POWERS OF APPOINTMENT

I. INTRODUCTION

When viewed within the pattern of rules that make up the estate tax chapter of the Internal Revenue Code, Sec. 2041 is unique. This is the one and only section that subjects to taxation in the decedent's estate property (i) that the decedent did not own at his death, and (ii) that the decedent never owned during his life. Where are the Republicans when we really need them?

The tax law with respect to powers of appointment changed significantly on October 21, 1942, and powers of appointment created before that date were "grandfathered" under the pre-existing law. I have never had the opportunity to deal with a "pre-1942" power of appointment in the first 42 years of my practice, and I don't expect to come upon one now. This outline, therefore, will limit itself to "post-1942" powers of appointment.

II. VOCABULARY

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

A. The person who creates a power of appointment is called the "donor."

B. The person who possesses a power of appointment is called the "donee."

C. The person or entity who receives the property as a result of the exercise of a power of appointment is called the "appointee."

D. The person who receives the property if the power of appointment is not exercised is called the "taker in default."

III. GENERAL VS. LIMITED POWERS OF APPOINTMENT

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

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

1. The donee,

2. The donee's estate,

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

EXAMPLE: D creates a trust and direct the trustee to pay the income to D’s child, C, for C’s life. As of C’s death, the property is to pass to C’s child, X. C is given the power to appoint the property to his own estate. If he exercises the power, the property will pass pursuant to the terms of C’s will. C possesses a general power of appointment.

B. A limited power of appointment is any power that is not a general power. In other words, a limited power of appointment is one as to which the permissible appointees do not include the donee, the donee’s estate, the donee’s creditors or the creditors of the donee’s estate.

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

IV EXCEPTIONS TO THE DEFINITION OF GENERAL POWER OF APPOINTMENT

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

A. First, a power of appointment will not be considered a general power if it can be exercised by the donee only in conjunction with the donor. See Sec. 2041(b)(1)(C)(i).

B. Second, a power of appointment will not be considered a general power if it can be exercised by the donee only in conjunction with another person who has a substantial interest in the property subject to the power of appointment that is adverse to the exercise of the power. See Sec. 2041(b)(1)(C)(ii).

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

C. The third, and potentially the most troubling, exception is the “ascertainable standard” rule.

1. If the exercise of a power of appointment is limited by an “ascertainable standard” relating to the health, education, support
and maintenance of the beneficiary, the power will not be treated as a general power of appointment. See Sec. 2041(b)(1)(A).

2. This is not an area of the law in which creativity is rewarded. The use of ANY standard other than health, education, support and maintenance presents the risk that the power will be held to be a general power. Thus, a standard relating to comfort, happiness, well-being, as the trustee may find necessary and desirable, or the absence of any standard at all (“in the absolute discretion of my trustee”), may very well result in the power being viewed as a general power.

3. A state court may apply the law of that state to hold that a power is subject to an ascertainable standard notwithstanding the use of “tainted” language. There might be other language in the trust that a court might find sufficient to limit what might otherwise be viewed as a nonascertainable standard. See Estate of Vissering v. Com'r, 990 F. 2d 578 (10th Cir. 1991). The lawyer who drafts documents which then are challenged by the IRS must be careful to maintain his/her malpractice insurance in force. For those among you ay be of a more cautious nature, just use those four magic words, “health, education, maintenance and support,” AND NO OTHERS, and you will sleep the peaceful sleep of the blessed. Thus endeth the sermon.

4. The IRS has argued that an unrestricted right in a beneficiary to remove and replace the trustee is a general power of appointment. The argument is that the beneficiary could remove the trustee and appoint himself as trustee. There is a tortured history involving this issue. The current law is Rev. Rul. 95-58, which states that a beneficiary will not be deemed to have a general power if he/she is given the right to remove the trustee and to appoint an individual or successor trustee, so long as the successor in not related to or subordinate to the beneficiary (within the meaning of Sec. 672(c)). Another solution to this problem is to require a “committee” to remove and appoint a successor trustee, such committee to consist of a majority of an easily identifiable group, such as the spouse and adult children of the grantor who are legally competent.

V. THE “TAR BABY” RULE

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

A. The exercise of the general power by the donee causes the property subject to the power to be taxed to the donee for estate/gift tax purposes.
B. If, instead of exercising the power, the donee releases the power, that release will be deemed to be the equivalent of an exercise and the property subject to the power will still be taxed to the donee.

C. If the donee simply permits the power to lapse by its own terms, the lapse will treated as a release of the power which, in turn, is treated as an exercise of the power.

D. Finally, if the donee dies without having either exercised or released the power, the property that was subject to the unexercised power at his/her death with be taxed in the donee’s estate.

VI. THE “FIVE AND FIVE” RULE

A. The lapse of a general power of appointment will NOT be treated as the equivalent of a release to the extent that the property that could have been appointed by an effective exercise of the lapsed power does not exceed the greater of (i) $5,000 or (ii) 5% of the aggregate value, as of the date of such lapse, of the property from which the exercise of the lapsed power could have been taken. See Sec. 2041(b)(2).

B. Only one “free” lapse is permitted each year.

EXAMPLE: W creates a trust for the benefit of H. The trust provides that all income be distributed to H currently. Principal is distributable to H pursuant to an ascertainable standard. In addition, H is given the unrestricted right to withdraw the greater of $5,000 or 5% of the trust corpus each year. H decides not to exercise his right of withdrawal in 2003, thus permitting his power to lapse. The lapse of H’s general power of appointment will not be treated as a release of the power, and H will not be taxed on the property that he could have taken by exercising the power of withdrawal.

VII. CONCLUSION

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