THE SECRET LIVES OF POWERS OF APPOINTMENT[1]

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I. Powers of Appointment Generally.

A. Overview.

The presence or absence of a "general" power of appointment can have significant state and federal income, estate, gift and generation-skipping transfer tax consequences. Therefore, it is crucial to distinguish, for tax purposes, between "general" and "nongeneral" (also known as "limited" or "special") powers of appointment. "General" powers are defined in §2041 and §2514[2] as powers, subject to certain exceptions, exercisable in favor of the power holder, his or her estate, his or her creditors, or the creditors of his or her estate. "Nongeneral" powers are any powers of appointment other than "general" powers.

Several parties are involved with powers of appointment. The individual establishing the power is the "donor," "creator," or "grantor" of the power. The individual with the ability to exercise the power is the "power holder," or the "donee" of the power. The person to whom the donee appoints the property is the "appointee." The person to whom the property will pass in the event the power holder fails to exercise the power is the "taker in default."

Despite being commonly included in various types of trusts, very little statutory law exists governing the creation, amendment, revocation, disclaimer, release or exercise of powers of appointments. Traditionally, estate planners have instead had to rely on an assortment of common-law cases. The Uniform Powers of Appointment Act, approved and recommended by the National Conference of Commissions on Uniform State Laws in July 2013 (the "Uniform Act"), codifies the laws governing powers of appointment. The Uniform Act relies heavily on the provisions of Division VI, Powers of Appointment, contained in the *Restatement (Third) of Property: Wills and Other Donative Transfers* (the "Restatement"), which was published in 2011 by the American Law Institute. While the Uniform Act substantially adopted the provisions of the Restatement and, in most ways seeks to codify, rather than alter, common law, certain differences do exist.

The tax consequences of powers of appointment can be summarized as follows:

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[2] All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise indicated.

- First, property subject to a general power of appointment held by a power holder at his or her death is includible in his or her gross estate under §2041 and therefore may be subject to estate tax.

- Second, an inter vivos exercise or release of a general power of appointment is a transfer of property that may be subject to gift tax under §2514.

- Third, the possession by a trust beneficiary, or the exercise by a power holder creating a trust, of a general power of appointment can cause the trust to be a "grantor" trust under §671–§679, resulting in some or all of the income of the trust being attributable to that beneficiary, power holder, or some other party.

- Fourth, the generation-skipping transfer tax, which generally is imposed on transfers, either outright or from a trust, to persons two or more generations below the "transferor" (a term defined in §2652(a)), can be imposed on distributions made by a power holder as a result of the exercise of a power of appointment. This tax is imposed at the "applicable rate," which is a flat rate equal to the maximum estate tax rate at the time of the transfer, subject to the allocation of GST exemption.

- Finally, nongeneral powers avoid all of the results described above.

Obviously, therefore, careful drafting is required to ensure that the proper power is used.

The comments to the Uniform Act and the Restatement each provides that a power to revoke or amend a trust or a power to withdraw income or principal from a trust is a power of appointment, whether the power is reserved by the transferor or conferred on another. However, the comments to the Uniform Acts state that a fiduciary distribution power is not a power of appointment;[3] whereas the Restatement provides that fiduciary distribution power is a nondiscretionary power of appointment governed under general trust law.[4]

B. Powers of Appointment under the Code.

The first step in defining a "general power of appointment" is to decide whether a given power is a "power of appointment" under the §2041 and §2514 regulations. For federal transfer tax purposes, a "power of appointment" (whether general or nongeneral) is any power that is "in substance and effect" a power of appointment "regardless of the nomenclature used in creating the power and regardless of local property law connotations."[5]

Reg. §20.2041-1(b)(1) identifies the following rights as powers of appointment:

- the power held by a trust beneficiary to "appropriate or consume the principal of the trust;"

[3] Uniform Act §102, cmt.

[4] Restatement §17.1, cmt. g.

[5] Reg. §20.2041-1(b), §25.2514-1(b).

- the power to "affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust;"

- the power, conferred upon a spouse under the community property laws of a state, of "testamentary disposition over property in which [the spouse] does not have a vested interest;" or

- the power, in certain cases, of a donee to "remove or discharge a trustee and appoint" the donee.

On the other hand, the following powers will not be deemed to be powers of appointment:[6]

- the power held by the decedent to appoint a successor trustee, including himself or herself, under limited conditions that did not exist at the time of his or her death without an accompanying unrestricted power of removal;

- the power to amend only the administrative provisions of a trust instrument, that cannot substantially affect the beneficial enjoyment of trust property or income;

- the mere power of asset management, investment, custody, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, if the power holder has no power to enlarge or shift any beneficial interests except incidentally; or

- the right of a trust beneficiary to assent to periodic accounting, relieving the trustee from further accountability, if the right of assent does not allow the power holder to shift or enlarge any beneficial trust interest.

C. General Powers of Appointment.

A general power of appointment is a power exercisable in favor of the power holder, his or her estate, his or her creditors, or the creditors of his or her estate.[7] It is not necessary for a power holder to have the power to appoint to all four of the foregoing categories (himself or herself, his or her estate, his or her creditors, and the creditors of his or her estate) for a general power of appointment to exist. Noting that the word "or" in §2041(b)(1) indicates the disjunctive, the Tax Court ruled that, if a decedent can exercise the power in favor of any one of the four categories, he or she holds a general power.[8]

1. Ascertainable Standard Exclusion.

[6] Reg. §20.2041-1(b)(1). *See also* Reg. §25.2514-1(b)(1).

[7] §2041(b)(1), §2514(c).

[8] *Estate of Edelman v. Commissioner*, 38 T.C. 972 (1962).

A power vested in a donee to consume, invade, or appropriate property, even though for his or her own benefit, is not deemed a general power of appointment if it is limited by an "ascertainable standard" relating to the health, education, support, or maintenance of the power holder.[9] The regulations provide that a power is limited by an ascertainable standard "if the extent of the [holder's-possessor's] duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them)." In Rev. Rul. 78-398, the IRS ruled that the beneficiary of a power may be the sole fiduciary authorized to exercise the power, without causing the power to be deemed "general," provided the exercise is subject to an ascertainable standard.

The words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life.[10] Additionally, whether a beneficiary is required to exhaust his or her other income before the power can be exercised is immaterial in determining whether a power is limited by an appropriate ascertainable standard.[11]

The regulations provide that the following limitations on exercise in favor of the power holder qualify as ascertainable standards:[12]

- "support";
- "support in reasonable comfort";
- "maintenance in health and reasonable comfort";
- "support in his accustomed manner of living";
- "education, including college and professional education";
- "health"; and
- "medical, dental, hospital and nursing expenses and expenses of invalidism."

Given this clear list of regulatory terms constituting ascertainable standards, one might assume that the question of what is or is not an ascertainable standard would not be raised frequently. On the contrary, however, the drafters of powers of appointment have shown a remarkable capacity for straying from this approved list of terms and adding distribution standards not authorized by the regulations. When this happens, state law must be examined to determine whether the distribution standard is an ascertainable one.[13]

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[9] §2041(b)(1)(A), §2514(c)(1). *See Best v. United State*s, 902 F. Supp. 1023 (D. Neb. 1995). The trust document permitting corpus invasion when "reasonably necessary for [spouse's] comfort, support and maintenance" does not create a general power of appointment in spouse, since invasion is nongeneral by an ascertainable standard relating to health, education, support, or maintenance under §2041(b)(1)(A), notably with language that bears a striking and essential similarity to language explicitly approved as ascertainable standards in Reg. §20.2041-1(c)(2).

[10] Reg. §20.2041-1(c)(2), §25.2514-1(c)(2).

[11] Reg. §20.2041-1(c)(2), §25.2514-1(c)(2).

[12] Reg. §20.2041-1(c)(2), §25.2514-1(c)(2).

[13] Rev. Rul. 77-194 (New Jersey law held not to impose an ascertainable standard when presented with a standard of "proper comfort and welfare"); Rev. Rul. 76-502 (Maryland law held to impose an ascertainable standard); PLR 9840020 (Ohio law ruled to impose an ascertainable

2. Joint Power Exclusion.

A power exercisable in favor of the donee, his or her estate, his or her creditors, or the creditors of his or her estate, and not limited by an ascertainable standard, may still be classified partially or entirely as a limited power if it is held jointly with another individual and if certain other requirements are satisfied.[14]

a. Pre-October 22, 1942 Joint Power.

All powers created on or before October 21, 1942 are treated as nongeneral powers if they are exercisable by the power holder only in conjunction with another person.[15] The identity of the other person or his or her interest, if any, in the property subject to the power is irrelevant. If the person in conjunction with whom the power is exercisable predeceases the donee, and no other person succeeds to his or her position, the donee is then considered to be vested with a general power.

b. Post-October 21, 1942 Joint Power.

If the power was created after October 21, 1942, the relationship of the joint power holder to the appointive property determines whether the power is a general power of appointment.

1. Exercisable with the Donor.

Powers of appointment created after October 21, 1942, are nongeneral powers if they are exercisable only in conjunction with the donor of the power.[16] Whether the donor retained the right to vest himself or herself with an interest in the property is irrelevant. If the donor predeceases the donee and no person having a substantial adverse interest to the exercise of the power by the donee succeeds to the creator's position and survives the donee, the donee has a general power of appointment.

2. Exercisable with an Adverse Person.

Powers of appointment created after October 21, 1942, are nongeneral powers if they are exercisable only in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to the exercise of the power in favor of the donee.[17] If any person who, after the donee's death, may possess a power of appointment with respect to the property subject to the donee's power, which that other person may exercise in his or her favor, that

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standard when instrument limited invasion to "support, care, health and welfare"); TAM 8210021 (New Jersey law held to impose an ascertainable standard when instrument limited invasion to "reasonable needs and comfort").

[14] §2041(b)(1)(B), §2041(b)(1)(C), §2514(c)(2), §2514(c)(3).

[15] §2041(b)(1)(B), §2514(c)(2).

[16] §2041(b)(1)(C)(i), §2514(c)(3)(A). *See, e.g.*, PLR 201718012, PLR 201718010–PLR 201718003, PLR 201410001–PLR 201410010, PLR 201310002–PLR 201310006 (pursuant to §2514(c)(3)(A), powers held by distribution committee members to direct trust distributions to themselves by majority vote with grantor's consent were not general powers of appointment because powers were exercisable only in conjunction with grantor/creator of powers).

[17] §2041(b)(1)(C)(ii), §2514(c)(3)(B). *See, e.g.*, PLR 201641020 (where co-trustees, holding joint power to make distributions to themselves, have adverse interests, no general power of appointment is treated as exercised or released when trustees jointly resign). *Cf.* PLR 199933034, PLR 199933020 (trust assets includible in child's gross estate under §2041 to extent of child's "five and five power," because said power did not require trustee's consent).

person is deemed to have an interest in the property adverse to the exercise of the decedent's power.[18]

A frequent question raised in this area is whether a trust can create a "distribution committee," which includes the donee and the grantor or adverse party, to hold the power to distribute to the done, and have that power not result in a general power in the donee's hands. To date, the IRS has approved most if not all such arrangements.[19]

The regulations provide in part that an interest adverse to the exercise of a power is considered substantial if its value in relation to the total value of the property subject to the power is not insignificant. The interest is valued in accordance with the actuarial principles set forth in the regulations or, if it is not susceptible to valuation under those provisions, in accordance with general principles of valuation.[20]

3. Fractional Interest.

If a jointly held general power created after October 21, 1942, is exercisable in favor of the person holding the power, the power is deemed a general power only with respect to the fractional part of the property subject to the power.[21] As with powers held jointly by a person with an adverse interest, a power is deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his or her estate, his or her creditors, or the creditors of his or her estate.[22] The donee is treated as though he or she was a joint owner of the property with the other holders who are permissible appointees. The power holder will be treated as having a general power over a fractional share of the property to be determined with reference to the total number of joint holders, who (or whose estates or creditors) are permissible appointees. The value of each share is determined by dividing the value of the entire property by the total number of persons in favor of whom the power is exercisable.[23]

D. Form of a power of appointment.

1. Governing Law.

Section 103 of the Uniform Act provides that unless the terms of the instrument creating the power provide otherwise, the actions of the donor, including the creation, revocation, or amendment of the power, are governed by the law of the donor's domicile, while the actions of the powerholder/donee, including the exercise, release, or disclaimer, or the revocation or

[18] §2041(b)(1)(C)(ii), §2514(c)(3)(B).

[19] *See* PLR 201925010–PLR 201925005, PLR 201850006–PLR 201850001, PLR 201718012, PLR 201718010–PLR 201718003, PLR 201550005–PLR 201550012, PLR 201440008–PLR 201440012, PLR 201436008–PLR 201436032, PLR 201434007–PLR 201434009, PLR 201430003–PLR 201430007, PLR 201426014, revoked in part on other grounds by PLR 201642019, PLR 201410001–PLR 201410010, PLR 201310002–PLR 201310006.

[20] Reg. §20.2041-3(c)(2), §25.2514-3(b)(2).

[21] §2041(b)(1)(C)(iii), §2514(c)(3)(C).

[22] Reg. §20.2041-3(c)(2), §25.2514-3(b)(2).

[23] §2041(b)(1)(C)(iii), §2514(c)(3)(C); Reg. §20.2041-3(c)(3), §25.2514-3(b)(3).

amendment of the power, are governed by the law of the powerholder's domicile at the time of the exercise. The comments to the Restatement, however, provide that the law of the powerholder/donee's domicile applies to the exercise of a power unless the instrument creating the power provides otherwise[24] and is silent as to the law governing the creation of the power.

Conversely, the majority view under common law has been that the law of the donor's domicile governs the actions of the powerholder/donee.[25] Accordingly, the position set forth in the Uniform Act and the Restatement represents a departure from the majority rule.

2. How a Power Is Created.

As a general rule, a power of appointment may be created by will, deed, trust, or other instrument. The Restatement provides that "[a] power of appointment is created by a transfer that manifests an intent to create a power of appointment."[26] The Uniform Act provides a more expansive definition, requiring, in addition to intent, that the power be an instrument that is valid under applicable law.[27] However, the comments to the Uniform Act provide that "[a] partially valid instrument creates a power of appointment if the provisions creating the power are valid."[28]

While, particularly in modern estate planning, many powers of appointment are readily evident on their face, other powers of appointment become apparent as such only upon a careful review of the instrument creating the power.

3. When a Power Is Created.

The date on which a power is deemed to be created is important generally for two reasons: (1) in determining whether the power is a pre-October 22, 1942 power; and (2) for disclaimer purposes under §2518. A power provided for in a will is deemed created on the date of the testator's death.[29]

A power created in an inter vivos trust instrument, whether revocable or irrevocable, is deemed to be created as of the date on which the trust takes effect through execution and delivery of the trust instrument and transfer of the trust property to the trustees. A power created in an inter vivos instrument is not considered to be created at some future date merely because: (1) the power is not exercisable on the date the instrument takes effect; (2) the trust is revocable; or (3) the identity of the power holder is not ascertainable until after the date the instrument takes

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[24] Restatement §19.1, cmt. e.

[25] *See e.g.*, *Beals v. State St. Bank & Tr. Co.*, 326 N.E. 2d 896 (Mass. 1975); *Bank of N.Y. v. Black*, 139 A.2d 393 (N.J. 1958); *Matter of Rossi*, 634 N.Y.S. 2d 372 (N.Y. Surr. Ct. 1995). *But see White v. United States*, 680 F.2d 1156 (7th Cir. 1982) (finding the law of the donee's domicile applied).

[26] Restatement §18.1.

[27] Uniform Act §201(a).

[28] Uniform Act §201, cmt.

[29] *Doyle v. United States*, 358 F. Supp. 300 (E.D. Pa. 1973) (estate argued that since trust over which the decedent held general power of appointment had not been funded as of the decedent's death, due to normal delay of probate proceedings, there was no property includible in the estate under §2041; the court, in applying Pennsylvania law, found that the power was deemed created as of the first decedent's death and, therefore, the general power of appointment existed as of the second decedent's death, notwithstanding lack of funding); Reg. §20.2041-1(e), §25.2514-1(e). However, a power provided in a will executed before October 22, 1942, is deemed to have been created before that date if the testator died before July 1, 1949 without having republished the will, by codicil or otherwise, after October 21, 1942. Reg. §20.2041-1(e), §25.2514-1(e).

effect.[30] If a donee exercises a power by creating a second power, the second power is considered created at the time the first power is exercised.[31]

4. Amendment or Revocation of a Power.

It is generally accepted that a power of appointment may only be amended or revoked by the donor if such power to amend or revoke is reserved.[32] The reservation of the power to amend or revoke is implicit in a revocable trust until such time as it becomes irrevocable.[33] Moreover, if the same individual is both the donor and the powerholder/donee, then, in his or her capacity as powerholder/donee, the donor can indirectly revoke or amend the power through a partial or total release of the power.[34]

E. Exercise of a Power of Appointment.

1. Terms Governing a Power of Appointment.

A well drafted instrument granting a power of appointment should specify, with a reasonable amount of precision, the manner in which the power may be exercised, specify the interests that may be created by the donee, whether the donee may delegate his or her authority to others, and whether the donee may create a successive power. In addition, the grantor should indicate: (1) who the appointees are; (2) whether appointment is discretionary or nondiscretionary as among appointees; (3) the method for releasing the power; and (4) how interests are to be adjusted in the event of a partial exercise. However, poorly drafted powers or powers existing in older documents, may not include express terms, therefore requiring a review of applicable statutory and/or common law to determine what terms may be applicable.

2. Manner of Exercise.

Under both the Uniform Act and the Restatement, in order to be a valid exercise of a power of appointment, the instrument purporting to exercise the power must manifest the intent to exercise, substantially comply with any restrictions imposed by the instrument granting the power, be valid under applicable law, and appoint in favor of a permissible appointee.[35]https://www.bloomberglaw.com/product/tax/document/4901948968 - A0Q7C2Z6N6A0Q7C2Z6N6

[30] Reg. §20.2041-1(e), §25.2514-1(e). A power of appointment over the proceeds of insurance is created at the time the policy is written. *See Whiteley v. United States*, 214 F. Supp. 489 (W.D. Wash. 1963); *Hyman v. United States*, 187 F. Supp. 661 (S.D.N.Y. 1960); *Estate of Rosenthal v. Commissioner*, 34 T.C. 144 (1960), *acq.*, 1963-1 C.B. 4.

[31] Reg. §20.2041-1(e), §25.2514-1(e).

[32] Uniform Act §206; Restatement §18.2.

[33] Uniform Act §206(1); Restatement §18.2, cmt. b.

[34] Uniform Act §206, cmt.; Restatement §18.2, cmt. d.

[35] Uniform Act §301; Restatement §19.1, §19.9. *See, e.g., Benjamin v. Corasaniti*, No. UWYCV186045572, 2020 BL 213499 (Conn. Super. Ct. Apr. 30, 2020) (decedent validly exercised power of appointment by clearly indicating intent to exercise power of appointment, complying with Connecticut and Illinois law, and met Illinois and trust instrument requirements to appoint to a permissible appointee).

In some jurisdictions, state statutes consider a general residuary clause as exercising a power;[36] other states do not. Under the Uniform Act and the Restatement, if the residuary clause does not include either a specific-exercise clause or blanket-exercise clause, the residuary clause will only be deemed to reflect the powerholder's intent to exercise, if there is no contrary intent expressed, the power being exercised was a general power, there are no takers-in-default or the takers-in-default clause is ineffective and the power was not released.[37] Where a blanket-exercise clause is used, unless the instrument manifests a contrary intent, it will be deemed to also extend to after-acquired powers of appointment.[38] However, the Uniform Act provides an exception where the donor is also the powerholder, in which case the blanket-exercise clause will only be effective if there are no takers-in-default or the takers-in-default clause is ineffective.[39] Although a blanket-exercise clause is expressly permitted under the Uniform Act and implicitly permitted by the Restatement, the best way to ensure that the donee's intent to exercise is unquestionable by specific reference to the power or powers being exercised.

Where a donor imposes restrictions on the exercise of a power of appointment in addition to those required under applicable law, such as requiring specific reference to the power, the powerholder/donee will be deemed to have substantially complied with the formal requirements if the powerholder/donee knew of the power and intended to exercise it and the manner of the attempt to exercise "does not impair a material purpose of the donor in imposing the requirement."[40] The comments to the Uniform Act and the Restatement each acknowledge that this may result in a blanket-exercise clause satisfying a specific reference requirement.[41]

Problems may still arise where a powerholder/donee clearly indicates the intent to exercise a power of appointment, but disposes of both his or her own property and the donor's property in a single instrument, has commingled the properties without indicating how the appointed property is allocated among permissible appointees, and the disposition includes impermissible appointees. In order to avoid appointing property to an impermissible appointee, the Uniform Act adopts the Doctrine of Selective Allocation to aid in the construction the disposing document.[42] The rule allows allocation of assets owned by the donee/powerholder to impermissible appointees, and appointive assets to permissible appointees to both maximize the appointment's effectiveness and avoid impermissible, and thus void, appointments.[43]

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[36] *See Orvarsson v. Atl. Union Bank*, No. 3115, 2020 BL 9624 (Md. Ct. Spec. App. Jan. 10, 2020) (Maryland allows use of residuary clause to exercise power of appointment, but where trust provided requirement that exercise be "specific," "express," residuary clause was insufficient to exercise power).

[37] Uniform Act §302; Restatement §19.4, text and cmt.

[38] Uniform Act §303(1); Restatement §19.6.

[39] Uniform Act §303(2).

[40] Uniform Act §304; Restatement §19.10. *But see Saletta v. Eimers*, 262 Cal.Rptr.3d 639 (App. 2d Dist. 2020) (where trust required beneficiaries to specifically exercise and refer to power of appointment in any will they created for purpose of designating their trust shares and beneficiary's holographic will bequeathed to Salettas "my shares of the [Family Trust]" with no reference to power of appointment, court held that Cal. Prob. Code did not allow for substantial compliance when donor required powerholder to specifically refer to power of appointment as condition of exercising such power; court further held that reformation of will to add phrase "under the power of appointment" for purposes of clarifying beneficiary's testamentary intent was not appropriate remedy).

[41] Uniform Act §304, cmt.

[42] Uniform Act §308. For a discussion of the doctrine and its interpretation by states, see Joel E. Hoffman, *Powers of Appointment and Selective Allocation*, 46 Cornell L. Rev. 416 (1961).

[43] Uniform Act, §308, cmt.; Restatement §19.19, cmt. d.

The first question to be asked when the donee of a power of appointment wishes to exercise the power by transferring the property subject to the power in further trust is whether the donee has the power to do so. Courts generally have held that the donee of a general power of appointment can appoint a trustee of the appointed property. However, there appears to be a split of authority regarding whether the donee of a limited power of appointment can appoint property to a trustee. In the cases holding that the donee cannot do so, the decisions largely have been based on the language in the instrument creating the power, which was found to require the donee to transfer the property outright, rather than in trust.[44] The better view, therefore, is that, absent a specific prohibition to the contrary, the donee of a limited power of appointment can transfer property subject to the power in further trust.[45] This is the position adopted by the Uniform Act and the Restatement, which provides that unless prohibited by the instrument creating the power, all powers, general or nongeneral, may be exercised in any form, including appointing the property in further trust and creating a new power of appointment over the property.[46] The comments to the Restatement provide that the default rule permitting appointment in further trust will apply unless the language of the instrument creating the power expressly prohibits appointment in trust and will not be inferred from a reference authorizing an outright appointment.[47]

Having determined that a donee can exercise a power of appointment by creating a new trust, the next question to be asked is the extent to which that donee can create new trust terms, or instead must use the terms contained in the instrument creating the power. Put another way, because the exercise of a power of appointment involves both the instrument creating the power and the instrument exercising the power, which document governs the exercise?

As a first step, trust law generally holds that the trustor of a trust, including a trust created pursuant to the exercise of a power of appointment, must have "a property interest equal to or greater than that which he endeavors to convey in trust."[48] So, for example, the power to appoint "among the children of the testator or their heirs upon such terms and conditions as the donee may direct" does not allow the donee to appoint to the children for life with a remainder to their children.[49] If the trustor has a smaller property interest than that which the trustor tries to transfer to a trust, the modern view probably holds that the trust will "take effect to the extent of the interest" the trustor holds.[50]

Further, the donor of a limited power of appointment, and not the donee, is the settlor of any trust created by the donee under an exercise of the power.[51] This can have ramifications not only for the terms of the trust, but also for the identity of the trustees. In a number of cases, it has been held that the donor of a power of appointment "did not intend to permit the donee to name new

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[44] Uniform Act §304, cmt.; Restatement §19.10, cmt. d. The language found to require outright transfer included directions that the appointed property be "paid over" or "transferred" "to or among" the class of designated beneficiaries. Uniform Act §304, cmt.; Restatement §19.10, cmt. d.

[45] Scott & Fratcher, *The Law of Trusts*, §17.2 (4th ed. 1998) ("Scott").

[46] Uniform Act §305(c); Restatement §19.14. *See also* Hess, Bogert & Bogert, *Bogert's Trusts and Trustees*, §43 (2013) ("Bogert").

[47] Restatement §19.14(e).

[48] Restatement §19.14(e).

[49] Scott, §17.2.

[50] Bogert, §43.

[51] Scott, §17.2.

trustees to displace the old trustees appointed by the donor himself." In other cases, the opposite conclusion was reached.[52]

The thornier question involves the scope of the trust terms that the donee of a limited power of appointment may include in the trust the donee creates under the power. For example, assume that the donor has a revocable trust that gives all of the trust property at donor's death to an irrevocable trust for donee's lifetime benefit. One section of the revocable trust instrument states that "trustee shall distribute trust property upon donee's death to such one or more persons, either outright or in trust, as donee may appoint under donee's will; if donee fails to so appoint, then trustee shall distribute such property to donee's issue." Another section of that instrument is a typical "savings clause," stating that "anything in this instrument to the contrary notwithstanding, all trusts created under this instrument shall terminate upon the death of the last to die of donor's issue living at the date of donor's death." (Such clauses, of course, are included to avoid accidentally violating the rule against perpetuities.) The donee exercises this power under the donee's will by creating a new trust for the benefit of the donee's issue. Is this new trust created under the donee's will a "trust created under [donor's] instrument," such that it must terminate in accordance with the savings clause, or is the donee free to apply a new savings clause to the trust the donee has created by will?

To answer this question the donee must resolve two conflicting ideas: first, that the donor, not the donee, is the settlor of the trust created under the power of appointment; and second, that by giving the donee the power to give property subject to the power of appointment either outright or in trust, the donor is allowing the donee to rewrite the trust terms in any fashion the donee feels is appropriate. There does not appear to be any case law that directly addresses this question. However, a New Jersey case, involving statutory construction, not construction of trust language, may prove instructive. In *In re Wold*,[53] the court held that the Uniform Statutory Rule Against Perpetuities, adopted by New Jersey in 1991, could be used by a beneficiary exercising a power of appointment contained in a trust created in 1944. As a matter of statutory interpretation, the court found that, "even if created under a pre-existing power of appointment, the New Jersey Uniform Statutory Rule Against Perpetuities would apply to an interest created under that power, whether general or specific, if exercised after July 3, 1991."

Although the *Wold* decision involves statutory rather than instrument construction, it may be of some help in determining the extent to which a donee is bound by existing trust terms when exercising a power of appointment in trust. Despite the general rule of construction that states that a trust is to be interpreted in light of the law existing at the time the trust is executed, *Wold* appears to say that, at least with regard to the rule against perpetuities, the law in existence at the time of exercise governs a trust created pursuant to that exercise. A more narrow reading of *Wold* would limit it to an interpretation of New Jersey's rule against perpetuities only, with no larger ramifications.

Perhaps the best view is that phrases in a trust instrument such as "every trust created hereunder" give rise to an ambiguity that must be resolved by looking to the intent of the grantor. A grantor who gives a beneficiary the power to determine whether a transfer should be made outright or in

[52] Scott, §17.2.

[53] 310 N.J. Super. 382, 708 A.2d 787 (Ch. Div. 1998).

trust probably can be presumed to have intended to give that beneficiary the greatest possible discretion. If the ambiguous provision is one that is necessary for a transfer not to fail (for example, if a savings clause is required to prevent the exercise of the power from failing under local law), then the provision should be applied to trusts created under a power of appointment. On the other hand, if there is no such imperative, then the clause ought not to be applied to such trusts.

Under this view, provisions in the instrument creating a power of appointment like "spendthrift clauses," which are not required in order for the appointment to be made, would never automatically apply to trusts created under a power of appointment. This is in keeping with the view that the donor of the power intended for the donee to have the widest possible latitude, because it allows the donee to create a trust that does not have a spendthrift clause. This would allow the donee to use more advanced tax planning techniques, such as transfers of lifetime or remainder interests in trusts.

As always, however, the best choice is to avoid such difficulties by properly drafting trust instruments to make clear which, if any, default provisions (such as rule against perpetuities savings clauses) are to be applied to trusts created under powers of appointment.

F. Estate and Gift Taxation of Powers of Appointment.

Once a taxpayer is found to have a general power of appointment, the next determination is the estate or gift tax treatment of that power, including the valuation of the property subject to the power. This determination depends on the date the power was created and the actions, if any, taken by the taxpayer with regard to the power at or before his or her death. The following discussion assumes that the power at issue is a general power of appointment, and all references to a "power" in this section, unless specifically indicated otherwise, mean a general power of appointment.

1. Estate Tax Consequences.

The estate tax consequences for general powers of appointment vary, depending upon whether the power was created before October 22, 1942, or after October 21, 1942.https://www.bloomberglaw.com/product/tax/document/4901957160 - A0Q7C3A0T7A0Q7C3A0T7 Property subject to the former power is includible in the power holder's estate under §2041 only if the power holder takes an affirmative step, such as exercising the power. However, property subject to the latter power is includible in the power holder's estate simply by virtue of his or her possession of the power.

a. Definition of "Exercise".

The concept of "exercise" of a general power is relevant to the analysis regardless of the date on which the power is created. Generally, state law determines whether a power has been exercised.[54] For example, the residuary clause of a will may be considered under local law as an

[54] Reg. §20.2041-1(d); *see Bartol v. McGinnes*, 185 F. Supp. 659 (E.D. Pa. 1960).

exercise of a testamentary general power of appointment in the absence of a contrary intention drawn from the whole of the decedent's will.[55] A power of appointment is considered exercised even though the disposition cannot take effect until the occurrence of an event after the exercise takes place, if the exercise of the power of appointment is irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence.[56] However, a testamentary power of appointment is not considered exercised if it is subject to the occurrence during the decedent's life of an express or implied condition that did not in fact occur.[57]

A power is considered exercised even if the exercise is in favor of the taker in default of appointment. This is true whether or not the appointed interest and the interest in default of appointment are identical, or the appointee renounces any right to take under the appointment.[58] So, for example, assume Donor grants Donee a life estate in property and a power to appoint the remainder by will and, in default of appointment, the property passes to Remainder Beneficiary at Donee's death. Donee exercises the power by will and appoints the remainder in favor of Remainder Beneficiary. Donee is considered to have exercised the power, although Remainder Beneficiary has taken no greater interest than he would have had as a taker in default. The value of the appointed property is included in Donee's gross estate.

i. Pre-October 22, 1942 Power.

If a decedent exercises a pre-October 22, 1942 power, his or her gross estate includes the value of the appointed property. The decedent's exercise may be by will or by a disposition of such a nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent's gross estate under §2035 to §2038.[59] If the decedent did not exercise a pre-October 22, 1942 power, there is no estate tax liability as a result of the mere existence of the power.[60] If a pre-October 22, 1942 power is exercised only as to a portion of the property subject to the power, §2041 is applicable only to the value of that portion.[61]

Under §2041(a)(1), a complete release of a pre-October 22, 1942 power is not an exercise of a general power.[62] Therefore, a pre-October 22, 1942 power may be released by a decedent without estate tax consequence under §2041.

A decedent may not only release a pre-October 22, 1942 power, but may also disclaim or renounce such a power without any estate tax consequences under §2041.

If a decedent possessed a pre-October 22, 1942 power that lapsed at his or her death or during his or her lifetime, §2041 imposes no tax liability on the lapse.

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[55] Reg. §20.2041-1(d); *see Barclay v. United States*, 175 F.2d 48 (3d Cir. 1949); *Thompson v. United States*, 148 F. Supp. 910 (E.D. Pa. 1957).

[56] Reg. §20.2041-1(d).

[57] *Id.*

[58] Reg. §20.2041-1(d); *see Wilson v. Kraemer*, 190 F.2d 341 (2d Cir. 1951); *Estate of Kerr v. Commissioner*, 174 F.2d 555 (3d Cir. 1949); *Guaranty Trust Co. of N.Y. v. Johnson*, 165 F.2d 298 (2d Cir. 1948).

[59] §2041(a)(1).

[60] *See, e.g.,* PLR 200225015, PLR 200205033.

[61] Reg. §20.2041-2(f)

[62] *See e.g.*, PLR 201803003.

ii. Post-October 21, 1942 Power.

Unlike pre-October 22, 1942 powers, the mere possession of a post-October 21, 1942 general power by a decedent at the time of his or her death results in the inclusion of the property subject to the power in the decedent's estate under §2041(a)(2). The fact that the decedent failed to exercise his or her power is irrelevant for purposes of §2041. The key consideration is whether the decedent in fact possessed a post-October 21, 1942 power.[63]

A common type of general power that exists at a decedent's death is often inappropriately overlooked for estate tax purposes. This type of power is a so-called "five and five" power. While the lapse of this type of power will not cause transfer tax consequences, if the power for the year of the power holder's death is exercisable as of death, then it is includible in the power holder's estate for estate tax purposes as a general power of appointment.

A post-October 21, 1942 general power released by a decedent at the time of his or her death is subject to estate tax.

A disclaimer or renunciation of a general power of appointment created before January 1, 1977, which is unequivocal and effective under local law, is not considered a release of the power.[64] A disclaimer or renunciation of a general power of appointment created in a transfer after December 31, 1976 is not considered a release of the power, provided the requirements of **§2518** have been satisfied.[65] An executor may also disclaim effectively on behalf of a deceased power holder.

In general, the lapse of a post-October 21, 1942 general power is considered to be a release of that power.[66] Therefore, if the lapse occurs at the time of the decedent's death, it is subject to estate tax. Each separate lapse of a post-October 21, 1942 power is deemed to constitute a separate and distinct release for purposes of §2041. A nongeneral power includes a power that allows the decedent to appoint a certain limited amount of property each year in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate on a noncumulative basis. This annual amount is limited to the greater of $5,000 or five percent of the aggregate value, at the time of each lapse, of the assets out of which, or the proceeds of which, the exercise of the power could have been satisfied. Therefore, a lapse of a power annually, under which the decedent is permitted to appoint the greater of $5,000 or five percent of the corpus, is not treated as a general power and escapes tax under §2041.

2. Gift Tax Consequences.

The gift tax consequences regarding powers of appointment, addressed in §2514, generally parallel the estate tax ramifications of such powers, described above. So, for example, §2514 prescribes different gift tax consequences for general powers of appointment, depending on whether the power was created on or before, or after, October 21, 1942. However,

[63] §2041(a)(2).

[64] Reg. §20.2041-3(d)(6)(ii).

[65] Reg. §20.2041-3(d)(6)(i), referencing Reg. §25.2518-2(c)(3) for rules relating to when the transfer creating the power occurs.

[66] §2041(b)(2).

there are a number of issues and questions raised by §2514, which are not encountered under §2041.

a. Definition of "Exercise".

If a donee exercises a general power, regardless of the date on which it was created, such exercise is deemed a transfer of property by the donee, and the property subject to the power is accordingly subject to the gift tax.[67]

i. Pre-October 22, 1942 Power.

If a pre-October 22, 1942 general power is not exercised by the donee, there is no gift tax liability as a result of the existence of the power. The treatment of releases of pre-October 22, 1942 powers for gift tax purposes largely parallels the treatment for estate tax purposes. A donee may not only release a pre-October 22, 1942 power, but may also disclaim or renounce such a power without any gift tax consequences under §2514.

ii. Post-October 21, 1942 Power.

The exercise or release of a general power of appointment created after October 21, 1942 is deemed a transfer of property by the done and is subject to gift tax.[68] Releases can occur in unusual ways. For example, a taxable release of a general power of appointment occurs when the donee resigns from a committee responsible for administering a profit sharing account from which the donee could have received distributions.[69] In *Estate of Robinson v. Commissioner*,[70] however, the Tax Court held that a decedent did not make a taxable release of her power of appointment in a marital trust when she entered into an agreement with the residuary legatees that resulted in the termination of the trust and the distribution of trust assets outright to her. The agreement converted the decedent's general testamentary power into an inter vivos power that she, in effect, exercised in favor of herself. Since no interest in trust property was conveyed to another person, no gift occurred.

A qualified disclaimer or renunciation of a general power of appointment created before January 1, 1977, which is unequivocal and effective under local law, is not considered a release of the power.[71] A disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976 is not considered a release of the power for gift tax purposes provided the requirements of §2518 have been satisfied. An executor may disclaim on behalf of a deceased holder of a power.

A lapse is considered a release, except for the "five and five" provisions. In general, the lapse of a post-October 21, 1942 general power is considered a release of a post-October 21, 1942 power under §2514(e), and a transfer of property subject to the lapsed power will occur.

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[67] §2514(a), §2514(b).

[68] §2514(b).

[69] TAM 9018002.

[70] 101 T.C. 499 (1993).

[71] Reg. §25.2514-3(c)(6).

A lapse is treated like a release for gift tax purposes, *but only to the extent that* the property that could have been appointed by exercise of the lapsed power of appointment exceeds the greater of $5,000 or five percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.[72]https://www.bloomberglaw.com/product/tax/document/4901957672 - A0Q7C3A2Q5A0Q7C3A2Q5

For example, assume Donor establishes a trust with a value of $200,000, granting Donee a noncumulative right to withdraw $10,000 a year from the principal of the trust fund. Donee fails to exercise this right the first year. This lapse will not constitute a taxable gift, since the withdrawal right ($10,000) is not greater than the greater of $5,000 or five percent of the value of the trust. Assume that, at the end of year two, the value of the trust has decreased to $80,000. Donee again fails to exercise the right. This year a gift will occur to the extent that the amount of the withdrawal right ($10,000) exceeds the greater of $5,000 or five percent of the value of the trust (five percent of $80,000, or $4,000). Therefore, the gift this year will be $5,000 ($10,000 minus $5,000).[73]

II. Important Uses of Powers of Appointment in Estate Planning.

A. Overview.

Many estate planners are talking about "flexibility" in planning by using trust protectors or advisors, or through decanting. But using powers of appointment are in most cases a better alternative when available, because they can be exercised in a nonfiduciary capacity.

B. General Powers.

1. Using General Powers of Appointment in Marital Deduction Trusts

One obvious use of a general power of appointment is to qualify a trust for a surviving spouse for a marital deduction under § 2056(b)(5). A general power exercisable by a surviving spouse by will or otherwise at his or her death will qualify as a general power for § 2056(b)(5) purposes, but so will an unlimited power to withdraw trust property.[74]

When a surviving spouse has a general power of appointment that meets the requirements of § 2056(b)(5), the trust will automatically qualify for the marital deduction. In this situation the trust will not be eligible for a qualified terminable interest or "QTIP" election under § 2056(b)(7). If the spouse has such a power and the trust automatically qualifies for the marital

[72] §2514(e); Reg. §25.2514-3(c)(4).

[73] Reg. §25.2514-3(c)(4).

[74] *See* Treas. Reg. § 20.2056-5(g)(1)(i).

deduction, then a decedent's estate could lose valuable post-mortem tax planning opportunities, such as the ability to make partial QTIP and reverse QTIP elections. Casner & Pennell, *supra*, at § 13.5.6.1 at 13-263. On the other hand, nothing in the legislative history for § 2056 addresses the issue regarding the "overlap" between § 2056(b)(5) and (b)(7), and nothing in § 2056(b)(7) or the related Treasury Regulations expressly preclude a QTIP election for a qualified transfer because the transfer also would qualify under § 2056(b)(5).

Giving a surviving spouse the right to withdraw property of a marital trust can be a very helpful power in case the surviving spouse wishes to make gifts of property in the marital trust. Under the marital deduction rules, the spouse must be the exclusive lifetime beneficiary of the marital trust for the trust to qualify for the marital deduction as either a general power of appointment trust or a QTIP trust. If, however, the spouse can withdraw trust property, he or she can potentially use the property of the trust, which would have a received a new basis on the death of the first spouse to die, to make gifts and engage in freeze-type planning. In this case the general power of appointment will be very helpful.

Just because a spouse can withdraw trust property and give it to another person or give property distributed to the surviving spouse to another person does not make the trust ineligible for a marital deduction. In fact, a spouse's power to do so is specifically contemplated in Treas. Reg. §20.2056(b)-7(d)(6) ("The fact that property distributed to a surviving spouse may be transferred by the spouse to another person does not result in a failure to satisfy the requirement of [§] 2056(b)(7)(B)(ii)(II)"). On the other hand, Treas. Reg. § 20.2056(b)-7(d)(6) provides that if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of § 2056(b)(7)(B)(ii)(II) is not satisfied. Therefore, a trust instrument that is intended to qualify for marital treatment cannot require that property withdrawn by or distributed to the surviving spouse be used for gift purposes.

Many lawyers like to recommend using a QTIP trust because of the post-mortem planning opportunities it presents. A QTIP trust, however, can also give the surviving spouse a right to withdraw trust property and remain eligible for a QTIP election and the post-mortem planning benefits it provides. For example, a client could give a surviving spouse the power to withdraw trust assets that does not meet all the requirements for a general power of appointment under § 2056(b)(5), such as making the power exercisable starting only a year after the decedent's death.[75]

In TAM 8943005, the IRS concluded that the surviving spouse's power to appoint up to $5,000 or 5% of the trust corpus annually constituted a general power of appointment but nevertheless opined that the trust qualified as a QTIP trust under § 2056(b)(7). The IRS opined that the surviving spouse's general power of appointment though exercisable in favor of other people, did not run afoul of the legislative intent behind the marital deduction generally and § 2056(b)(7) specifically, because any further appointment by the surviving spouse would be subject to gift tax. The IRS did not address or even mention the possibility of a marital deduction for the trust

[75] *See* Casner & Pennell, Estate Planning § 13.5.2.1 (6th ed. 1999)(describing the requirements for a general power of appointment marital trust under § 2056(b)(5) and pointing out that an intended but defective general power of appointment marital trust may qualify for a QTIP election); § 13.5.6.1.3 (suggesting imposing a delay on the exercise of a power or requiring the spouse to obtain the consent of a third party to the exercise of the power).

under § 2056(b)(5). It is noteworthy that the IRS opined that the trust qualified as a QTIP trust because § 2056(b)(7)(B)(ii)(II) specifically disallows such a power, even in the hands of the surviving spouse.

2. Using General Powers to Choose Estate Tax and Applicable Credit Instead of GST Tax

If an irrevocable trust established after 1985 is not fully exempt from the GST tax, a taxable termination may occur at the death of the last to die of the nonskip person beneficiaries of the trust. If, however, a nonskip person beneficiary has unused estate tax applicable credit, it may make more overall tax sense to substitute the estate tax for the GST tax by giving the nonskip person a testamentary general power of appointment over the trust assets. Whether or not the beneficiary exercises the power, the trust property will be included in the beneficiary's gross estate.

One way to trigger estate tax inclusion instead of GST tax is for the trustee to exercise a fiduciary power built into the trust instrument to give a nonskip person beneficiary a general power of appointment. Another possible way route to giving a nonskip person beneficiary a general power of appointment would be for the beneficiary to act as trustee of a trust that does not have an ascertainable standard for distributions. Under § 2041(b)(1), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that a power which is limited by an ascertainable standard is not deemed to be a general power of appointment.[76]

If a beneficiary is acting as trustee and can make distributions to himself or herself, and the distribution standard in the trust is not limited to an ascertainable standard, the beneficiary-trustee will be treated as having a general power of appointment over the trust property. For this to work, the governing trust instrument and state law cannot restrict the beneficiary from serving as trustee or otherwise have a "savings clause" that would limit the beneficiary's discretion if acting as trustee. In Washington there may be a practical limitation to using this approach by reason of RCW 11.98.200, which prohibits a beneficiary acting as trustee from making distributions to himself or herself if distributions are not limited to an ascertainable standard.

If there is no suitable mechanism to give the beneficiary a general power of appointment over the nonexempt trust, consider whether the trust can be modified or decanted to add such a power. There may be a provision in the trust instrument that authorizes the modification of the trust. Alternatively, the trust could be modified under state law pursuant to a nonjudicial settlement agreement, decanting, court reformation or otherwise. Careful review of all the relevant facts, trust provisions, state law considerations and tax consequences should be undertaken before taking affirmative steps to give a beneficiary a general power of appointment over a nonexempt trust. In particular, if the beneficiary resides in a state with an estate tax but not GST tax, such as Washington or Oregon, the GST tax may be cheaper than the combined federal and state estate tax or the state estate tax alone if the trust has an inclusion ratio that results in a fairly low rate of GST tax.

[76] *See* Treas. Reg. § 25.2041-1(c).

3. Exercising a Presently Exercisable General Power to Start a New Rule Against Perpetuities Period Running

Under general principles of property law, as well as the Uniform Statutory Rule Against Perpetuities, the "starting date" to determine when property must vest under a rule against perpetuities starts at the creation of the nonvested interest. If a person has a nongeneral power of appointment of any kind or a testamentary general power of appointment, his or her exercise of the power does not start a new perpetuities period running. Instead, the exercise relates back to the date the power was created, which means that the power must be exercised in a way that ensures all interests in the trust must vest within the perpetuities period that applied when the trust was first settled.[77]

If, however, a beneficiary has a presently exercisable general power of appointment that allows him or her to unconditionally vest the trust property in himself or herself, the "relation back" rule does not apply. Instead, the measuring date for applying the relevant rule against perpetuities period will be the first to occur of the date that the power holder exercises the power or the power terminates (i.e. by reason of the death of the power holder). This rule applies only if the power is unconditionally exercisable; a condition precedent to its exercise will not qualify for the exception to the relation back rule.[78]

Based on these rules, if a person has a presently exercisable general power of appointment, he or she can exercise it to settle a new trust with a longer perpetuities period. This may be helpful in a state like Washington where the current rule against perpetuities is now longer than the common law rule or in other states where there is no longer a rule against perpetuities. The exercise of the power, however, will be a taxable gift under § 2514 and will make the power holder the transferor for GST tax purposes, so the power holder will need to consider the tax implications of the exercise of the power. A trustee or other fiduciary with the ability to confer such a power on a beneficiary will need to consider the tax implications and the fiduciary implications of conferring such a power on a beneficiary.

4. Exercising a General Power to Obtain a New Basis in Non-U.S. Situs Assets in the Estate of a Nonresident Alien Decedent.

Under general principles of U.S. federal income tax law, any assets includable in the gross estate of a decedent receive a new basis on the decedent's death whether or not the decedent had a taxable estate or whether the estate paid estate tax. If, however, the decedent was a nonresident alien, this blanket rule applies only to the decedent's U.S. situs assets; the decedent's non-U.S. assets do not automatically receive a step up in basis. This general rule suggests that U.S. beneficiaries of the estates of nonresident aliens may receive assets with carryover basis rather than a new basis.

This lack of an automatic step up in basis is not typically an issue for many nonresident alien decedent's estate because a U.S. citizen or resident beneficiary will receive a step up in basis for

[77] *See,* e.g., RCW 11.98.130 (property subject to the exercise of a power of appointment created in an instrument must vest within 150 years of the date of that instrument); RCW 11.98.010 (recodified in 1984 as RCW 11.98.130, applying a "wait and see" approach based on the common law rule against perpetuities for trusts created before January 1, 2002).

[78] *See* Uniform Statutory Rule Against Perpetuities ("USRAP") § 2 (and comments to 2(a) and 2(b)).

non-U.S. situs assets passing to the beneficiary under the decedent's will or by intestate succession.[79] Similarly, assets passing from a nonresident alien's revocable trust typically, though not always, receive a new basis on the decedent's date of death on the decedent's non-U.S. situs assets.[80] A U.S. beneficiary who receives non-U.S. situs assets from a trust over which a nonresident alien decedent has a general power of appointment, however, will not automatically receive a new basis in those assets. Instead, the U.S. beneficiary will receive the assets with a new basis only if the power holder exercises the general power of appointment at death by will.[81] For this reason, it may make sense for a nonresident alien who has a testamentary general power of appointment over non-U.S. situs assets to exercise the power so as to give the beneficiary the assets with a new basis. Of course, the decedent's exercise of a testamentary general power of appointment may cause tax issues in his or her country of residence, so all concerned should also address those issues.

C. Other Considerations.

Powers of appointment, both nongeneral and general, are very useful tools to allow flexibility in estate planning. What follows are a few general ideas for their use.

1. Basic Drafting Tips.

What follows is a summary of those drafting items practitioners should consider including in their documents.

a. Carefully Draft If Entities Are to Be Permissible Appointees of a Nongeneral Power.

If a will or trust ostensibly creating a nongeneral power grants a beneficiary the power to appoint to "such persons and entities, other than the beneficiary, her estate, her creditors, and the creditors of her estate, as she may appoint by will," the power could be deemed to be a general power of appointment if the beneficiary owns an interest in any kind of entity. For example, assume the beneficiary is a 50% shareholder in a closely held corporation. Under the power described above, the beneficiary could appoint the property to the corporation. Because she owns a 50% interest, that same percentage of the property subject to the power could be includible in her gross estate under §2041. To avoid this result, either limit the permissible appointees to "individuals," not "persons" or "entities"; or limit the types of entities to which the property may be appointed (for example, only those entities in which the beneficiary has no ownership interest). Alternatively, the practitioner could include some type of savings clause (i.e., "anything in this instrument to the contrary notwithstanding, the beneficiary shall not have any power that will cause the property subject to a power of appointment to be includible in her gross estate under section 2041 of the Code"). However, this latter choice not only is more cumbersome, it could be used too broadly.

[79] § 1014(b)(1).

[80] § 1014(b)(2).

[81] § 1014(b)(4).

b. When Naming a Class of Appointees, Exclude the Power Holder from the Class.

This should be self-evident, but practitioners can get caught very easily. For example, assume parent creates a trust for the benefit of child during child's lifetime, and wants child to have a nongeneral power of appointment at child's death, exercisable among other children and grandchildren. It is easy to say that child has the power to appoint to parent's "issue"; however, child as power holder has the power to appoint to himself or herself and, therefore, has a general power of appointment. The proper way to identify the permissible appointees under the power is "trustor's issue other than child."

c. Do Not Give a Power Holder the Right to Relieve Support Obligations.

Another easy way to get caught in this area is to exclude the power holder from the class of permissible appointees, but to allow that power holder to exercise the power in a manner that could relieve the power holder of his or her obligation of support. This is particularly true for powers of appointment exercisable during life. The IRS in PLR 9036048 has created a helpful example of how to properly avoid giving a beneficiary the power to relieve his or her obligation of legal support.

d. When Drafting an Ascertainable Standard, Stick to the Exact Words in the Regulations.

As already noted, the terms that prescribe an "ascertainable standard" are set out clearly in the regulations under §2041 and §2514. If the practitioner wishes to create a trust over which the beneficiary may be a trustee, and an ascertainable standard is to be used to avoid giving a beneficiary a general power of appointment, the practitioner should use "health, education, maintenance, and support" as the principal distribution standard. If the client insists upon using terms more broad than those four, the practitioner should limit the language to those examples set forth in the regulations. Given the continued litigation over the word "comfort," it is amazing how often this word appears in powers of appointment that were intended as nongeneral powers. This word should be avoided in nongeneral powers of appointment unless it is used exactly as it is in the regulations. However, it should not be relied upon, by itself, to create a general power of appointment either.

e. When Drafting a Power of Appointment, Allow the Donee the Greatest Flexibility.

There is some question whether the donee of a nongeneral power of appointment can appoint in trust and whether the default terms in a trust instrument (those that apply to "every trust" created under the instrument) apply to trusts created under a power of appointment that was created in that instrument. To avoid controversy, powers of appointment should be drafted clearly, ensuring that the donor's intent is captured. So, for example, if a donee of a nongeneral power is to have the testamentary power to appoint property of a trust for donee's benefit in further trust, subject to whatever terms the donee believes are appropriate, the language creating the power should include text similar to the following:

> Upon donee's death, trustee shall distribute the balance of the trust property, either outright or in trust, to [identify the class of permissible appointees] as donee may appoint by will and specifically referring to this power of appointment. Anything in this instrument to the contrary notwithstanding, any trust created pursuant to this power of appointment shall not be considered a trust created under this instrument.

Note that this is very broad language and may be inappropriate in certain circumstances. Another approach is to exclude the last sentence of the sample language above and instead make specific exceptions in the default provisions that the donor does not wish to apply to trusts under the power of appointment. So, for example, the spendthrift provision might state that "no interest in any trust under this instrument (other than a trust created pursuant to a power of appointment under this instrument) shall be anticipated, encumbered," etc.

2. Power of Appointment Allows for Discretionary Distributions.

We're all familiar with the movement in the last thirty years, culminating in the Uniform Prudent Investor Act, to view trust administration and drafting in light of the modern portfolio theory.[82] Although a detailed explanation of that theory is beyond the scope of these materials, it can be summarized as promoting trust asset investing on a "total return" basis, considering the total return in both income and growth from all assets. This is a departure from the historical perspective, which emphasized the character of the return under trust accounting principles.

The problem with investing on a total return basis is that, if the current trust beneficiary is entitled to "income" in the trust accounting sense only, that beneficiary will receive few if any distributions during years when growth assets (e.g., stocks) are outperforming income-producing assets (e.g., bonds). As a result, trustees will not be inclined to adopt a total return investment approach if it will place the current beneficiary at an economic disadvantage. In order for trustees to take advantage of this investment approach, the trust must be drafted to allow an acceptable return to all beneficiaries, current and remainder.

One way to ensure that the interests of all beneficiaries are protected is to allow principal distributions to be made to the current beneficiary. This can be done in one of two ways, each of which may involve using a power of appointment: (i) the trustee or other third party (like a trust protector) can have the discretion to make distributions to the current beneficiary; or (ii) that beneficiary can have a withdrawal power. Because many trusts provide that a beneficiary is or could be the trustee, if the former approach is taken, the trustee's withdrawal right should be limited by an ascertainable standard. If the latter approach is used, the beneficiary's withdrawal right should be limited to the greater of five percent of the trust assets or $5,000.

A third approach, of course, is to use a "total return" trust or "private unitrust," under which the current beneficiary is entitled to an automatic percentage of the trust assets without regard to its character as income or principal. In the author's view, this is not a substitute for discretionary principal distributions that many clients favor.[83]

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[82] *See, e.g.,* Horn, Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the 'Give-Me-Five' Unitrust, 33 Real Prop., Prob. & Tr. J. 1 (Spring 1998), for an early example of the movement.

[83] *See, e.g.*, Cline & Jory, *The Uniform Prudent Investor Act: Trust Drafting and Administration*, 26 Est. Plan. 451 (Dec. 1999).

3. Use Nongeneral Powers to Accomplish Family Goals.

Except when tax considerations or personality issues direct otherwise, trusts should include at least a nongeneral power of appointment. Inclusion of such a power prevents the problem of a beneficiary who is unable to handle his or her assets from taking trust property outright automatically. So, for example, a trust created by Parent for Child's lifetime benefit usually should include a nongeneral power of appointment for Child at death to appoint among Parent's issue. Such a power allows Child to make specific directions for specific beneficiaries, including the exclusion of certain beneficiaries, the creation of special needs trusts, and so on. The donor can control the exercise of the power by limiting the power's scope to a greater or lesser degree.

4. Use Powers to Determine Distribution Levels.

One key to flexibility in estate planning is to allow for the greatest possible flexibility in trust distributions. Such flexibility allows a beneficiary to have as much property as he or she needs, but also allows for skipping a beneficiary entirely if that beneficiary already has independent resources. A truly flexible distribution power would be at the complete discretion of the power holder, without regard to ascertainable standards. However, the beneficiary cannot hold such a power without subjecting the trust property to either estate or gift tax.

One possible solution is to name an independent trustee (or trust advisor) to hold this discretion. As a check on that trustee's discretion, it would be preferable for the beneficiary to be able to remove and replace that trustee. Such was the situation in PLR 9845014. As in that private ruling, the beneficiary should not be able to appoint as a successor any related or subordinate person as defined in §672(c). Further, the beneficiaries should avoid any reciprocal arrangements that might subject the trust property to estate tax.

The problem, of course, is that a trustee of any sort has a fiduciary obligation and therefore may not be able to exercise as much discretion over distributions as he or she may want if it works to the detriment of other beneficiaries. Giving a third party the lifetime nongeneral power to appoint among existing beneficiaries would allow greater latitude, without exposing that third party to fiduciary liability.

5. Extending the Term of a Trust if Permitted.

A trust that is grandfathered for GST purposes, or that is GST exempt, may not be drafted to last as long as it might be. Nongeneral powers of appointment can be exercised by transferring the property in further trust to extend the life of the trust as long as possible.

There are two potential limitations to this technique. First, the practitioner would need to determine which state law governs the administration of the trust; if that state has an applicable rule against perpetuities, the trust created under the exercised would be limited by that rule. Second, there is some question whether a nongeneral power of appointment is subject to the rule against perpetuities savings clause in the trust that grants the power.[84]

6. Adding beneficiaries in a Nonfiduciary Capacity.

[84] For more details, see II.B.3, above.

A common reason for adding special trustees or trust protectors is to allow those parties to name additional beneficiaries not originally contemplated in the trust agreement. Some have argued that decanting of the trust is another technique for doing so. While these approaches have some usefulness, they are limited by the fact that, if the party holding the power to add the beneficiaries is also a fiduciary, his or her fiduciary duty to existing beneficiaries probably precludes adding future beneficiaries.

A nongeneral power of appointment held by a third party solves this problem, because power holders are not subject to fiduciary obligations.

III. Little Known Facts About Powers of Appointment.

A. Some General Powers of Appointment Do Not Attract Estate or Gift Tax.

Estate planning lawyers are used to thinking that a client's possession of a general power of appointment means that the property subject to the power is subject estate or gift tax. If, however, a client has a general power of appointment that was created on or before October 21, 1942, the client or his or her estate will not be subject to estate tax unless the client actually exercises or releases that power.[85] If the client does not exercise the power and simply lets it lapse, the property subject to the power will not be subject to estate tax or gift tax by reason of the lapse.

[85] *See* § 2041(a)(1); § 2514(a).

B. Contracts to Exercise or Not Exercise Powers of Appointment Not Presently Exercisable are Not Enforceable

Lawyers are generally familiar with contracts to make wills, which courts will generally enforce as long as the contract is an otherwise valid contract. On the other hand, if a person who holds a power of appointment that is not presently exercisable enters into an agreement to exercise the power in a particular manner, that agreement is not enforceable. If the power holder breaches the contract, the other party to the contract cannot obtain damages for breach or specific performance of the contact. The First, Second, and Third Restatements of Property all have this rule, though the Restatement (Third) of Property – Donative Transfers carves out an exception to this rule for a power created by the donor in himself or herself in a revocable trust that the donor settled.[86] The Washington version of the Uniform Powers of Appointment Act, which the state adopted in 2021 and which takes effect on January 1, 2022, contains these rules.[87] Similarly, a contract to not revoke a will in which a donee exercises a power of appointment is also not enforceable.

The reason that such contracts are not enforceable is because the donor of the power did not intend to allow the donee of the power to exercise it until it actually becomes exercisable. If the donee of the power could contract to exercise or not exercise the power in a particular manner before it became exercisable, that would mean that in substance the power is presently exercisable. Because this would defeat the donor's intent in granting a power of appointment exercisable in the future, courts will not enforce agreements of this kind. In other words, when a donor gives a donee a power of appointment exercisable in the future, the donor intends for the donee to select the appointees based on the facts and circumstances that exist at the time the power becomes exercisable and not before.

Despite these rules, if the donee of a power enters into a contract to exercise or not exercise a power and actually performs the agreement, the appointment or nonappointment is not invalid a long as the exercise or nonexercise does not have the effect of benefiting a nonpermissible appointee.[88] Also, a person who agrees with donee of a power to exercise or not exercise the power is not without a remedy if the donee fails to perform. In this situation the counterparty may be entitled to restitution from the donee for the consideration the counterparty paid the donee.[89]

C. Attempts to Exercise a Power of Appointment to Indirectly Benefit Nonpermissible Appointees are Void.

From time to time the holder of a power of appointment may attempt to exercise the power in a way that benefits an impermissible appointee. For example, the holder of a nongeneral power of

[86] *See* Restatement of the Law of Property (1940), § 340; Restatement (Second) of the Law of Property: Donative Transfers (1986) § 16.2; Restatement (Third) of the Law of Property: Wills and Donative Transfers (2011) § 21.2.

[87] *See* Washington Law ch. 140, Part III, section 3406 (to be codified as part of a new chapter of title 11 of the RCW).

[88] *See* Restatement (Third) of the Law of Property: Wills and Donative Transfers (2011) § 21.2, comment (c).

[89] *Id*.

appointment may agree with a creditor that the holder will exercise the power in favor of a relative of the creditor in exchange for the creditor relieving the power holder from a debt. As discussed above, such a contract is not enforceable if the power is not presently exercisable. More generally, though, the holder's actual exercise of the power in this manner is void because it benefits an impermissible appointee – a creditor of the power holder.[90]

A similar situation may result when the holder of a nongeneral power of appointment agrees to appoint property to a permissible appointee based on the agreement of that appointee to give the property to another person who is not a permissible appointee. If the holder fails to exercise the power, the contract is not enforceable. If the holder does exercise the power, it will be void.[91]

In all of these situations the exercise is void because it is a "fraud on the power," which is another way of saying that the holder of the power attempted to exercise the power for an impermissible purpose or in favor of an impermissible appointee. The Restatement (Third) has many examples of how a fraud on a power may occur, such as an agreement by the donee of a power to exercise it in favor of a permissible appointee who will in turn give the property to an impermissible appointee. The view of the authors of the Restatement (Third) is that depending on the power holder's motives in exercising the power in a way that benefits an impermissible appointee, the entire exercise may be void even if there is a part of the appointment that is permissible. The comments to the Restatement (Third), however, note that in situation motives may be hard to prove because of oral agreements.

The rules related to fraud on a power of appointment are closely related to the rules that prohibit enforcement of contracts to exercise or not exercise powers of appointment that are not presently exercisable. In many cases the power holder is attempting to do indirectly what he or she could not do indirectly: confer a benefit on an impermissible appointee. At a minimum a court will not enforce the agreement and if the holder actually exercises the power for an improper purpose, the court will void the exercise. In this way a court preserves the intentions of the donor of the power.

D. Exercising a Nongeneral Power of Appointment or a Testamentary General Power of Appointment Does Not Start a New Perpetuities Period (Except When it Does).

As discussed above, as a general matter of trust law the exercise of a nongeneral power of appointment or a testamentary general power of appointment does not allow for the start of a new perpetuities period. Instead, the exercise relates back to the date that the power was originally granted, and any new nonvested interests created by the exercise must vest during the perpetuities period that applies to the original trust.[92] Accordingly, when a beneficiary of a trust that is subject to the rule against perpetuities exercises a power of appointment, the resulting nonvested interests must vest by the original perpetuities date of the trust. In a state that relies on

[90] *See* Washington Law 2021 ch. 140, Part III, section 3307; Restatement (Third) of the Law of Property: Wills and Donative Transfers (2011), § 19.16.

[91] Restatement (Third) of the Law of Property: Wills and Donative Transfers (2011), § 19.16, comment (b).

[92] *See*, e.g., RCW 11.98.130.

a period measured by lives in being on the date of the creation of the power the power holder may be able to add additional measuring lives when he or she exercises the power, which can effectively extend the life of the trust. But in the final analysis the power holder must exercise the power so that all interests vest by the perpetuities date or else the exercise will be invalid.

Despite all of that, there are some exceptions to this rule. Under the common law of powers of appointment, the exercise of a nongeneral power of appointment to create a presently exercisable general power of appointment shifts the starting date for the application of the rule against perpetuities to the date of the exercise of the nongeneral power. In a few states, the exercise of a nongeneral power to create a testamentary general power of appointment would shift the measuring date to the date of the exercise of the nongeneral power. Finally, in a few states the exercise of a nongeneral power to create another nongeneral power may shift the measuring date to the date of the exercise of the first power. For example, when Delaware had a rule against perpetuities for intangible property, it had this rule. Arizona also has a rule of this kind, though it requires a deliberate exercise of the nongeneral power to shift the measuring date forward.

Under federal gift tax and estate tax law, however, if the exercise of a nongeneral power of appointment starts a new perpetuities period running that does not refer to the date of the creation of the power, the exercise of the nongeneral power is treated as an exercise of a general power (the "Delaware tax trap").[93] As noted above, the Delaware tax trap can usually be triggered only by exercising a nongeneral power of appointment to create a presently exercisable general power of appointment. In this situation, the date of the exercise of the nongeneral power of appointment is the start date for the running of the rule against perpetuities with respect to the later exercise of the general power of appointment. In a few states, however, the exercise of a nongeneral power to create a testamentary general power or to create another nongeneral power may trigger the Delaware tax trap.

The exercise of a nongeneral power of appointment that starts a new perpetuities period running may be helpful to cause assets to be included in a decedent's gross estate for federal estate tax purposes and therefore qualify for a new basis under § 1014. This could be useful in a situation in which the power holder's estate is less than his or her estate tax-free amount. On the other hand, the unintentional resetting of the measuring date by the exercise of a nongeneral power may result in an unfortunate tax situation. For example, triggering the Delaware tax trap for a trust that is exempt from the GST tax by reason of its effective date or by reason of the allocation of exemption will cause the transferor to shift to the power holder and require a recalculation of the trust's inclusion ratio. Similarly, exercising a nongeneral power to spring the Delaware tax trap may trigger state death taxes that might not otherwise be due.

E. <u>There is a Federal Rule Against Perpetuities for Some Nongeneral Powers of Appointment</u>.

We're used to thinking about the relationship of powers of appointment and the rule against perpetuities as a state law matter. There is, however, an effective federal rule against perpetuities that applies to the exercise of general powers of appointment over trusts that are grandfathered

[93] *See* § 2041(a)(3); § 2514(d).

from the GST tax. Under the GST tax effective date regulations, the exercise of a nongeneral power of appointment over a pre-effective date trust generally does not cause a loss of the trust's GST exemption as long as the exercise does not trigger a federal gift tax or estate tax.[94]

If, however, the power holder exercises the power in a way that postpones the vesting, absolute ownership, or power of alienation of trust property for a period that exceeds the common law rule against perpetuities (lives in being plus 21 years) measured from the date of the creation of the nongeneral power, the exercise will be treated as a constructive addition to the trust, which shifts the transferor to the power holder and will cause a change in the trust's inclusion ratio.[95] There is an exception to this rule if the power holder validly exercises the nongeneral power to postpone the vesting, absolute ownership, or power of alienation of property for period not to exceed 90 years from the date of the creation of the power, which is essentially the "wait and see" rule of the USRAP.[96]

These rules in the GST tax effective date regulations apply regardless of the applicable state law. Because this federal rule applies only to trusts created before 1986, it is likely to have little practical significance because the movement for states to abolish their rules against perpetuities did not gather steam until the 1990s. For example, Washington's 150-year rule against perpetuities generally applies only to trusts established on or after January 1, 2002, which means that no trust exempt from the GST tax by reason of its effective date would have a power of appointment that could trigger a constructive addition to a new trust.

F. Can a Client Give a "Naked" Power of Appointment?

The essential characteristic of a power of appointment is that it is a personally held power exercisable by the holder in a nonfiduciary capacity. We are used to thinking of a trust beneficiary having a power of appointment as part of his or her beneficial interest in a trust. If someone other than a trust beneficiary has a power to designate the recipient of an interest in trust property, we usually think of that as a fiduciary or trustee-held power, which is not a "power of appointment."

However, it is possible for a donor to give an individual a power of appointment without that individual otherwise having an interest in the property subject to the power. This is referred to as a "naked" power and may at first glance to seem to present a planning opportunity, particularly if giving a beneficiary a power of appointment might otherwise raise gift tax issues. The Restatement (Third) of Property and the Uniform Power of Appointment, which will become law in Washington on January 1, 2022, act both seem to limit the use of a "naked" power by providing that the instrument that creates the power must also transfer the appointive property.[97]

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[94] *See* Treas. Reg. § 26.2601-1(b)(v)(A).

[95] Treas. Reg. § 26.2601-1(b)(v)(B)(2).

[96] *Id*.

[97] *See* Washington Law 2021 ch. 140, Part III, section 3201(a)(ii); Restatement (Third) of Property: Wills and Other Donative Transfers (2011) § 18.1 ("A power of appointment is created by a transfer that manifests an intent to create a power of appointment.").

This requirement is fairly easy to satisfy in the trust context if a settlor transfers property to a trustee and gives a nonbeneficiary a power of appointment over the property. On the other hand, if an individual owns property the Restatement and the Uniform Act suggest that the individual cannot simply give another person the power to transfer an ownership interest in that property. It seems unlikely that an individual would ever give such a "naked" power to another person, who could potentially trigger gift tax liability to the donor of the power by exercising the power. To this extent, the "instrument" limitation seems not particularly important (but has been criticized nevertheless).[98]

Giving an individual a naked power, however, may raise a question of whether the power is actually a fiduciary distributive power. If the power passes from one individual on his death or some other event to another individual, then the power will almost certainly be treated as a fiduciary power rather than as a true power of appointment. Clients typically want a third party to have a distribution power to help implement their intent over decades. Simply giving an individual a power of appointment that will vanish when the holder dies is not an effective way to implement a client's intent. Among other things, the power holder may die before exercising the power, causing a loss of the flexibility that the client intended to obtain by giving the power. Viewed in this light, a fiduciary distributive power is a much more effective way to add flexibility to a trust arrangement.

Even if a naked power was clearly personally held by an individual alone, it is possible that a court would consider the power to be a fiduciary power under the facts and circumstances related to the trust. For example, if the power passes from one powerholder to another on the death, the power would appear to be a fiduciary power because it is not truly personally held.

Under the Washington Directed Trust Act, a "trust director" with a power over the distribution of trust property is a fiduciary.[99] However, "powers of appointment" are not within the scope of act. The act defines a "power of appointment" as the power of a person acting in a nonfiduciary capacity to designate the recipient of an ownership interest in the trust property.[100] Of course, a "trust director" may have a power over the distribution of trust property, which raises a question of whether a power of distribution held by an individual is a "power of appointment" or a "trust director" power.

The act tries to finesse this issue by providing that any power given to a person to designate the ownership of trust property is a "power of appointment" if the person who holds it is not acting as a *trustee*.[101] However, this is hard to square with the concept of a "trust director" who is not a "trustee" but has a power to designate the ownership of trust property, which apparently is a "power of appointment" under the Act even though a "trust director" is, generally speaking, a fiduciary under the Act. The comment to the Uniform Act calls this a "rule of construction" that can be overridden if the power holder is acting in a fiduciary capacity under the trust instrument.[102] Does this mean that any "trust director" with a power to distribute trust property

[98] *See* Bove, "Don't Be Shy About Using a Naked Power of Appointment," Trusts & Estates, December 1, 2016.

[99] *See* RCW 11.98B.070(1).

[100] RCW 11.98B.030(1).

[101] RCW 11.98B.030(3).

[102] *See* Uniform Directed Trust Act, § 5, Comment 1

actually has a naked power of appointment rather than a fiduciary power? The test may be whether the power passes to a successor "trust director." If so, then the power would appear to be a fiduciary power rather than a naked power.