

Powers of Appointment

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I. INTRODUCTION

When viewed within the pattern of rules that make up the estate tax chapter of the Internal Revenue Code, Sec. 2041 is unique. This is the one and only section that subjects to estate taxation property (i) that the decedent did not own at her death, and (ii) that the decedent never owned during her life.

The tax law with respect to powers of appointment changed significantly on October 21, 1942, and powers of appointment created before that date were "grandfathered" under the pre-existing law. This outline is limited to the tax treatment of "post-1942" powers of appointment.

II. VOCABULARY

There are some terms that you need to know in order to understand what Sec. 2041 is and how it works.

- A. The person who creates a power of appointment is called the "donor."
- B. The person who possesses a power of appointment is called the "donee" or "power holder."

- C. The person or entity who receives the property as a result of the exercise of a power of appointment is called the “appointee.”
- D. The person who receives the property if the power of appointment is not exercised is called the “taker in default.”

III. GENERAL VS. LIMITED POWERS OF APPOINTMENT

Powers of appointment are classified as being either (i) "general" or (ii) "limited." Limited powers of appointment are sometimes called "special" powers. The words "limited" and "special" are interchangeable. Some states use one word and other states use the other, but they mean the same thing.

- A. A general power of appointment is one, subject to the exceptions noted below, which may be exercised in favor of *any one* of the following four appointees:

1. The donee,
2. The donee's estate,
3. The donee's creditors, or
4. The creditors of the donee's estate.

Example: D creates a trust and directs the trustee to pay the income to D's child, C, for C's life. At C's death, the property is to pass to C's child, X. C is given the power to appoint the property to his own estate. If he exercises the power, the property will pass pursuant to the terms of C's Last Will and Testament (rather than pursuant to the terms of the trust). C possesses a *general* power of appointment—even though he does not personally benefit from the exercise of the power of appointment.

- B. A limited power of appointment is any power that is not a general power. In other words, a limited power of appointment is one as to which the permissible appointees do not include the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.
- C. IRS said that a testamentary power of appointment granted to the son of trust settlors, to appoint the principal and accrued, undistributed income to a class consisting of the "Settlors' issue," is properly viewed as not including the son's estate or the creditors of the son's estate after his death. Accordingly, IRS said, the POA does not constitute a general power of appointment within the meaning of Section 2041(b)(1) and will not cause the value of the trust property to be included in the son's gross estate (PLR 201229005).

Example: D creates a trust to pay the income to C for life and then to pay the remainder to C's issue. P also gives C the power to alter this plan of distribution by designating by his Last Will and Testament which among C's issue are to receive the trust property and in what proportions. C's power is a *limited* power of appointment because C may not exercise the power in favor of C, C's estate, C's creditors, or the creditors of C's estate.

IV. EXCEPTIONS TO THE DEFINITION OF GENERAL POWER OF APPOINTMENT

There are three exceptions to the definition of what constitutes a general power of appointment. The first two may be stated quite easily. The third requires some elaboration.

- A. First, a power of appointment will not be considered a general power if it may be exercised by the donee only in conjunction with the donor. See Sec. 2041(b)(1)(C)(i). The person holding a Financial Power of Attorney, which allows the holder to make gifts to herself, is good example of a power of appointment that is not considered a general power. This is because the power of appointment is exercisable only in conjunction with the principal – the person who granted the Financial Power of Attorney.
- B. Second, a power of appointment will not be considered a general power if it may be exercised by the donee only in conjunction with another person who has a substantial interest in the property subject to the power of appointment that is adverse to the exercise of the power. See Sec. 2041(b)(1)(C)(ii).
- C. Caution: the regulations are more restrictive – 20.2041-3 (c) (2) and (3).
 1. Such power is not considered a general power of appointment if it is only exercisable by the decedent with the consent or joinder of a person having a substantial interest in the property subject to the power that is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power.
 2. A co-holder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a co-holder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. This is referred to as a "last power holder standing" case. In this case, no portion of the property is includable in the estate of the first co-holder to die. Rather, the entire property is includable in the estate of the second co-holder to die.
 3. If you don't have a "last power holder standing" case, then 20.2041-3(c)(3) applies. *See* Revenue Ruling 76-503, 1976-2 C.B. 275, and Revenue Ruling 77-158, 1977-1 C.B. 285 (the Revenue Rulings). These revenue rulings involve powers of appointment in the estate tax

context under section 2041 held by three trustees. The rulings focus on rights given to the three trustees (by unanimous vote in one ruling and by majority vote in the other) to make distributions to whomever they selected, including themselves. Each trustee could name a successor trustee in the event of his resignation or death. The rulings conclude that because the co-holders of the power of appointment must share their power with a deceased or resigning trustee's replacement upon his death or resignation, they did not have a qualifying "adverse interest". Consequently, at the death of one of the trustees: (1) the deceased trustee possessed a general power of appointment, and (2) one-third of the trust's value would be included in the deceased trustee's estate.

The "last power holder standing" distinction makes sense. The principle behind this rule is that a person who will succeed as the sole holder of a power of appoint is less likely to cooperate with the others who hold this power. By not cooperating, the power holder will have more of the trust corpus available to him. Because of this, his interest is truly adverse to the other power holders. Because his interest is adverse, it prevents the other holders from having a general power of appointment. On the other hand, if the power holders will always have to deal with one another (or with a successor), they have nothing to gain by not cooperating. Indeed, they have everything to gain by cooperating—and agreeing to make distributions to one another. For this reason, if the "last power holder standing" situation does not exist, each power holder will be deemed to hold a general power of appointment. As a consequence, when the first power holder dies, a proportionate share of the fund over which he may exercise his general power of appointment is includable in his estate.

EXAMPLE: D creates a trust in which the trustee is directed to pay the income to C for life. At C's death, the remainder of the trust is to pass to C's child, D. C is given the power to appoint the trust property to himself and, thus, to terminate the trust, but the power requires the consent of D. Since D's remainder interest would be eliminated by the exercise of the power, D's interest is adverse to C's exercise of the power. Accordingly, the power will not be classified as a general power of appointment.

- D. The third, and potentially the most troubling, exception is the "ascertainable standard" rule.
 - 1.. If the exercise of a power of appointment is limited by an "ascertainable standard" relating to the health, education, maintenance, and support of the power holder, the power will not be treated as a general power of appointment. See Sec. 2041(b)(1)(A). A power, no matter how broad, if not so exercisable, is not a general power. PLR 79-03055 (Upon her death the trust principal is given either outright or upon further trust, to her heirs-at-law and next of kin, in such manner, interests and proportions as she shall in and by her Last Will and Testament in that behalf direct, limit and appoint.)
 - 2. This is not an area of the law in which creativity is rewarded. The use of ANY standard other than health, education, maintenance, and support presents the risk that the power will be held

to be a general power. Thus, a standard relating to comfort, happiness, well-being, welfare, as the trustee may find necessary and desirable, or the absence of any standard at all (“in the absolute discretion of my trustee”), may very well result in the power being viewed as a general power.

3. A state court may apply the law of that state to hold that a power is subject to an ascertainable standard notwithstanding the use of “tainted” language. There might be other language in the trust that a court might find sufficient to limit what might otherwise be viewed as a nonascertainable standard. See *Estate of Vissering v. Com'r*, 990 F.2d 578 (10th Cir. 1991). The lawyer who drafts documents which then are challenged by the IRS must be careful to maintain his/her malpractice insurance in force. For those among you who may be of a more cautious nature, just use those four magic words, “health, education, maintenance and support,” and no others!.
4. In an effort to save attorneys from their own errors, a number of states have enacted savings statutes that automatically convert what would be general powers of appointment held by trustees into limited or special powers of appointment. These statutes do so by imputing an “ascertainable standard” even though the trust agreement itself does not. Rev. Rul. 54-153 (Where a trustee, who is also a beneficiary of a trust, is prevented by a State statute from participating in a decision to distribute corpus to himself, his estate, his creditors, or the creditors of his estate, no part of the trust property is includable in his gross estate under section 2041 by reason of the fact that the trust instrument provides that the trustees may distribute corpus to the beneficiary.) Similarly, they prohibit the Trustee from exercising the trust powers to discharge the Trustee’s support obligation (which itself would be treated as a general power of appointment because it could be deemed a use of trust corpus for a payment to the Trustee’s creditors). Va. Code Ann. § 64.2-776
5. However, the Service will not recognize a state law that seeks to retroactively change an individual’s property rights or powers after the federal tax consequences have attached. Rev. Proc. 94-44, 1994-2 CB 683
6. The IRS has argued that an unrestricted right in a beneficiary to remove and replace the trustee is a general power of appointment. The argument is that the beneficiary could remove the trustee and appoint himself as trustee. There is a tortured history involving this issue. The current law is Rev. Rul. 95-58, which states that a beneficiary will not be deemed to have a general power if he/she is given the right to remove the trustee and to appoint an individual or successor trustee, so long as the successor is not related to or subordinate to the beneficiary (within the meaning of Sec. 672(c)). Another solution to this problem is to require a “committee” to remove and appoint a successor trustee, such committee to consist of a majority of an easily identifiable group, such as the spouse and adult children of the grantor who are legally competent.

V. THE “TAR BABY” RULE

The tax effects of a general power of appointment bring to mind the Joel Chandler Harris story of B’rer Rabbit and the tar baby. Once B’rer Rabbit touched the tar baby, he was stuck in the tar. No matter what he did, he couldn’t get loose again. Another analogy might be to say that a general power of appointment is the legal profession’s version of the herpes virus—once you’ve got it, you can never get rid of it. Consider the following:

- A. The mere possession of the general power of appointment, even without the knowledge that you possess it, will cause inclusion in the power holder’s estate.
- B. The exercise of the general power by the donee causes the property subject to the power to be taxed to the donee for estate/gift tax purposes.
- C. If, instead of exercising the power, the donee releases the power, that release will be deemed to be the equivalent of an exercise and the property subject to the power will still be taxed to the donee. The release will be treated as a taxable gift.
- D. If the donee simply permits the power to lapse by its own terms, the lapse will be treated as a release of the power which, in turn, is treated as an exercise of the power.
- E. Finally, if the donee dies without having either exercised or released the power, the property that was subject to the unexercised power at his/her death will be taxed in the donee’s estate.

VI. THE “FIVE AND FIVE” RULE

- A. The lapse of a general power of appointment will NOT be treated as the equivalent of a release to the extent that the property that could have been appointed by an effective exercise of the lapsed power does not exceed the greater of (i) \$5,000 or (ii) five percent of the aggregate value, as of the date of such lapse, of the property from which the exercise of the lapsed power could have been taken. See Sec. 2041(b)(2).
- B. Only one “free” lapse is permitted each year.
- C. According to the legislative history of this provision, Congress believed it was appropriate to give trust beneficiaries access to a small portion of the trust corpus independent of the trustee, without this access having adverse tax consequences. In a sense, this is not unlike the treatment of annual exclusion gifts as non-taxable transfers.

Example: W creates a trust for the benefit of H. The trust provides that all income be distributed to H currently. Principal is distributable to H pursuant to an ascertainable standard. In addition, H is given the unrestricted right to withdraw the greater of \$5,000 or five percent of the trust corpus each

year. H decides not to exercise his right of withdrawal in 2014, thus permitting his power to lapse. The lapse of H's general power of appointment will not be treated as a release of the power, and H will not be taxed on the property that he could have taken by exercising the power of withdrawal.

- D. The "5 and 5" power possessed in the year of death is included in the gross estate because this power does not "lapse."—it terminates because of death, not because the exercise period has ended without exercise. Dietz, 72 TCM 1058 (1966)
- E. The risk of inclusion can be minimized by providing that power exercisable each year only in, e.g., the month of December (so that no power would be possessed at date of death if death occurs other than in December).

VII. ESTATE PLANNING

- A. The ascertainable standard exceptions permit surviving spouse to be his or her own trustee of the credit shelter trust.
- B. Non-general powers can be used to create flexibility, e.g., a long-term trust for a child granting to the child a testamentary power to appoint to or in trust to a surviving spouse or surviving children.
- C. The "5 and 5" exception—when coupled with the hanging power concept permits a parent to fund substantial premiums for an insurance trust with little or no adverse gift tax consequences to the parent and little or no gift tax or estate tax consequences to the children.
- D. The donee of a general power generally should allocate by Will the portion of the estate tax attributable to the power to the property (typically a trust fund) subject to the power, in order to avoid frustrating his estate plan by having that portion of the tax exhaust his personally-owned assets.

VIII. CONCLUSION

Powers of appointment, properly utilized, can provide the client and his/her family with a degree of flexibility that cannot be attained through any other estate planning device. The grant of a power of appointment, whether general or limited, has the ability to postpone the ultimate decision as to the distribution from the death of the client to the death of a lineal descendant of the client, an extension of at least one generation. The most critical caveat arises if you are intending that the power of appointment be limited, rather than general. In that case, be sure to use an ascertainable standard!