon its exercise, but only for tax purposes. For property law purposes, however, they generally begin and end as special powers. In part, our transfer tax laws (gift and estate taxes) take into consideration the common law rule that non-charitable interests cannot be

deferred forever; at some point (typically governed by the rule against perpetuities, "RAP"), the interest must vest in a non-charitable beneficiary. Thus, the imposition of a transfer tax on individual wealth would be reasonably predictable for each family, at least (roughly) every one hundred years. Thus, if the provisions of a deed, trust, or other arrangements have the effect of postponing the vesting of an interest beyond the RAP, those provisions will be ignored and the interest will automatically vest within the period allowed by the rule.

One state, however, (Delaware) had a law that, through the exercise of successive special powers of appointment, would allow the vesting of a non-charitable interest to be postponed beyond the rule against perpetuities. Viewing this as a means of indefinitely deferring the imposition of a transfer tax, congress enacted sections 2514 (d) and 2041 (a) (3), which impose a transfer tax on the exercise of a special power of appointment used to create another special power, the subsequent exercise of which could postpone the vesting of ownership without reference to the creation of the first power (which would ordinarily start the running of the RAP). If the donee of a special power exercised the power in the manner contemplated by sections 2514(d) and 2041(a)(3) the power would be treated as a general power, the exercise of which would of course be a gift, or if the powerholder deceased, the property subject to the exercise would be includable in his estate. Since the effect of this law would be to impose a gift or estate tax on an individual who never actually owned the property because he only possessed a special power of appointment, it is viewed as a tax trap, and, because of its original relation to Delaware, it is called the "Delaware Tax Trap".

As it turned out, however, the Delaware tax trap could actually be used to bail out of an otherwise troublesome generation-skipping tax (GST) problem, by granting the beneficiary (whose estate would otherwise be skipped and subject to a GST because she held only a special power of appointment) a special power which would then be intentionally exercised in the "prohibited" fashion, causing the property or a specified portion of it to be included in her estate under the Delaware tax trap, thus avoiding the generally higher GST tax. How the minds of clever tax lawyers weave through the web created by the Code.

In the meantime, more than a dozen states have repealed their rule against perpetuities. In those states, exposure to the Delaware tax trap could become even more of a problem, because, in the typical case, and since a trust could now last forever, the states did not require that the exercise of a special power of appointment (created under a preceding special power) be restricted to a time period based on the creation of the original special power. It seems now, however, that such states are beginning to officially recognize this potential tax problem and are taking steps to reduce or eliminate the Delaware tax trap exposure by adopting a rule declaring that the exercise of a special power which arises from the exercise of a previous special power will, by the state's law, be measured from, or be deemed to have been created on, the grant of the original special power.[38]

The Delaware tax trap does not apply to the grant or exercise of a general power, because, as discussed above, the possession of a general power will cause inclusion in the powerholder's estate, and the exercise of a general power will start the running of a new period of perpetuities.[39]

Conclusion

Powers of appointment are regarded by some (certainly including the author) as one of the most flexible estate, property, and tax planning tools available today. They can be used to build extensive flexibility into an estate plan with or without tax consequences, and they can be used to protect property from a powerholder's creditors, while still offering the opportunity of the powerholder enjoying the property. But practitioners using powers of appointment must as well be ever mindful of the somewhat complicated tax ramifications of powers in order to realize their optimum use in a plan.

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[1] Leach, *Powers of Appointment*, 24 A.B.A. Journal 807, 807 (1938)

[2] Treas. Reg. 25.2511-2 (b)

[3] *Corliss v. Bowers*, 50 S. Ct. 336 (1930), Internal Revenue Code (IRC) §§674, 676

[4] IRC §§2036 & 2038

[5] Treas. Reg. §20.204101 (b) (2) and §25.2514-1 (b) (2)

[6] IRC §2035 (a)

[7] *Supra,* note 2

[8] *Supra,* note 3

[9] IRC §674 (and §676 if a general power is retained)

[10] Treas. Reg. 25.2511-2 (b)

[11] IRC §§2036, 2038

[12] IRC §2035 (a)

[13] *Supra,* note 10

[14] IRC §678 (b)

[15] IRS §2041 (b)

[16] See, e.g. *Matter of Stillman,* 433 N.Y.S. 2nd 701 (1980)

[17] Treas. Reg. 20.2041-1 (c) (1)

[18] IRC §678 (a) (1)

[19] IRC §678 (b)

[20] Treas. Reg. §25.25 11-1 (b) (4)

[21] *Crummey v. Commissioner,* 347 F. 2nd 82 (9th Cir 1968). Rev Rul 73-405, 1973-2 C.B. 721

[22] IRC §§2041 (b) (2) and 2514 (c)

[23] Rev Rul 67-241, 1967-2 C.B. 225

[24] *Supra*, note 21

[25] Treas. Reg. §§20.2041-1 (c) (2) and 25.2514-1 (c) (2)

[26] Rev Rul 78-398, 1978-2 C.B. 237

[27] Treas. Reg. §§20.2041-1 (b) (1) and 25.2514-1 (b)

[28] Treas. Reg. §§20.2041-1 (c) (2) and 25.2514-1 (c) (2)

[29] *Est. of Regester v. Commissioner*, 85 T.C. 1 (1984); TAM 9419007

[30] PLR 9451049

[31] IRC §672 (e)

[32] IRC §674 (b) (5)

[33] See, Alexander A. Bove, Jr., *Exercising Powers of Appointment. A Simple Task or Tricky Business?* EPTL, June 2001

[34] A person would be a permissible appointee if the power can be exercised in favor of any one of the following: The powerholder himself, his creditor, his estate, or the creditors of his estate. See IRC §§2041-3 (c) (2) and 25.2514-3 (b) (2)

[35] Treas. Reg. §§20.2041-3 (c) (2) and 25.2514-3 (b) (2)

[36] IRC §2038 (a) (1)

[37] IRC §2041 (b)(1)(c)(iii)

[38] See, e.g., Alaska Stat. 34.27.051 (2000); 25 Del. C. §504 (2000)

[39] Restatement Second Property (Donative Transfers) §1.2 comment d