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Introduction

Powers of appointment play an important role in estate planning. The proper use of powers can give great flexibility to an estate plan without incurring any transfer tax whatsoever. Needless to say, the price of such benefits is careful adherence to the requirements of the tax law. Fortunately, the rules in this area are among the clearest and best settled in the transfer tax field. The problems that do arise often seem to result from failure to understand the wide latitude the existing rules give the planner in meeting a client's wishes. In other words, there is little or no need to operate at the undefined fringe of the transfer tax system in using powers of appointment in estate planning.

The following discussion of powers of appointment emphasizes what can be done within the well-established rules. After an introduction to the property law of powers and the accompanying terminology, I summarize the tax treatment of powers and introduce the difference between "special" and "general" powers. The discussion then moves to considering these rules in the context of estate planning. First, I outline the situations in which a taxable power may be useful. These are limited in number but of great importance in accomplishing certain common estate planning goals. Equally common goals should be accomplished through the creation of nontaxable powers. The rest of the chapter, therefore, deals with different methods of giving the object of a client's bounty access to property transferred by the client without creating transfer tax consequences for the beneficiary.

POWERS OF APPOINTMENT: DEFINITIONS AND BASIC RULES

The power of appointment is first and foremost part of Anglo-American property law. Its history is complex but its present role is as straightforward as it is important. It is, in broadest terms, a device for giving someone a greater or lesser degree of control of the distribution of property in the future, which control can then be exercised in the light of circumstances then existing that cannot be foreseen at the time the power is created. The simplest example involves a trust created by A for the benefit of his child B for life. At B's death the trust will terminate and be distributed to such of B's children in such proportions as B shall designate in B's will, and if B makes no designation, to B's children in equal shares. B's ability to choose who will receive how much of the trust is a power of appointment. A is the donor of the power and B the donee. B's children are permissible objects of the power and they are also the takers in default of B's exercising the power. Because B could only exercise the power by will it is a testamentary power of appointment. Powers can also be exercised during life and are then described as *inter vivos* powers, or as powers of appointment by deed, since they usually must be exercised by a document executed with the formalities required for the transfer of real property. Unless forbidden by the instrument creating the power, *inter vivos* powers can also be exercised by will.

In estate planning terms, A is the client for whom the plan is created. The tax status of the power, however, will affect B's transfer tax situation. The creation of the power by A may involve transfer tax, of course. In the example above, if the trust were created *inter vivos* A would have made a completed transfer for gift tax purposes. If the trust were testamentary, the trust property would be taxed as part of A's estate. The taxation of powers of appointment, however, involves taxation of *the donee*, that is, of the person holding the power. In other words, in formulating an estate plan involving powers of appointment the planner must keep in mind that the estate tax and gift tax effects of the powers, if any, will be borne by someone other than the client for whom the plan is created. The ramifications of the plan, therefore, are more widespread than they would be otherwise and the careful planner may very well have to broaden the search for information relevant to the plan.

Not every power of appointment, however, results in taxation to the donee. The gift tax in Internal Revenue Code Section 2514 and the estate tax in Section 2041 divide all powers of appointment into two classes: general powers of appointment and special powers of appointment. The distinction between the two is simple to state. A general power is a power that is exercisable in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.¹ Special powers are all other powers.

The listing of the four objects of appointment that create a general power has been construed to be disjunctive. The ability to appoint to any one of the four will create a general power of appointment.² In addition, the power to appoint property to satisfy taxes, debts, or other changes enforceable against the donee's estate is a general power of appointment, as is a power to appoint property to satisfy the donee's legal obligations, such as those of support.³ Roughly put, the transfer tax system treats as general powers those that allow the donee to use the property over which the power is applicable as if it were the donee's own.

Any other power of appointment is a special power of appointment. The Treasury Regulations specifically state that the special power may be worded in a broad or narrow manner. That is, the power may be one to appoint to anyone other than the four entities that define a general power of appointment, or one to appoint to specific persons or classes of persons none of which is the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.⁴

Classifying a power as general or special determines the treatment of the power for estate and gift tax purposes. Under I.R.C. Section 2041 the donee of a general power of appointment created after October 21, 1942, is considered the owner of the appointive property. All property subject to the power on the date of death is included in the donee's gross estate.⁵ All that is required is that the general power of appointment exist. The donee's lack of capacity to exercise the power for reasons of minority or incompetency is irrelevant.⁶ Nor is it necessary that the general power of appointment be exercisable by will. An inter vivos power that ends with the donee's death is in existence at death and will lead to tax.⁷

Property subject to a general power of appointment created on or before October 21, 1942, is included in the donee's gross estate only to the extent of property as to which the general power of appointment is exercised.⁸ This difference in treatment depending on the date of creation of the power reflects the somewhat complicated history of estate tax treatment of general powers of appointment.⁹ The change in treatment led to a transition rule for partial releases of general powers, which is preserved in the statute.¹⁰

While the number of "pre-1942 powers," as they are often called, decreases with every passing year, it is still possible in the late 1980s to encounter such relics of the old law. Because these pre-1942 powers result in estate tax only if exercised, the estate planner must be aware of the state law regarding exercise of a general power of appointment. In a minority of states a general residuary clause will exercise a general power of appointment held by the testator by adding the appointive property to the residue. The result would be, of course, the taxing of the appointive property in the donee's estate. The problem can be avoided by adding to the will an express refusal to exercise any power of appointment held.

The addition of such boilerplate as a prophylactic measure should be considered whenever a will is drafted.

The gift tax treatment of general powers is also based on the analogy between holding a general power of appointment and outright ownership. The inter vivos exercise of a general power of appointment no matter when created is a transfer of the appointive property for gift tax purposes. The gift tax effect will depend on the extent to which the transfer is complete, on the availability of exclusions and deductions and indeed on every variable that enters into the analysis of any other transfer of property by a donor. For a general power of appointment created on or before October 21, 1942, the analysis ends here.¹¹

A general power of appointment created after October 21, 1942, need not be exercised, however, to cause gift tax consequences. The release or lapse of such a power during the donee's life will also result in a transfer of property for gift tax purposes. The concept of release is a straightforward one. It requires some act by the donee that extinguishes the power. By giving up the power to direct the property to himself, his estate, his creditors, or the creditors of his estate, the donee of the power becomes the transferor of the property subject to the power. Whether or not a gift results depends on the application of the principles of the gift tax.

A lapse occurs when the donee does nothing and the power disappears by its own terms. For example, a trust meeting the requirements of I.R.C. Section 2503(c) is a popular vehicle for making gifts to a minor. All additions to such a trust qualify for the present interest exclusion of Section 2503(b) up to the dollar limits of that section. The trust property must pass to the beneficiary at age 21. Because many donors feel that 21 is too young an age at which to give a person outright ownership of substantial property many of these trusts are drafted to give the minor beneficiary the right to terminate the trust and acquire the trust property during a short period of time after attaining the age of 21 years. If the termination right is not exercised the trust continues until the beneficiary reaches a more mature age. The donor, of course, hopes that the beneficiary can be convinced of the wisdom of not exercising the termination right.

The right to end the trust and acquire the trust property, however, is a right to appoint to oneself and is therefore a general power of appointment. If the beneficiary does not exercise the power it ends. This extinguishing by its own terms is a lapse of the power. For gift tax purposes the beneficiary (who is the donee of the power) is the transferor of all the trust property. In other words, the beneficiary is treated as the creator of the trust. Whether or not there is a completed gift depends, of course, on the terms of the trust.

To summarize, a general power of appointment created after October 21, 1942, is the equivalent of outright ownership for purposes of the gift tax. A release or a lapse of such a power is a transfer. If the property

over which the power applies is in trust, the release or lapse is the equivalent of the donee of the power taking the property out of the trust and then putting it back in. The release or lapse does not change the terms of the original disposition of the property by the donor of the general power of appointment; it simply makes the donee the author of those terms.

A donee can get rid of an unwanted general power of appointment without triggering the consequences of a lapse or release. It is possible to make a qualified disclaimer of the power under Section 2518.¹² The requirements of that section must be met of course, and state law must allow the disclaimer of a general power of appointment. It is possible that the enactment of Section 2514(c)(3) applicable to disclaimers made after December 31, 1981, allows the disclaimer of a general power of appointment effective for federal transfer tax purposes regardless of the provisions of state law, but the point is unclear and probably will remain so until regulations are issued under this subsection.

If estate tax results from the inclusion of property subject to a general power of appointment held by the decedent, the code provides a special rule placing liability for the tax on the recipient of the property (whether an appointee or a taker in default) in Section 2207. That section allows the decedent's estate to recover from the recipient "such portion of the total tax paid as the value of such property bears to the taxable estate." The appointive property, therefore, is assumed to pay estate tax at the average rate to which the estate is subject. If the taxable estate absent the appointive property is small, perhaps so small that tax would be totally offset by the unified credit, it is possible that all the tax due is caused by the operation of Section 2041. If the estate beneficiaries and the recipients of the appointive property are different persons, Section 2207 will in effect cause the former to bear some of the estate tax liability caused by property going solely to the latter. This problem is easily eliminated, at least in testate estates. The rule of Section 2207 operates "[u]nless the decedent directs otherwise in his will" and therefore can be overridden by a tax apportionment clause. Such a clause could easily direct that the appointive property bear the *increase* in estate tax caused by its inclusion in the gross estate under Section 2041. The choice of an appropriate tax apportionment clause is an important part of estate planning subject to many considerations. It is important to realize, however, that the code provides a rule with regard to tax caused under Section 2041 that may not be to every client's liking but will operate unless steps are taken to avoid it.

Special powers of appointment have no estate or gift tax effect whatsoever. One may die possessed of a special power, exercise one during life, or allow it to lapse, or release it, and there will be no need to be concerned with estate or gift tax, except perhaps in one limited situation. The government has maintained that the exercise of a special power of

appointment that has the effect of extinguishing another interest of the donee of the power in the appointive property that could itself be disposed of without reference to the special power results in a gift of that interest.¹³ One situation, which has actually been litigated, involved an income beneficiary of a trust who was also the donee of a special power of appointment by deed over the corpus of the trust. The exercise of the special power by appointing all the trust property to permitted appointees would be a gift under Section 2511 of the value of the income interest if the analysis above is correct. In *Self v. United States* the Court of Claims disagreed with the government's position and found that the income interest was terminated rather than transferred.¹⁴ The Internal Revenue Service declared it would not follow *Self*¹⁵ and finally prevailed on the same issue in the Tax Court in *Estate of Regester*.¹⁶ The Tax Court specifically stated that it would not follow *Self*, and for now the matter is in that limbo of conflicting authority from which clients should be preserved.¹⁷

ESTATE PLANNING WITH POWERS OF APPOINTMENT

The Uses of General Powers

It should be obvious from the foregoing discussion that the deliberate creation of a taxable or nontaxable power of appointment is a fairly simple matter. Assuming for the moment what will be discussed at length below, that is, that there are many different ways to inadvertently create a general power of appointment, why would any planner deliberately advise that a client give a donee the power to appoint to the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate? There are three specific planning goals that supply the answer to that question.

The first, and perhaps the most important, is the desire to create a Section 2056(b)(5) or Section 2523(e) general power of appointment marital deduction trust. No marital deduction is allowed for estate or gift tax purposes for the transfer of a terminable interest to a spouse. The definition of that term includes a life income interest in a trust the remainder of which is given to someone other than the spouse or the spouse's estate. If, however, the income interest is of a certain sort, defined by statute and regulation, and if the spouse has a general power of appointment over the trust, the property transferred to the trust will qualify for the marital deduction.¹⁸

The requisite power of appointment is not quite the same as the general power of appointment defined in Sections 2041 and 2514. First, the power must be "exercisable in favor of such . . . spouse, or of the estate of such . . . spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others."¹⁹ This marital deduction

general power of appointment, therefore, is a sort of subset of all general powers of appointment. Of the four objects of appointment that define a general power of appointment, only two, the donee and the donee's estate, will create a general power of appointment that satisfies the requirements of the marital deduction. In addition, both the estate tax and the gift tax sections require that the power be "exercisable by such spouse alone and in all events." The careful drafter will include precisely those words in the actual power. In fact, the terms of the power of appointment necessary to obtain the marital deduction are all set out in the statute and the careful planner will not depart from them.²⁰ There is, however, no problem with the creator of the power specifying takers in default who will receive the trust property should the spouse not exercise the power.

Some formal limitations on the exercise of the power are allowed. For instance, the spouse can be required to make specific reference to the power in the spouse's will or to exercise the power only in a will executed after the death of the first spouse to die. Powers exercisable during life can be required to be exercised in a particular form and the spouse can be required to give notice to the trustee of exercise.²¹ Anything more, however, will ruin the estate plan. Clearly, innovation is not at a premium here.

The properly drafted power will, of course, require the inclusion of the trust property in the spouse's estate if the spouse dies possessed of the power, or it will result in gift tax if the spouse uses an inter vivos power to transfer trust property or releases the power or allows it to lapse. This result is an integral part of the rationale of the marital deduction: what is deducted in the estate of the spouse first to die is taxed in the estate of the spouse second to die (to the extent it has not been consumed during life) or as the surviving spouse makes gifts of the property. Since ultimate taxability is the goal, the deduction may be secured by *either* a testamentary or an inter vivos power. If only the former is given, the spouse can make no inter vivos transfer of the property and since no one may hold a power to transfer property to anyone other than the spouse taxability is assured. If only an inter vivos power is given, Section 2041 will still tax any property left in the trust at the spouse's death because the decedent did indeed possess the power at death.

The choice of the Section 2056(b)(5) trust as the vehicle for obtaining the marital deduction must depend, of course, on the needs, desires, and circumstances of each client. One possible advantage of this sort of arrangement involves the general power of appointment itself. A person who receives property either through the exercise or the lapse of a general power of appointment may disclaim the property within nine months of the exercise or lapse of the power.²² In the typical marital deduction situation this ability to disclaim within nine months of the death of the second spouse to die may be of advantage. Assume that the surviving

spouse is the beneficiary of a Section 2056(b)(5) trust. The takers in default of the spouse's exercise of the general power of appointment are the descendants then living of the couple with the distribution to be made *per stirpes*. If at the death of the spouse beneficiary the children of the marriage are living they will take the trust property in absence of an appointment. If those children are of mature age they may desire to pass the trust property directly to their children in preference to swelling their own estates. Since they have nine months after their parent's death to disclaim the trust property, they can make that decision at the last minute. If the marital deduction property were held in a testamentary qualified terminable interest property (QTIP) trust the contingent remainders in that trust would have to be disclaimed, if at all, within nine months of the death of the spouse whose will created the trust.²³

The second situation in which a general power of appointment may be deliberately created involves the new generation-skipping transfer tax enacted as part of the Internal Revenue Code of 1986. The new tax is levied at the highest estate tax rate.²⁴ It does not apply, however, to transfers otherwise subject to estate or gift taxation with respect to a person one generation below the transferor.²⁵ If a member of that generation is given a general power of appointment in order to "force" taxation of property in his or her estate, there will be less tax paid than if the generation-skipping transfer tax were to apply, so long as that person's marginal estate tax bracket is less than the maximum rate. For example, parent sets up a trust with child as life income beneficiary, remainder to grandchildren. The child has an "interest"²⁶ the termination of which will be a taxable event.²⁷ The trust corpus will at that time be subject to tax at the prevailing maximum estate tax rate. If, however, the child holds a general power of appointment over the trust, the trust property will be included in child's gross estate and will not be subject to the generation-skipping transfer tax. If the child's marginal estate tax rate is less than the maximum rate, there will be a tax saving through the general power of appointment.²⁸

Finally, the inter vivos general power of appointment may be useful in circumventing certain problems raised by the rule against perpetuities. Generally speaking, the perpetuities period starts anew for dispositions made through exercise of an inter vivos general power of appointment but relates back to the time of the creation of the power when a disposition is made by exercise of a special power of appointment or of a testamentary general power. An inter vivos general power, therefore, may be useful if the donor wishes to give the donee the alternative of appointing the property in further trust for a period that would violate the rule against perpetuities as measured from the time of the creation of the power.

This relationship between the rule against perpetuities and powers of appointment has had one effect on Section 2041. In some states the per-

petuities period runs from the exercise of a testamentary power, be it special or general. Under such a statute it is possible to create a perpetual private trust through the creation of a series of life estates with special testamentary powers of appointment over the remainder. The trust property would thus forever escape transfer taxation. In order to prevent this result, Section 2041(a)(3) provides that assets subject to a special power of appointment are included in the gross estate of the donee of a special power of appointment if the donee exercises the power "by creating another power of appointment which under the applicable local law can 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." In other words, the price of starting the perpetuities period anew is taxation. In addition, it is important to realize that the statutory language goes beyond simply closing the loophole created in a few states. If a special power is exercised so as to create an inter vivos general power the statutory requirement quoted above will be fulfilled: the special power will have been exercised to create a power from the exercise of which the perpetuities period will begin to run anew. Every donee of a special power must be aware of this trap.

The Unintentional Creation of General Powers in Pursuit of Planning Goals

If the rules for the creation of a general power of appointment are as straightforward as they have been described and if the situations in which they are useful are as limited as they appear to be, the reader may be justified in wondering why the fuss. Unfortunately, a closer examination of the rules surrounding the taxation of powers of appointment is fully justified. It is possible to create a general power of appointment in many ways besides giving a donee the power to appoint to one or more of the magic quartet. The resulting unintentional creation of a general power of appointment is often the byproduct of the attempt to meet one or more common planning goals. Fortunately, these goals can generally be accomplished well within the limits of Section 2041. The remainder of this chapter first describes the major pitfalls and then attempts to set out some straightforward ways of working within Section 2041 and thus avoiding taxation.

Even though the donee may not have the power to appoint to one of the four entities that figure in the definition of a general power of appointment, the power cannot be properly classified unless the takers in default are considered. If the takers in default of exercise of the power include one or more of the definitional quartet, the power is a general power. The theory behind this result is quite simple. By not exercising the power the donee can in effect appoint to the takers in default. In this context, not to choose is to choose.²⁹

Clearly, takers in default have to be chosen with care. Usually, the takers in default are objects of the bounty of the donor of the power of appointment. The power itself is created to provide flexibility. The donor probably assumes that in the absence of special circumstances the power will not be exercised and the appointive property will be distributed to the takers in default. If this situation is indeed the usual one surrounding the creation of a power of appointment, the inadvertent creation of a general power should seldom occur; the takers in default would always be persons (or perhaps a charitable entity) other than the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate.

One situation related to the possibility of the identity of the takers in default creating a general power of appointment has been litigated. The question involves the status of insurance settlement options selected by the insured that provide for an annuity to the beneficiary followed by distribution of the principal to the executor of the beneficiary's estate. The Seventh Circuit has held that the principal was not includable in the deceased beneficiary's estate.³⁰ The Fifth Circuit, however, construed a similar provision to be a general power of appointment on the theory that the payment to the decedent's estate subjected the fund to her unfettered control.³¹ While the technical basis for the Fifth Circuit's holding may be questioned, it does emphasize the need to consider the destination of property in the absence of an "appointment" by the decedent.

A far more common situation in which a general power of appointment may be inadvertently created exists whenever a beneficiary has power to appropriate trust property to himself or herself. The Treasury Regulations make clear that such a power is a general power of appointment: "[I]f a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment."³² Similarly, a power in a beneficiary "to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment" that may be general if the beneficiary can benefit from the exercise of the power.³³

It must also be realized that the provisions of the Regulation quoted above do not apply only to trusts. Any similar arrangement will also fall within the ambit of Section 2041. Perhaps the most common, and the most troublesome, is the legal life estate coupled with a power to consume. Depending on the local law of life estates and waste, the power to consume may be a general power of appointment.³⁴ The extent of the life tenant's rights and responsibilities, of course, is set by state law. In the absence of specific language in the instrument creating the legal life estate the exact nature of those rights and responsibilities may be unclear. Litigation over the matter in the federal courts may require those courts to interpret

state law in the absence of definitive holdings of the highest court of the state.³⁵

A similar situation arises when a beneficiary is also trustee and as trustee has the power to appoint trust property to himself or herself. Such a power may be a general power of appointment depending on the terms governing the decision to make the self-benefiting payment. Suffice it to say for now, an unlimited discretionary power to make payments to oneself, even if it is exercised in a fiduciary capacity, is a general power of appointment. So common is the inadvertent creation of a general power of appointment in a trustee beneficiary that some states, most prominently New York, prohibit a trustee beneficiary from participating in decisions to benefit himself or herself.³⁶ At least one federal district court has found that state case law created a similar prohibition. In *Garfield v. United States*³⁷ the court held that Massachusetts case law established the principle that in cases of "ambiguity" a trustee beneficiary did not have the power to decide to make payments to himself. Such savings provisions, of course, will vary from state to state, but they would seem to be frail reeds on which to rest an estate plan. In addition, a statute like that in New York in effect requires that a discretionary trust have at least one trustee who is not a beneficiary.

It should be noted here that an independent trustee may have the broadest discretion to pay property to a beneficiary for any reason without the beneficiary having a general power of appointment. So long as the beneficiary can only compel the trustee to honestly exercise discretion the beneficiary has no taxable power over the trust.³⁸

Giving the Beneficiary Access to the Trust: Exceptions—the General Rule of Section 2041

The foregoing discussion of the ways in which a general power of appointment can be inadvertently created outlines the dangers to be avoided in creating an estate plan involving trusts or trust-like arrangements in which beneficiaries are to have rights of access.³⁹ Such plans probably are quite common. While the advantages of trusts are many, especially when one is concerned for the continuity of management of assets that are to benefit the elderly or infirm, many clients probably feel that so long as beneficiaries are competent they should not have to go begging to an indifferent trustee in order to obtain access to trust property beyond what is required to be paid them on a regular basis.

In addition, it would seem to be becoming more and more difficult, especially in large metropolitan areas, to find professional management of smaller trusts. In many situations, the beneficiary may be the most available and trusted fiduciary. For example, the creator of a family spray trust funded with the unified credit share of a relatively small estate may

very well feel that the surviving spouse and one or more of their children should be the persons charged with apportioning income and principal among a group of people including themselves. Even if professional fiduciary services are available, the cost may be prohibitive unless the trust is invested in common trust funds or other collective investment vehicles. If the client prefers individualized investment advice there may be few alternatives to the trustee beneficiary.

Given these assumptions the quest for ways to protect beneficiaries from possession of a general power of appointment assumes great importance. Fortunately, there are three basic techniques for accomplishing that end, each one based on a statutory exception to the definition of a general power of appointment contained in Section 2041(b)(1). The first involves powers subject to an "ascertainable standard" defined in Section 2041(b)(1)(A), the second involves the so-called five and five power found in Section 2041(b)(2), and the third, joint powers dealt with in Section 2041(b)(1)(C).

The first and most important of these exceptions removes from the definition of general power of appointment any "power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent."⁴⁰ The theory behind this exception is a most sensible one. So long as the donee's ability to appropriate property is limited by a standard the exceeding of which would subject the donee to an action by others interested in the property and result in restoration of the wrongly appropriated property, the donee does not have that unfettered command over the property which is, for transfer tax purposes, the essence of the general power of appointment.⁴¹ In other words, a beneficiary can be given access to trust property governed by an ascertainable standard or as trustee can be given power to pay property to himself or herself subject to an ascertainable standard and there will be no transfer tax consequences arising from the possession of the power.

The easiest way to create an ascertainable standard is to follow precisely the language of the statute and regulations. Section 20.2041-1(c)(2) of Treasury Regulations states that "the extent of the holder's duty to exercise and not to exercise the power" is governed by an ascertainable standard if it is "reasonably measurable in terms of his needs for health, education, or support (or any combination of them.)" The regulation goes on to state that as far as the Treasury is concerned *support* and *maintenance* "are synonymous and their meaning is not limited to the bare necessities of life." As an added bonus the regulation also gives examples of powers "limited by the requisite standard":

"support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "edu-

cation, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism."

Finally, the regulation warns the planner what standards *not* to use: "A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard."

Given the detail of this Treasury Regulation Section 20.2041-1(c)(2), the drafting of ascertainable standards should be an easy task. Assuming that the language approved by the regulation will allow accomplishing the client's desires within the context of local law governing trust administration, it is difficult to imagine what more could be desired. The approved language clearly allows payments to continue an accustomed standard of living that should, within the limits of local law, if any, allow increased distributions to take account of inflation. The language related to health should allow payments for the treatment of medical problems, even catastrophic illnesses. If the beneficiary is a young person, the approved language allows payments for education through the most advanced graduate levels. Finally, the regulation specifically states that "it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised."

In short, before the estate planner departs from the approved language of Treasury Regulation Section 20.2041-1(c)(2) in drafting a standard to govern a beneficiary's access to trust property the planner should be sure that the client's desires can be met in no other way. Given the volume of litigation and administrative rulings, the Internal Revenue Service appears disposed to challenge any standard that departs from the approved language of the regulation. In addition, these challenges take a very narrow and technical view of what sort of language is equal to the approved language of the regulation.

Perhaps the most striking example of the IRS's approach is Revenue Ruling 77-60.⁴² The facts of that ruling involved a decedent who had been given under the will of a predeceased spouse a life estate in certain properties with power to invade corpus as desired "to continue the donee's accustomed standard of living." The ruling holds that the quoted language does not create an ascertainable standard because under that language payments could be made for expenditures going beyond the beneficiary's "needs for health, education or support." Taxability in this instance seems to turn on the single word "continue." If the standard of invasion had been phrased in terms of "support in the donee's accustomed manner of living" there would be perfect harmony with the statutory standard.

Of course, as noted above, the exact meaning of any standard used in a trust instrument, or in the creation of a legal life estate depends on local law. Presumably, if it could be shown that the approved language of the regulation actually created under local law a standard that was not

related to the beneficiary's needs for health, education, support, or maintenance the beneficiary would indeed possess a general power of appointment.⁴³ As a practical matter, however, the IRS would probably not be inclined to challenge any standard that conformed to the approved language of the regulation. Challenges are raised over "creative" drafting, with the IRS attempting to show that the standard does not relate to the statutory quartet and the taxpayer attempting to show that under local law the standard is "ascertainable" and related to the four magic words. Such inquiries are complicated by the frequent lack of precedent from the highest state court and the consequent need for the federal court to make a decision about what the state law is.

This is not to say that taxpayers always lose. *Brantingham v. United States*⁴⁴ involved the estate of a decedent who had been given a life estate in her late husband's residuary estate along with "the uncontrolled right, power and authority to use and devote such of the corpus thereof from time to time as in her judgment is necessary for her maintenance, comfort and happiness."⁴⁵ In spite of the use of the word "happiness," which is specifically condemned by Treasury Regulation Section 20.2041-1(c)(2), the court found that this standard was indeed an ascertainable one within the meaning of Section 2041(b)(1)(A). The court's holding is based on its reading of Massachusetts law, which governed the trust. In *Dana v. Gring*⁴⁶ the Massachusetts Supreme Judicial Court found that a power to distribute principal for "happiness" of the beneficiary was governed by an objective, ascertainable standard because a reading of the dispositive instrument as a whole indicated that the creator of the trust intended to preserve its principal for eventual distribution to the remaindermen.

The IRS has indicated its nonacquiescence in *Brantingham* on the rather strange ground that *Dana v. Gring* is inapplicable to the later case because the powerholder in *Brantingham* was not a fiduciary as was the powerholder in *Dana*.⁴⁷ Presumably, the frank disapproval of the word "happiness" in the regulation was not seen as sufficient ground for disapproving the Seventh Circuit's *Brantingham* decision. Of course, the IRS may be unwilling to raise the federalism issue inherent in not following the highest court of a state on a matter of local property law. Whatever the reasons, however, pursuing an action to the highest level in order to establish the existence of an ascertainable standard is a stiff price to pay for correcting a problem that may very well have been avoided by careful drafting.

Brantingham involved the word "happiness." Another troubled word in this area is "emergency." The fondness of draftspeople for the word is understandable. Many, perhaps most, clients feel sure that whatever happens a beneficiary should have access to a trust if an emergency arises. After all, what is the use of having a pool of capital preserved for a beneficiary's needs if it cannot be drawn on when it is really needed? The IRS,

however, maintains that emergencies can be related to matters other than health, education, support, or maintenance and therefore a standard of invasion or encroachment to meet "emergencies" does not satisfy Section 2041(b)(1)(A). The Tax Court accepted this argument in its decision in *Estate of Sowell*.⁴⁸ On appeal, however, the Tenth Circuit disagreed.⁴⁹ The appellate court found that under the law of New Mexico that governed the trust the word "emergency" would be construed as limited to situations involving the sanctioned quartet of Section 2041(b)(1)(A).

The Tenth Circuit's opinion is not a model of clarity. It rests heavily on dictionary definitions and much of the reasoning seems to be conclusory. The opinion, however, was cited with approval by a district court in *Hunter v. United States*⁵⁰ in support of a holding that the term *emergency* is always "measurable in terms of health or to support a beneficiary's standard of living."⁵¹

Whether or not these cases portend the eventual acceptance of the term *emergency* as an ascertainable standard it is probable that the road to acceptance will not be smooth. The careful estate planner should seriously consider whether the term *emergency* really adds anything to a standard of invasion. After all, the *Hunter* court approved the term by reasoning that it really was synonymous with a beneficiary's health or support needs. If that is the case, why raise the problems sure to come from the use of a questionable term. Unless local law makes it clear that the approved language of Regulation Section 20.2041-1(c)(2) will not allow exercise of the power in an emergency there would seem to be no need to engage in creative drafting.

The questions accompanying the use of the ascertainable standard exception to the definition of a general power of appointment may discourage its use. In addition, it does not provide absolutely unfettered access to trust property by a beneficiary. Unfettered access is possible, however, without the consequences of possession of a general power of appointment so long as the beneficiary is subject to limitations on the amount of property that can be obtained. The so-called five and five power of Section 2041(b)(2) is an exception to the general rule that regards the lapse of a general power of appointment created after October 21, 1942, as an exercise. The statute provides that a taxable lapse occurs only "to the extent that the property, which could have been appointed by exercise of such lapsed powers exceeded in value, at the time of such lapse" the greater of \$5,000 or 5 percent "of the aggregate value, at the time of such lapse, of the assets out of which . . . the exercise of the lapsed powers could have been satisfied."

To phrase this in a more positive way, a power in a beneficiary to withdraw annually the greater of \$5,000 or 5 percent of the value of the corpus of a trust will have no transfer tax consequences. If the power is not exercised in any year the lapse will be sheltered by Section

2041(b)(2). Similarly, a power to withdraw income is sheltered to the extent of the greater of \$5,000 or 5 percent of the income. The withdrawal can be for any purpose whatsoever and requires no justification on the beneficiary's part.

The only trap in this arrangement involves the beneficiary's death before the power has lapsed for the year. If the withdrawal can be made at any time, the beneficiary will die possessing a general power of appointment. Death while possessed of a power is not a lapse. The gross estate will include the property that could have been withdrawn. Exposure to taxation in this way can be greatly reduced if the time period for exercise of the power is limited. For example, if the power is limited to exercise during the last two weeks of the month of December, the property that could have been withdrawn will be included in the beneficiary's gross estate only if death occurs during those two weeks.⁵² Presumably, the period of exercise should be coordinated with an annual valuation of the trust so that the 5 percent figure is easily ascertained.

The consequences of a lapse over an amount greater than that sheltered by the five and five rule are the same as that of any lapse.⁵³ The powerholder is considered to be the transferor of the property over which the power has lapsed. Depending on the terms of the trust there may or may not be transfer tax consequences. If the income beneficiary of a trust the remainder of which belongs to someone else has a one time power to withdraw \$10,000 in one year from corpus, the lapse of that power in a year in which the corpus is worth \$100,000 will result in a transfer of \$5,000 to the trust [$\$10,000 - (5\% \text{ of } \$100,000)$]. There will be a gift of the actuarial value of the remainder interest in the trust; the beneficiary has retained the income interest in the \$5,000. In addition, the beneficiary is now the transferor of 5 percent of the entire value of the trust (of the \$100,000 in the trust the beneficiary is the transferor of \$5,000 by virtue of the lapse). Assuming that there are no further withdrawal powers, when the beneficiary dies 5 percent of the value of the trust at that time will be included in his or her gross estate under Section 2036(a)(1). The beneficiary has transferred \$5,000 to a trust in which he or she has an income interest, a transaction which fits Section 2036 precisely.

If the withdrawal power is annual and noncumulative, successive lapses will increase the proportion of the corpus which the beneficiary has transferred. In the example in the previous paragraph, if the power to withdraw \$10,000 can be exercised every year, and assuming that the corpus of the trust always is valued at \$100,000 each year, the beneficiary will transfer \$5,000, make a gift of the remainder interest in that amount and become the transferor of 5 percent of the trust corpus. If the beneficiary dies in the fifth year, his or her taxable estate will include first, the \$10,000 that could have been withdrawn in that year, since that is a general power of appointment subject to Section 2041 and, second, 20 percent of

the corpus of the trust under Section 2036(a)(1).⁵⁴ Each year the beneficiary transferred 5 percent of the corpus; after four years the beneficiary has become the transferor of 20 percent of the corpus. Of course, these calculations become more complex as the value of the trust changes. In any event, if the lapse of the withdrawal power is not fully sheltered by Section 2041(b)(2) the transfer tax consequences can become quite serious.

Perhaps the most common use of the five and five power is in connection with the creation of a so-called Crummey power. The name comes from *Crummey v. Commissioner*,⁵⁵ which stands for the proposition that a gift to a trust, which would otherwise be at least in part a gift of a future interest, can be transformed into a gift of a present interest, \$10,000 of which is excluded from taxable gifts by Section 2503(b), to the extent that a beneficiary can demand the distribution to himself of the gift. Such a demand power is a general power of appointment the lapse of which will have tax consequences to the extent it exceeds the limits of the five and five power.

Crummey powers are often used in inter vivos life insurance trusts to provide a present interest exclusion for amounts contributed directly or indirectly to the trust for the payment of premiums. Of course the technique can be used with any trust in order to allow funding of the trust over a period of time without incurring gift tax. One consideration, however, is always present when drafting a Crummey power. If the power to withdraw can be satisfied only from the addition to the trust the 5 percent limit of Section 2041(b)(2) is applied to the amount of the addition. If, however, the withdrawal power may be satisfied from the entire corpus of the trust the 5 percent limit is applied to that entire amount. For example, if the Crummey power is phrased so that the beneficiary may withdraw from the trust any additions made in a given year, \$10,000 of additions will result in a \$5,000 taxable lapse—\$5,000 is greater than 5 percent (\$500) of the property from which the withdrawal can be satisfied. The result of the lapse will depend on the rules for taxation of a general power outlined above. If the withdrawal power is phrased to allow the withdrawal from the entire trust of an amount equal to the year's additions, a \$10,000 addition will result in a taxable lapse only if the trust's total value is less than \$100,000.

The increase in the present interest exclusion to \$10,000 effective January 1, 1982, has led to attempts to obtain the fullest possible exclusion without exceeding the protection from lapse of Section 2041(b)(2). Perhaps the most ingenious approach is the "hanging power."⁵⁶ This variation is drafted to allow in any one year the lapse of a withdrawal power only to the extent it is sheltered by the five and five rule. Any power to withdraw more than the sheltered amount continues until the next year when the power again lapses only to the extent it is sheltered by Section 2041(b)(2). This pattern continues until the withdrawal powers have completely ended.

Of course, this technique is useful only where additions to the trust will continue for a fixed number of years and where the life expectancies of the holder or holders of the *Crummey* powers are long enough to allow the planner to be reasonably sure that all the powers will totally lapse before death or termination of the trust. If a powerholder dies while possessing unlapsed powers, Section 2041 will include the property that could be withdrawn at death in the gross estate.⁵⁷

The mechanics of the *Crummey* power are fairly well established. The beneficiary must have notice of the existence of the power and a reasonable time in which to exercise it.⁵⁸ Minors may hold withdrawal powers with all the attendant benefits so long as there is no impediment under local law to the appointment of a guardian who could exercise the rights on their behalf.⁵⁹ In fact, the *Crummey* power has become a most powerful tool.

Recently, however, there are indications that the IRS is beginning to attempt to restrict the benefits of this device. In Revenue Ruling 85-88 the IRS dealt with multiple withdrawal powers held by a single beneficiary in multiple identical trusts created by the same grantor. The IRS ruled that the lapses of the withdrawal powers in the identical trusts must be aggregated. In other words, only one \$5,000 amount was available to shelter the lapse. The 5 percent limit is applied to the aggregate amount of property from which the withdrawal could be satisfied. If the trusts are small, 5 percent of the aggregate amount may be less than \$5,000 and any lapse greater than that amount will not be sheltered. This ruling leaves open the question of aggregation where dissimilar trusts created by different grantors are involved. Should the instant holding be extended questions will arise involving proration of the single available five and five shelter.

The second significant recent ruling, Revenue Ruling 85-24, involved the creation of trusts with *Crummey* powers by each of three members of a partnership. Each trust gave to the grantor's child a withdrawal power and also gave similar powers to each of the other two partners. The IRS invoked the reciprocal trust doctrine of *Estate of Grace*⁶⁰ to deny a present interest exclusion based on the powers held by the partners. Clearly, the creation of reciprocal withdrawal powers is to be avoided.

Finally, a word must be given to the income tax consequences of the withdrawal power. This aspect of the *Crummey* power has not received much attention.⁶¹ In a recent private letter ruling, however, the IRS took a position that could lead to severe income tax consequences for holders of withdrawal powers.⁶² The ruling holds that the powerholder is taxable on the income generated by the property that could be withdrawn during the period in which the power may be exercised. This result is in full accord with Section 678(a)(1). Since the withdrawal is usually exercisable only for a short period, the tax consequences of this portion of the ruling need not be significant. The ruling goes on, however, to assert that the powerholder

will remain taxable on all the income generated by the portion of the trust over which the withdrawal power has lapsed. The IRS reaches this conclusion by finding that the lapse is a release for purposes of Section 678(a)(2). Should this proposition become well established the use of *Crummey* powers will become far more difficult. The problems are only magnified by the "kiddie tax" provisions of the Internal Revenue Code of 1986 since many powerholders are minors.

The final method of preventing a power to appropriate from being treated as a general power of appointment involves joint powers. First, if a power created on or before October 21, 1942, is exercisable only in conjunction with another person, it is not a general power of appointment. If the power is created after October 21, 1942, it is not a general power of appointment if it is exercisable only in conjunction with the creator of the power. If the power is exercisable only in conjunction with a person who has a substantial interest in the property subject to the power that is adverse to exercise in the decedent's favor, the power is not a general power of appointment. Finally, if after the two exceptions just mentioned are taken into account the power is a general one but exercisable in favor of the other powerholder it is considered a general power in the decedent only to the extent of the decedent's aliquot portion of the property subject to the power. In other words, the powerholders are assumed to agree to divide the appointive property among themselves.

The operation of these provisions are well illustrated by the applicable Treasury Regulations.⁶³ On the whole, the deliberate creation of joint powers does not seem to be a popular planning technique. If we recall that the usual goal is to give a beneficiary access to property without giving the beneficiary a general power of appointment that will result in transfer tax consequences, the disadvantages of the jointly held power are evident. The price of the exception is an adverse interest in the other powerholder. In other words, the cooperation of that other powerholder is necessary to allow the beneficiary access to the appointive property. Attitudes can change and no matter how cooperative the other powerholder (and that powerholder must be a person—corporations, including corporate fiduciaries, are not considered to have adverse interests) may be when the power is created, a change of heart can completely derail the best laid plans. The exceptions based on ascertainable standards and the five and five power depend only on the skill of the draftsman.

CONCLUSION

In summary, the power of appointment is an important tool for meeting clients' needs for flexible estate plans. The transfer tax principles involved in its use are fairly well settled and really quite favorable to accomplishing many common estate planning goals.

NOTES

1. I.R.C. § 2041(b)(1) (which refers to the donee as the "decendent"); I.R.C. § 2514(c) (which refers to the donee as the "possessor").
2. *A.W. Jenkins, Exr.*, 70-1 U.S. Tax Cas. (CCH) ¶12,677 (5th Cir.); *reh'g. denied* 428 F.2d 538; *cert. denied*, 400 U.S. 829 (1970); *Estate of Edelman*, 38 T.C. 972 (1962). The power is also a general power if the donee may accomplish transfer of the property to one of the four entities by not exercising the power. See below.
3. Treasury Regulation (hereafter Treas. Reg.) § 20.2041-1(c)(1).
4. *Ibid.*
5. I.R.C. § 2041(a)(2).
6. The question of the effect of lack of capacity to exercise a general power of appointment has been litigated in a majority of the Circuit Courts of Appeal with the result of unanimous support for the position of the Internal Revenue Service summarized in the text. See *Boeving v. United States*, 650 F.2d 493 (8th Cir. 1981); *Williams v. United States*, 634 F.2d 894 (5th Cir. 1981); *Estate of Gilchrist v. Commissioner*, 630 F.2d 340 (5th Cir. 1980); *Estate of Rosenblatt v. Commissioner*, 633 F.2d 176 (10th Cir. 1980); *Estate of Alperstein v. Commissioner*, 613 F.2d 1213 (2d Cir. 1979), *cert. denied* 446 U.S. 918 (1980); *Pennsylvania Bank and Trust Co. v. United States*, 597 F.2d 382 (3rd Cir.), *cert. denied* 444 U.S. 980 (1979); *Fish v. United States* 432 F.2d 1278 (9th Cir. 1970).
7. *Jenkins v. United States*, 428 F.2d 538 (5th Cir. 1970).
8. I.R.C. § 2041(a)(1).
9. For a good summary see Amy M. Hess, "The Federal Taxation of Nongeneral Powers of Appointment," 52 *Tennessee Law Review* 395, 401-9 (1985).
10. I.R.C. § 2041(a)(1) flush language.
11. I.R.C. § 2514(a). There is once again a transition rule embodied in the statute. *Ibid.*
12. Treas. Reg. §§20.2041-3(d)(6)(i), 25.2514-3(c)(5).
13. Treas. Reg. § 25.2514-1(b)(2).
14. 142 F.Supp. 762 (Ct.Cl. 1956).
15. Revenue Ruling (hereafter Rev. Rul.) 79-327, 1979-2 C.B. 342.
16. 83 T.C. 1 (1984).
17. It should be noted that special powers have no significance under the new generation-skipping transfer tax enacted as part of the Internal Revenue Code of 1986. The "taxable termination" of the new tax, unlike that of the old, applied only to interests, that is, the right to receive income or corpus, not to powers. I.R.C. §§2612(a)(1), 2653(c)(1).
18. See Chapters 7 and 23.
19. I.R.C. §§2056(b)(5), 2523(e). In the estate tax section the ellipses in the quoted text are replaced by the word "surviving" and in the gift tax section by the word "donee."
20. See Chapters 7 and 23.
21. Treas. Reg. §§20.2056(b)-5(g)(4), 25.2523(e)-1(g)(4).
22. Treas. Reg. § 25.2518-2(c)(3).
23. It must be noted that the disclaimer may create nonetheless a "direct skip" subject to the generation-skipping transfer tax.
24. I.R.C. §§2602, 2641.
25. I.R.C. § 2611(b)(1).
26. I.R.C. § 2652(c)(1)(A).

27. I.R.C. § 2612(a).
28. This is the briefest sort of discussion of this matter. The use of the general power of appointment always carries with it the possibility that the donee will appoint the property away from the objects of the donor's bounty.
29. *Martin vs. United States*, 780 F.2d 1147, 1148 (4th Cir. 1986); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1971).
30. *Second National Bank v. Dallman*, 209 F.2d 321 (7th Cir. 1954).
31. *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1971).
32. Treas. Reg. § 20.2041-1(b)(1).
33. *Ibid.*; *J.B. Maytag Estate*, 493 F.2d 995 (10th Cir. 1974); *A.B. McSwigan Estate*, 319 F.Supp. 176 (1970).
34. See below on ways of limiting powers to remove them from the definition of a general power of appointment.
35. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).
36. N. Y. Estates, Powers & Trusts Law § 10-10.1 (McKinney 1967).
37. 80-2 U.S. Tax Cas. (CCH) ¶ 13,381 (D.C. Mass. 1980).
38. Rev. Rul. 76-368, 1976-2 C.B. 271.
39. The following discussion is couched in terms of the estate tax. The gift tax provisions are identical.
40. I.R.C. § 2041(b)(1)(A).
41. *Compare Finlay v. United States*, 752 F.2d 246, 248 (6th Cir. 1985) ("In practical terms, there is an ascertainable standard if and only if, in the eventuality that [the trustee beneficiary] had used more of the corpus of the trust than was proper for her support and maintenance, the remaindermen could successfully have proceeded against her for the amount of waste.")
42. 1977-1 C.B. 282.
43. See Private Letter Ruling 8601003.
44. 631 F.2d 542 (7th Cir. 1980).
45. *Ibid.* at 543.
46. 374 Mass. 109, 371 N.E.2d 755 (1971).
47. Rev. Rul. 82-63, 1982-1 C.B. 135.
48. 74 T.C. 1001 (1980).
49. 708 F.2d 1564 (10th Cir. 1983).
50. 597-F.Supp. 1293 (W.D. Pa. 1984).
51. *Ibid.* at 1298.
52. Treas. Reg. § 20.2041-3(d)(3).
53. See p. 352 of this article.
54. Treas. Reg. § 20.2042-3(d)(3), (4), (5).
55. 397 F.2d 82 (9th Cir. 1968).
56. For fuller descriptions of this technique see Adams & Bieber, "Making 5 and 5 Equal 20: Crummey Powers after ERTA," *Trusts & Estates* 122 (1983) p. 22; Covey, Powers of Withdrawal, *Practical Drafting* (1982), pp. 58, 77-80.
57. Treas. Reg. § 20.2041-3(d)(3).
58. See, e.g. Private Letter Ruling 8047131, in which a period of exercise of two weeks was held sufficient.
59. Private Letter Ruling 8004170.

60. 395 U.S. 316 (1969).
61. For a full discussion see Westfall, "Lapsed Powers of Withdrawal and the Income Tax," 39 *Tax Law Review* 63 (1983).
62. Private Letter Ruling 8521060.
63. Treas. Reg. § 20.2041-3(c).