

Back to Basics: Powers of Appointment

D.C. Bar Taxation Section
Estate Planning Committee
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Agenda

■ Introduction

- Basics
- Key Definitions

■ Tax Considerations

- Income, Gift & Estate, & GST Tax – issues and implications
- Tax consequences of holding and/or exercising

■ Creating & Using Powers of Appointment

- Drafting Tips
- Traps for the Unwary

■ Bonus Materials

- Planning Strategies & Recent Developments

Questions to be Answered

■ Introduction

- What is a Power of Appointment?
- Who are the relevant parties?
- What are the key types and features?

■ Creation, Use, & Tax Considerations

- What are the important tax issues of which to be aware?
- What are the tax implications of holding or exercising?
- How is a Power of Appointment created and exercised?
- What are the important drafting considerations and best practices?

■ Bonus Materials

- What are some planning strategies to consider?
- Are there recent developments to know?

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Introduction

■ Power of Appointment – the power to direct/transfer assets

- *Distinct from a Power of Attorney*
- Often appears in a trust or power of attorney
- Can be General or Limited (Special)
 - ❖ May be limited to an ascertainable standard
- May survive the death of the grantor, or could be revoked during life or at death (via Will)

■ General Power of Appointment Causes Tax Consequences

- Power holder can be taxed on assets subject to the general power (or income therefrom) – even if the power is never exercised!
- Typically want to avoid this outcome (by using a limited power)

■ General Power May Expose Assets to Creditors

- Depends on state law

Definitions

■ Parties

- Grantor – person who grants the power of appointment
- Power holder / Donee – person who holds the power (right) to appoint (transfer) assets
- Permissible Appointees – person(s) in whose favor a power of appointment may be exercised – *could be a class or individual(s)*
- Takers-in-Default – person(s) who receive property if power is not exercised (e.g. if there is a release or lapse of a power)

■ General Power – power holder may appoint assets to:

- (i) Himself or herself, or (ii) his or her estate, or
- (iii) His or her creditors, or (iv) the creditors of his or her estate.

■ Limited Power of Appointment – NOT a general power

- Cannot appoint assets to self, creditors, estate, or estate's creditors
- Or limited by an Ascertainable Standard, or adverse party

Definitions

■ Exercise

- To exercise a Power of Appointment is to use the Power to appoint property to one or more of the eligible appointees
- Requirements:
 - ❖ Intent
 - ❖ Compliance with any rules specified by the grantor and state law

■ Non-Exercise

- Release – power holder voluntarily forfeits all or part of a power
 - ❖ Allowed unless expressly forbidden by the grantor
- Disclaimer – voluntary refusal of property from a decedent's estate
 - ❖ Permitted by common law and most state statutes
- Lapse – failure to exercise the power within the specified time, such that it expires under its own terms

Types of Powers of Appointment

■ General vs. Limited (aka Special or Non-General)

- May be broad or narrow
- Ascertainable Standard (e.g. "HEMS") → Limited Power
 - ❖ HEMS = Health, Education, Maintenance, & Support

■ Presently Exercisable vs. Postponed

- Presently Exercisable = can be exercised now
- Testamentary powers are postponed until power holder dies

■ Other Features & Types

- Imperative powers – must be exercised
 - ❖ Non-Imperative powers are more common
- Exclusive powers – permissible appointees may be excluded
- Powers may be held in a Fiduciary capacity
 - ❖ Can lead to decanting – appointing property from a trust to a new trust

Hypotheticals

- Barack gives Michelle the power to appoint the \$1,000,000 in his bank account to herself or her mother
 - What is this? Consequences?

- Barack gives Michelle the power to pay his bills from and manage the \$1,000,000 in his bank account
 - What is this? Consequences?

- Barack gives Michelle the power to appoint the \$1,000,000 in his bank account to her mother, Uncle Joe, Bill, Hillary, Mitch, John, and Grover.
 - What is this? Consequences?

Tricky Hypothetical

- Mitt puts \$100,000,000 in a Cayman Islands trust and names his wife Ann as the income beneficiary for her life, remainder to his children.
 - He gives Ann the power to appoint up to \$100,000 of principal each year to herself.
 - ❖ What is this? Consequences?

 - He also gives Ann the power to appoint up to \$5,000,000 of principal each year to herself, her mother, their children, and their grandchildren, but only for health and educational expenses.
 - ❖ What is this? Consequences?

 - He further gives Ann the power to appoint up to \$50,000,000 of principal at her death to any descendant of his.
 - ❖ What is this? Consequences?

Reasons for Using of Powers of Appointment

■ Flexibility

- Allow for Changes to:
 - ❖ Circumstances of Beneficiaries
 - ❖ Tax laws
- Permit Correction of Poor Planning or Drafting Errors
 - ❖ After a will matures or an irrevocable trust is funded, revisions are not allowed; exercising a power of appointment may be the solution

■ Reduce Beneficiary Disputes

- Give current beneficiaries power over remainder beneficiaries who otherwise might dispute investment decisions and distributions

■ Reduce Transfer Taxes

- Cause a trust that is not exempt from GST tax to be subject to estate tax instead of GST tax

Possible Disadvantages

■ Tax Reasons

- General Power of Appointment Causes Inclusion in Estate of Power Holder
- If Not Properly Exercised, May Result in Inadvertent Estate Taxation

■ Non-Tax Reasons

- May Allow Permissible Appointee to Unduly Influence Power Holder to Make Changes to Will
- Lack of Control Over Final Disposition of Assets

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General Powers Cause Tax Consequences

- **General Power of Appointment** – only the exercise, release or lapse of a general power of appointment will typically result in tax consequences to the power holder
 - Whether a power is general is largely a question of applicable state property law, but an important federal “safe harbor” exists:
 - ❖ Reg. §20.2041-1(c) – (i) power to consume, invade, or appropriate the property pursuant to a HEMS standard; or (ii) power only exercisable with consent of donor or adverse party
- **Limited Power of Appointment** – by contrast, the exercise, release, or lapse of a limited power of appointment usually does not result in any tax consequences to the power holder
 - Exception: the “Delaware Tax Trap” – when a limited power of appointment is exercised to create another power of appointment that extends the vesting period

Estate Tax Consequences

- **Exercise:** under § 2041(a)(2) all property subject to a general power held by the power holder at death, or exercised by a disposition of such a nature that, if it were a transfer of the power holder's own property, would be subject to estate tax under §2035-§2038 is includable in the power holder's gross estate
- **Release:** a testamentary release of a general power of appointment or a lifetime release of a general power of appointment that involves a disposition of property that would be covered by §2035-§2038 is equivalent to an exercise of the power
- **Disclaimer:** A "qualified disclaimer" under §2518 avoids tax consequences for post-1942 powers
 - **Elements:** (i) must be irrevocable and in writing; (ii) made within 9 months after the power is created or after power holder reaches 21; (iii) power holder has not accepted the interest or any of its benefits, and (iv) the interest passes to someone other than the power holder
- **Lapse:** a power lapses when it expires by its own terms; a lapse is treated as the equivalent of a release of the power
 - **Five and Five Power** – Under §2041(b)(2) if a lapse of a general power of appointment during any calendar year is limited to the greater of (i) \$5,000 or (ii) 5% of the value of the property (at the time of lapse), then there are no estate tax consequences; if it exceeds this threshold, only considered a lapse to the extent of the excess

Exercise During Life May Cause Estate Tax Consequences

- **Example:** Michelle creates a trust that holds an apartment building in which income is payable to Barack for life, remainder to whomever Sasha appoints by deed during her life. After Barack dies, Sasha exercises this power during her life to appoint income from the rent money to herself and appoints the remainder to Malia.
 - Will Sasha incur any estate tax consequences? If so, why?

Five and Five Power Examined

- **Example 1:** Michelle establishes a \$300,000 trust fund for Barack in which Barack has a noncumulative power to invade to the extent of the greater of \$5,000 or five percent of the trust fund each year. Barack fails to exercise his withdrawal right for five years and then dies.
 - Does Barack's estate incur any estate tax consequences? If so, how much is includable?
- **Example 2:** Michelle establishes a \$200,000 trust fund for Barack in which he has the power to invade an amount not to exceed \$20,000 a year. Barack does not exercise his withdrawal right for 2012 and then dies that same year.
 - Does Barack's estate incur any estate tax consequences? If so, how much is includable?

Gift Tax Consequences

- The gift tax provisions for powers of appointment, in §2514, closely parallel the estate tax rules of §2041.
- **General Powers of Appointment**
 - **Exercise/Release:** exercise or release of a general power by the power holder will result in a taxable gift to the extent property subject to the power passes to someone other than the power holder
 - **Lapse:** "five and five" exception applies to determine whether a lapse constitutes a taxable release for gift tax purposes
 - **Disclaimer:** qualified disclaimer pursuant to §2518 is also applicable in the gift tax context
- **Limited Powers of Appointment**
 - **General Rule:** exercise or release of a limited power does not constitute a taxable gift
 - ❖ **Exception:** "Delaware Tax Trap" – when limited power is exercised to create a new power of appointment that can be validly exercised without regard to the date of creation of the first power (i.e. extending the perpetuities period)
 - ❖ **Exception:** the Service takes the position that if a power holder of a limited power of appointment has a life income interest and exercises or releases a limited power to appoint the property to someone other than the power holder, a transfer of an income interest has taken place, which is taxable under general gift tax principles. See e.g. *Estate of Regester v. CIR*, 83 TC1 (1984); but cf. *Self v. U.S.*, 135 F. Supp 939 (Cl. Ct. 1956) (Court of Claims held the income interest in the power holder was extinguished rather than transferred)

Income Tax Consequences

- Power holder is treated as the owner for federal income tax purposes, of any portion of a trust for which the power holder has a power exercisable solely by herself to vest the corpus or the income from the Trust in herself
 - Exceptions:
 - ❖ Pursuant to §678(b), if the grantor of the trust is considered the owner for income tax purposes
 - ❖ Pursuant §678(c), if the power holder, acting in the capacity as trustee or co-trustee, merely applies the trust income to support or maintain a person whom the power holder is obligated to support or maintain, except to the extent that such income is actually so applied
 - ❖ Pursuant to §678(d), the power holder disclaims the power within a “reasonable time” after becoming aware of the existence of the power

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Drafting Tip #1: Do Not Inadvertently Exercise

- **General Rule** – Residuary clause in a will exercises any testamentary powers of appointment held by the testator.
- Avoid the general rule by:
 - (i) including language in the testator's will that makes it clear that the testator does not intend to exercise any power of appointment other than ones that are specifically exercised
 - ❖ **Sample Language:** My residuary estate shall not include any property over which I have, at the time of my death, solely a power of appointment
 - (ii) providing in the document that creates the power of appointment, that any exercise of the power must specifically refer to the power
 - ❖ **Sample Language:** The foregoing power of appointment shall be exercisable by specific reference thereto in the last will and testament of the beneficiary.

Drafting Tip #2: Comply with Any Restrictions Imposed By Document

- **Example** – Ms. Robinson creates a trust for Michelle and gives Michelle a testamentary limited power of appointment over the trust which may be exercised to appoint the assets remaining in Michelle's trust at death in further trust for (a) Barack or (b) Ms. Robinson's descendants. Michelle wants to exercise her power of appointment to create a lifetime trust for Sasha and to give Sasha a further limited power of appointment.
 - The drafter of Michelle's testamentary documents should be careful to limit Sasha's power of appointment to the same permissible appointees that are included in Ms. Robinson's trust instrument.
 - Also, the drafter should be careful that in the absence of Sasha's exercise of her power of appointment, the assets of her trust are not able to pass beyond the class of permissible appointees.
 - ❖ **Example:** A typical provision passing assets to the child's heirs at law in absence of descendants could possibly pass the assets to a person who would not be a permissible beneficiary of the trust assets (e.g., the child's spouse).

Drafting Tip #3: Exclude Power Holder

- **Example** – Barack creates a trust for Malia, and wants Malia to have a limited power of appointment during her lifetime and at death, exercisable among Barack's other children and grandchildren.
 - If the trust provides that "Malia has the power to appoint to Barack's descendants," then Malia, as power holder, has the power to appoint to herself and therefore, has a general power of appointment.
 - To avoid this mistake, identify the permissible appointees as Barack's descendants other than Malia (i.e., the grantor's descendants other than the power holder).
 - ❖ Note: The result would be different if the power of appointment was not exercisable during the child's lifetime (i.e., a testamentary power of appointment only).

Drafting Tip #4: Be Careful if Entities Are Permissible Appointees

- **Example** – If a document grants a beneficiary the power to appoint to "such persons and entities, other than the beneficiary, the beneficiary's estate, the beneficiary's creditors and the creditors of the beneficiary's estate," the power could be deemed to be general power of appointment if the beneficiary owns an interest in an entity.
 - Assume the beneficiary owns a 50% interest in a family limited partnership. Under the power described above, the beneficiary could appoint the property to the partnership. Because the beneficiary owns a 50% interest in the partnership, that same percentage of the property subject to the power could be includible in the beneficiary's gross estate under § 2041.
 - ❖ To avoid this result, limit the permissible appointees to "individuals" rather than "persons or entities" or limit the types of entities to entities in which the beneficiary has no ownership interest.

Drafting Tip #5: Include a Savings Clause

- In addition to paying careful attention while exercising a power of appointment and drafting the terms of the appointed trust, the drafter should consider a savings clause.
 - **Sample Language:** Notwithstanding anything contained herein to the contrary,
 - ❖ (i) in the event any term, condition, or permissible beneficiary (including a permissible object of any power of appointment) of my will or revocable trust shall cause the foregoing exercise of my powers of appointment to be invalid, then with regard to the assets subject to said power, such term, condition or beneficiary shall be deemed to be deleted, and
 - ❖ (ii) the applicable perpetuities measuring period as to the assets subject to my aforesaid powers of appointment shall not be extended by any exercise thereof.

Traps for the Unwary #1: Define HEMS Precisely

- When creating a trust over which the beneficiary may be a trustee, an ascertainable standard may be used to avoid giving the beneficiary a general power of appointment by using "health, education, maintenance, and support" as the distribution standard.
 - The language should be limited to the examples set forth in the regulations under §§ 2041 and 2514
 - ❖ "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."
 - Decedent's power, as trustee and beneficiary of trust, to invade trust corpus for his "happiness, health, support and maintenance" is a general power of appointment. *Forsee v. U.S.*, 76 F. Supp. 2d 1135

Trap for the Unwary #2: Support Obligations

- Section 20.2041-1(c) of the regulations provides that a power exercisable for the purpose of discharging a legal obligation of the decedent is considered a power of appointment exercisable in favor of the decedent or the decedent's creditors (i.e., a general power of appointment). Accordingly, a power exercisable over trust income or principal is a general power of appointment if it is exercisable for the benefit of a person to whom the holder has a legal duty to support.
 - In PLR 9036048 the IRS ruled that beneficiary was not relieved of her obligation of legal support because the trust instrument (i) required the beneficiary to appoint a special trustee if the beneficiary had a legal obligation to support any beneficiary of the trust and (ii) provided that special trustee would have the power to make all decisions regarding distributions to any such beneficiary.

Trap for the Unwary #3: Delaware Tax Trap

- Section 2041(a)(3) of the I.R.C., commonly known as the "Delaware Tax Trap," provides that a beneficiary will be deemed to possess a general power of appointment if he or she exercises a limited power of appointment to create another power of appointment which, under applicable local law, could be validly exercised so as to postpone the vesting of any estate or interest in such property for a period ascertainable without regard to the date of the creation of the first power.
 - This type of exercise is usually considered to begin a new period for application of the rule against perpetuities under state law, and therefore, triggers taxation as a general power of appointment.
 - If the power holder wishes to grant a person a further power of appointment, the Delaware Tax Trap problem can be avoided by restricting the perpetuities measuring period upon the exercise of this second power to the period relating to the first power.

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Recent Developments

■ Recent Private Letter Rulings

- PLR 201229005 (July 23, 2012) and PLR 201231007 (August 3, 2012): In these companion rulings, a trust beneficiary's testamentary power of appointment was held not to be a general power of appointment, because the beneficiary could only appoint the trust property among "the Settlor's issue," which the Service ruled did not include the beneficiary's estate or the creditors of his estate.
 - ❖ Take away: while these Private Letter Rulings indicate that having a power to appoint among a class consisting of the "Settlor's issue" does not constitute a general power of appointment it is still good practice to limit such powers by including language that excludes the power holder, the power holder's estate, and the creditors of the power holder and the power holder's estate.

■ Uniform Powers of Appointment Act

- In 2011, a drafting committee was formed by the National Conference of Commissioners on Uniform State Laws to draft a Uniform Powers of Appointment Act. The initiative was started because the "power of appointment is a staple of modern estate-planning," yet many jurisdiction within the United States (including the District of Columbia) "have very little statutory or case law on powers of appointment." The first draft was read for comments in July 2012.

Planning Strategy #1: Use Limited Power of Appointment to Provide Flexibility

- Example – A trust created by parent for child's lifetime benefit that includes a limited or general power of appointment for the child at death to appoint among parent's issue, can prevent the problem of distributing trust property outright to a beneficiary who is unable to handle his or her assets.
 - Such a power allows the child to make specific direction for specific beneficiaries, including the exclusion of certain beneficiaries, the creation of special needs trusts, etc.

Planning Strategy #2: Use General Powers of Appointment in GST Non-Exempt Trusts

- Example – Parent creates a trust for child's lifetime benefit, with a remainder interest to grandchild.
 - Assume that parent has already fully allocated his or her GST exemption, so none can be allocated to this trust. If the trust property is not includible in child's gross estate at death, then a taxable termination will occur when the property passes to grandchild upon child's death and the trust property will be subject to GST tax.
 - On the other hand, if the trust property is subject to estate taxation on child's death, child becomes the transferor for GST tax purposes, so distributions to grandchild will not be subject to GST tax. If child's marginal estate tax rate is lower than the GST tax rate (the highest estate tax rate), inclusion in child's estate will be the better choice.
 - ❖ To ensure the property is subject to estate tax at child's death, give child a general power of appointment over the property.

Planning Strategy #3: Use Independent Trustee to Make Distributions in Excess of HEMS

- The most flexible distribution standard would be at the complete discretion of the power holder, without regard to ascertainable standards. However, a beneficiary cannot hold such a power without subjecting the trust property to estate tax.
 - A possible solution is to allow the beneficiary to designate an independent trustee to make discretionary distributions (distributions in excess of health, education, maintenance and support) for the beneficiary without regard to ascertainable standards.
 - ❖ PLR 985014 states that the beneficiary should not be able to appoint an independent trustee who is related or subordinate to the beneficiary as defined in §672(c).

Questions?

Conclusion

- **Power of Appointment Can Be a Very Useful Tool**

- **There are Different Types of Powers of Appointment**

- General vs. Limited
 - ❖ May be limited to an ascertainable standard
- Presently Exercisable vs. Testamentary

- **General Power of Appointment Causes Estate Inclusion**

- Power holder's estate includes FMV of assets subject to the general power even if it was never invoked!
- Typically want to avoid this outcome (by using a limited power)

- **Careful Drafting is Important**

Helpful Resources

- I.R.C. § 2041
- I.R.C. § 2514
- Treas. Reg. § 20.2041-1
- Treas. Reg. § 25.2514-1
- Jonathan G. Blattmachr, *Powers of Appointment: A Primer on a Most Important Tool* (Nov. 1, 2011) (presented at Heckerling 2012)
- Cline, 825-3rd T.M., *Powers of Appointment – Estate, Gift and Income Tax Considerations*
- Jesse Dukeminier, et al., *Wills, Trusts, and Estates* (8th ed. 2009)