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# USE OF POWERS OF APPOINTMENT IN ESTATE PLANNING

JOSEPH CURTIS

## *Definition*

Whatever its nomenclature, a power of appointment may be regarded for estate planning purposes as one to make a disposition of property, or of rights in property, other than such property as is owned outright and absolutely. A power to amend a trust so as to shift beneficial interests therein; a discretionary power to accumulate or distribute income; one to determine the respective shares of the income recipients; or to invade corpus; are all powers of appointment, whatever they may be designated, bringing into operation the provisions of IRC sections 2041 and 2514 in the determination of the Federal estate and gift tax consequences that follow upon exercise, release or lapse of the power. These Code sections have no applicability in treating upon a reserved power, one which the settlor reserved in himself, as there are other far more reaching sections, such as 2036 and 2038, applicable to property subject to a reserved power. This paper will be confined to treating upon donated powers, those given to others by a settlor of a trust, the primary targets of sections 2041 and 2514. A further confinement will be to treat only upon estate and gift tax consequences and not income tax considerations. Where a power is hereafter mentioned, it should be understood to mean only a donated and not a reserved power, and where tax incurrence is referred to, estate and gift taxes and not income tax is the reference.

## *Classification*

Only general powers, as defined by the Code, without property law refinements, generate possible tax liability to the donee-holder of the power or to his estate. Nongeneral powers bear no tax significance and therefore for purposes of the tax aspects of estate planning, it is necessary to have only two classifications of powers, general powers and all others, whatever other classifications may have some significance in property law. General powers are defined by the Code as being those exercisable in favor of the donee or his estate or the creditors of either, 2041(b)(1), 2514(c), including where the appointive property may be used to satisfy any tax liability of the donee or his estate. Regs. 2041-1(c); 2514-1(c). If the appointive property can in no way be used for the economic benefit of the donee or his estate, it is a nongeneral power, beyond the encompassment of 2041 and 2514, nor is it reachable by any other section of the Code solely by reason of the existence and functioning of the power.

### *Taxability*

Once determined that the power is a general one within the Code definition, the tax consequences are clear. The appointive property, for tax purposes, is property owned absolutely by the donee. Common law concepts, that the property remains that of the donor and passes to the appointees or takers in default from the donor and not from the donee, are wholly discarded in tax law. If the general power is exercisable by deed, and is so exercised by the donee, it is his gross gift to the appointees. If it is released inter vivos, or he permits it to lapse during his lifetime (with an exception to be noted *infra*), it is his gross gift to the takers in default. And if the donee dies possessed of the power, the appointive property is a part of his gross estate, whether or not he exercises the power by will. It is, in all tax respects, the donee's property to dispose of as he chooses, whether to himself, his estate, appointees or takers in default. The same tax provisions applicable to an absolute owner of property apply if the donee appoints in trust retaining the income right or the right to designate who shall get the income, or retaining the right to alter, amend or terminate, or a reversionary interest, or in contemplation of death. 2041(a)(2).

Given a nongeneral power, no matter how broad, so long as he cannot appoint for the economic benefit of himself or his estate, there is no such tax incurrance by the donee or his estate whether he exercises, releases or permits the power to lapse. The common law concept, that the appointive property passes to the appointees or takers in default from the donor and not from the donee, continues to prevail as well in tax law, at least since 1942.

### *Use of Powers in Estate Planning*

Powers of appointment are not to be used in estate planning to gain tax advantage. There is none to be gained. It should be apparent that the tax consequences are no different (1) whether (a) one gives property outright to his child, or (b) gives the property in trust for his child with a general power of appointment in the child. Similarly, they are no different (2) if (a) he gives the property in trust for his child for life, remainder to his child's issue per stirpes, or (b) gives in trust for his child for life with a power to appoint to such of child's issue and in such manner and shares as child should see fit. There is a tax advantage in either of the alternatives under (2) compared with either under (1), but due to generation tax-skipping, not to the use of powers, which powers obviously can be employed in (1) or (2). The advantage of the power given in (2)(b) is to permit child to take into consideration future events in the determination of who of his issue is to take, in what shares and in what manner, instead of fixing the shares at father's death without regard to circumstances as they may exist at child's death, perhaps many decades later.

Powers of appointment are very useful in estate planning where the objective is the use of a power, when future interests are to be created, to enable consideration of future events in the determination of the ultimate disposition of the property. Once having determined that this is desirable, then and only then should tax considerations enter into the plan. In tax planning, the objective is to avoid creation of a power that may needlessly incur tax cost upon its exercise, release or lapse. Determination of the use of a power should be made on the basis of how desirable is the flexibility of being able to consider circumstances as they may exist decades later in ultimately disposing of the property. Determination of the nature of the power should be made on weighing tax costs against perhaps overriding objectives.

It would be very rare, if not wholly nonexistent, except for the marital deduction trust in which a general power is mandatory to preserve the deduction, that the objective of giving a general power of appointment to the donee would outweigh the tax burden of doing so. There may be a unique situation in which a settlor or testator might not wish to give property outright to a donee, but to give him the power to take it outright any time the donee chooses, irrespective of the tax costs. It would be even more unique to give him only a testamentary power to appoint the property by will to the donee's estate, knowing, if so advised, of the additional estate tax burden that may be incurred, whether or not the power is exercised. The objectives of a long term trust are preservation of principal and appropriate administration, providing family resources as needed without needless dissipation, generation tax-skipping, and ultimate distribution to a class of beneficiaries, be they children, issue, grandchildren, nephews and nieces. A general power in the donee is a threat to all of them. A special power is no threat to any of them and provides added flexibility. A general power in the donee is to be avoided unless there are compelling reasons for it, as in the case of the marital deduction trust, or in the case of where tax consequences are to be belittled or bedamned.

#### *Extent of Benefit and Control to be given Donee*

A decision to use a nongeneral power of appointment in conjunction with a generation tax-skipping trust must be followed by a further decision as to the extent of benefit and control over the property to be given the donee. This is wholly a matter of the settlor donor's wishes, but he should be advised of the possibilities open to him without losing the tax saving objective. It may be that the donor intends that donee should have only the life income right with a power to appoint the principal by will among the donee's children, or whatever the class of objects of the power. On the other hand, donor may wish donee to have as much economic benefit in and control over the property as can be given without incurring additional tax cost to donee or his estate.

The Code provisions allow considerable latitude in this regard, specifically excluding certain rights in the donee in defining a taxable general power. Consider the following example:

Father, *F*, has income producing property which he wishes to give to his son, *S*, however he wants to avoid the value of the property in either his own or *S*'s gross estate for estate tax purposes, and also avoid a second gift tax liability should *S* decide to give it to his children in *S*'s lifetime. *F* has therefore decided to transfer the property in trust for *S* and *S*'s children, giving to *S* as much economic benefit in the trust property and also as broad control over the disposition of the property as is possible without defeating the generation-skip tax saving objective. The trust terms will provide:

1. "Annual trust income to be paid to *S* during *S*'s life." No problem, of course. The principal does not become part of *S*'s gross estate by reason of his life income right where he was not settlor.
2. "*S* to have the power by deed or by will to appoint the property to such of his children in such manner and in such shares as he may see fit, and in default of exercise of the power, the property to pass per stirpes to *S*'s issue living at his death." The power is not exercisable in any way in favor of *S* or his estate and therefore incurs no tax liability whether exercised or not.
3. "*S* may invade corpus for any purpose whatever, but not to exceed \$5,000 or 5% of the value of the corpus whichever is greater in any one year." Although this would otherwise be considered a general power, section 2041(b)(2) specifically makes an exception where the invadable amount is so limited. The advantage is that if *S* should not invade the corpus in each year, it will not be treated as a lapse of a general power whereby *S* would be making a transfer of \$5,000 in each year, retaining the right to the income therefrom under sec. 2036 coupled with 2041(a)(2).
4. "*S* may invade corpus in excess of \$5,000 but only to meet extraordinary illness costs or to the extent necessary to maintain his ordinary standard of living and failure of other means of support." Sec. 2041(b)(1)(A) specifically excludes this from the definition of a general power where the right to invade is subject to an ascertainable standard relating to health, education, support or maintenance.
5. "*S* may refuse the income in any year and cause it to be added to the trust corpus." This is not advisable in light of the tax saving objective. The income is *S*'s property and therefore each year he refuses it, he would be making a transfer under 2036 in which he retained the right to the income from such income added to corpus.
6. "*S* may terminate the trust at any time and appropriate the trust corpus as he pleases, but (a) only with the consent of *F* while living, or (b) all of *S*'s children after *F*'s death." (a). While sec. 2041(b)

(1)(C)(i) specifically provides that if the power is exercisable only with the consent of the donor, it will not be treated as a general power, and this therefore would be all right from the standpoint of *S*'s gross estate, it would result in inclusion of the property in *F*'s gross estate under sec. 2038. (b). 2041(b)(1)(C)(ii) provides that if the power is exercisable only with the consent of one having an interest in the property substantially adverse to an exercise in favor of the donee, it will not be considered a general power. *S*'s children do have such an adverse interest and thus the (b) part would not be objectionable from a tax standpoint.

The above trust terms, omitting 5 and 6(a), offer maximum benefit and control in the donee without losing the generation-skip tax advantage. Of course, the powers given the donee may be greatly restricted, depending upon the donor's wishes. The above term 2 power may be made exercisable only by will; it may be made nonexclusive and non-illusory, where by *S*, if he exercises the power, must appoint a substantial amount to each of his children; it could omit "in such manner" and provide that *S* must appoint the property outright to his children and not in trust. The powers of corpus invasion could be more limited or entirely omitted, as could the income right. These are matters for donor's decision and do not affect taxability.

### *Rule Against Perpetuities*

Without treating in depth on the applicability of the Rule against Perpetuities to powers of appointment, at least one basic should be mentioned in any paper on the use of powers in estate planning. Most basic of all is that the common law period of the Rule, lives in being plus 21 years and periods of gestation, commences to run from the time of creation of a power, other than a general power exercisable by deed, and not from the time of exercise of the power. *Minot v. Paine*, 120 N.E. 167 (Mass.). Violations of the Rule occur more frequently in two planning areas: (1) when a testator wishes to tax-skip, or for whatever reason wishes interests to formulate beyond more than one generation, which can be done if vesting of interests is carefully geared to members of future generations living at his death; and (2) when a settlor, establishing an inter vivos trust, creates interests which would be perfectly good if done by will, but not so by deed. Both of these planning areas are particularly susceptible to the Rule even when no powers of appointment are to be used. Using powers, there are pitfalls. A typical violation in (1) would be to give by will to grandchildren, described by class, a special testamentary power of appointment, which, because there may be afterborn grandchildren, may not become exercisable within the period of the Rule. The power is therefore void in its creation. The same would apply to (2), one earlier generation, if the

special testamentary power in children were to be created by deed during the life of the donor, who could presumably have more children.

### *Exercise of the Power*

A power of appointment is not considered to be exercised by the donee at common law unless there is (1) specific reference to the power, (2) specific reference to the appointive property, or (3) his dispositions would be ineffective without including the appointive property. *In re Proestler's Will*, 5 N. W. 2d 922 (Iowa). Many states have, by statute, altered this concept in varying degrees. Va. Code Ann. #64-67; Md. Ann. Code Alt. 93 #4-407. The more common form of statute permits the appointive property to pass in accordance with the residuary clause of the donee's will, unless there is an express intent that it should not serve to exercise the power. The common law rule requires evidence of a positive intent to exercise the power, whereas the more usual statute requires evidence of an intent not to exercise the power. There is much that could be said on the value of either position. It has been by the respective legislatures which have adopted or rejected the statutory change. Is it more likely that the donee intended that all property over which he should have the power of disposition should pass under his will, including appointive property (the statutory position)? Or is it more likely that the donee intended the appointive property to pass, however it would, should he not specifically exercise the power (the common law concept). Conjecture in the realm of what may have been in the mind of a deceased donee, is wholly unreliable, if not impossible. The donor should be apprised of this and take it in hand, as he may. If the donor has provided for who should take in the event that donee fails to otherwise dispose of the appointive property, he should make the test a positive disposition by the donee and not one by negative inference. He can and should do this by simply providing that the power can be exercised by the donee only by specific reference to it, thus overcoming any statutory provision to the contrary.