TO: Senior Partner

FROM: Amber Homolka

RE: Special Powers of Appointment

DATE: 22 April 2019

A power of appointment is the right to dispose of property, given by an owner to someone else. [1] The appointment is often made be by deed, will or trust and allows the third party to determine the identity of the person or persons who will receive all or some portion of property that is often held in trust or devised by will. These powers are attractive because they afford the possibility of altering disposition of assets long after the grantor or owner has passed away, in accordance with changes in circumstances.

Special powers of appointment warrant great consideration in implementation when the power holder is considering a power exercise. A client who possesses a special power of appointment will need expert legal advice in order to make an educated decision about when and how to exercise such power. Given the current high exemption amount for the estate tax, clients with substantial estates who hold a special power will benefit from planning with the power in mind. In so planning, counsel for the power holder must address local property law and the income, estate and gift tax considerations to adequately inform the client of his or her options.

I. Defining "Special" Powers of Appointment

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[1] See William Streng, Estate Planning Fundamentals Chapter 9, page 2 (Spring 2019) (unpublished manuscript)(on file with University of Houston Law Center). Also, Howard M. Zaritsky, *Estate Planning with Powers of Appointment*, 5.01, Copyright (c) 2019 Thomson Reuters Tax and Accounting.

There is no mention of a "special" power of appointment, as such, in the tax code. Also called a "limited" power of appointment, these powers stand in contrast to the general power of appointment found in IRC §2041(b)(1). We define a special power of appointment by reference to what it is not. A general power is exercisable by the decedent, his (or his estate's) creditors, or his estate.[2] It is generally understood that a "special" power of appointment, though not called such in the tax code, lies in exceptions to the definition of a general power. Because inclusion in the gross estate for tax purposes is commonly the greatest concern of estate planners and their clients, it is by reference to section 2041 that we look. A general power of appointment is included in the gross estate. As a result, estate planners either a) create powers that are excepted to this inclusion and are therefore "special" or "limited", or b) create a planning scenario where a general power ceases to be in the holder's estate at death and is therefore not includible.

If there are sufficient limitations on a power of appointment that make it such that the holder cannot simply take the asset for his own use, without any limitation, adversarial concern or discussion, then they are excepted from being general powers. For example, a power that is only exercisable for the health, education, support or maintenance of the holder is not general (and therefore is "special"). Also, if the power holder must work in conjunction with the person who created the power, then it is a "special" power. Likewise, if the power holder must exercise the power in conjunction with someone who also has a "substantial" interest in the property at issue, then the power is "special" as well.[3]

State law generally does not classify powers of appointment as "special" at all. The term has arisen in context of estate planning. The extent to which state law may affect a tax classification is examined below in II.

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[2] IRC §2041(b)(1).
[3] See discussion *supra* Part III.a.

II. Local Law Considerations

a. State Law Property Concepts

How does one know whether the property right at issue is even a power of appointment to begin with? One must look to the state law of property to determine this inquiry.[4] For example, Texas Property Code, Chapter 181 provides that a "power" is the authority to "appoint or designate the recipient of the property, to invade or consume property, to alter amend or revoke an instrument under which an estate or trust is created or held and to terminate a right or interest under an estate or trust, and any authority remaining after a partial release of power.[5]

State property law often makes a distinction between "exclusive" powers and "non - exclusive" powers.[6] An exclusive power allows the holder to allocate assets exclusively to the person or persons listed in the grant; none may be excluded. If the power is non-exclusive, the donee may exclude entirely one of more objects of the power, or persons who would be eligible to receive property as a result of the power's exercise.

State law always informs any federal tax court that is considering the nature of the property right, if it is considering the tax consequences thereof. To the extent that creditors' rights and exclusivity of the appointment may affect the special or general nature of the appointment, they may be instrumental in any transfer tax interpretation. It must be remembered that classification of the property right is always dictated by state law and is *never* displaced by federal tax law, when a court is considering the power of appointment at hand.[7]

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[4] See *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).
[5] Texas Property Code §181.001(2).
[6] See Streng at Chapter 9, page 4.
[7] See Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) at 466.

b. State Statute and "Ascertainable Standard"

State property law classifications are critical when courts examine certain powers of appointment that were drafted with a standard for the holder to follow when taking a withdrawal for himself. To the extent that a special power is not clearly created by following statutory language of "health, support, education and maintenance" for withdrawals, as outlined in IRC 2041, additional words and state law of trusts often is a turning point for the court when determining whether the power, a right under state law, should be viewed in that instance as "general" or not general, or "special". This is discussed below at III.a.

III. Tax Planning Considerations

a. Estate Tax

The estate tax is the main concern of most clients, as regards a power of appointment. The holder of a power of appointment will have his estate subjected to the estate tax if the power is not carefully drafted. A decedent who dies holding a "general power of appointment" will have it included in his gross estate under Internal Revenue Code section 2041.[8] This can thwart the testator's desires, if care is not taken. Owners or donors of the power of appointment can ensure that a power of appointment is "special" rather than general to avoid its inclusion in the gross estate. To do so, they must avoid certain pitfalls.

i. Attorneys should draft the power to take assets subject to a standard of health, support, education and maintenance *only*.

Where a power holder can divert funds or assets to himself, there is a danger of the property right being classified as a general power, subject to inclusion in the gross estate. The power to

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[8] IRC §2041.

dispose of the donor, testator or grantor's assets is often given in a power of appointment subject to certain limitations, especially where the power holder can appoint income to himself. The donor may wish to provide for college, health care catastrophes, or the like in events that could not be foreseen by him or her when documents were drafted. The holder of the power, much like a trustee for his own behalf, would then evaluate whether his (or other would-be beneficiaries') circumstances fit within the standard intended by the giver of the power of appointment.

However, the Code makes it clear that any standard that is broader than the clearly-defined "ascertainable standard" in Code Section 2041 will place the power of appointment firmly in "general" territory and thus make it subject to the gross estate inclusion. Therefore, attorneys should make any standard in the power-granting document adhere to the "ascertainable standard" so that they may be "special" powers of attorney. The code section should be followed assiduously in this regard, and no artistic license should be taken by the drafting attorney.

The power's standard for disposition of assets should be limited to "a

power to consume, invade, or appropriate property" that are "relating to the health, education, support, or maintenance" only.[9] Indeed, where drafters have expanded the "ascertainable standard" with other language than that in the statute, there has been inclusion of the power in the gross estate.

The word "comfort" is a controversial word that ought not to be included in a trust, unless the drafting attorney has a desire for controversy and possible malpractice suits. The regulations clearly state that "power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard."[10] If this word is used, then a position not to include

[9] IRC §2041(b)(1)(c).

[10] Treas. Reg. §20.2041-1(c)(2).

the power on Form 706 will result in controversy. In one notable Tenth Circuit case, the court held that under the requisite Florida property law, inclusion of the word "comfort" expanded the ascertainable standard, creating a general power of appointment.[11]

Consider also a Missouri will that included the word "comfort" in the standard for a power. Were it not for Missouri property law which, under the terms of the trust, the power would have been included in the gross estate. Thus, the taxpayer avoided inclusion of the power in the gross estate by a hair. It was only after a thorough analysis by the IRS in Private Letter Ruling 200014002 that it was found that decedent's lack of the ability to exercise her trustee power to distribute principal to herself, under the Missouri trust code and terms of this trust, that a general power was not held. Where other language in the trust makes it such that the power of appointment is quite limited, due to state law, then tax courts will interpret the property right according to such state law.

State laws may be found to have an ascertainable standard, even if the attorney drafts too-expansive language. Many states have enacted savings clauses that impute the "ascertainable standard" in Code Section 2041 to a broadly-drafted testament or power grant. Texas is such a state. Texas Property Code §113.029(b) allows for the IRC §2041(b)(1)(a) "health, education, support or maintenance" standard to apply in any trust wherein an express indication to the contrary has not been memorialized. Therefore, a Texas trust that is absent a standard will be "saved" from gross estate inclusion if no express indication to opt out of the savings statute has been made in the instrument.[12] Note, however, that the IRS will not allow a state law that seeks

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[11] *Estate of Vissering v. Com'r of Internal Revenue*, 990 F.2d 578 (10th Cir., 1993).

[12] Texas Property Code §113.029(b)(amended in 2013). See also Streng, at Chapter 9, page 18, footnote 11. Consider, in contrast, Louisiana law, which nullifies "testamentary dispositions committed to the choice of a third party person" under Civil Code §1572. Louisiana allows for a very limited power of appointment, with the limitation that all beneficiaries must be descendants of the testator under Civil Code §2031. This is in stark contrast to the expansive state property law of Texas regarding powers of appointment and its savings clause.

to change an individual's property rights or powers after the federal tax consequences have been deemed to apply.[13]

ii. Attorneys should consider making the power exercisable in conjunction with another person.

Where possible, attorneys should draft a power of appointment to be exercised with another person. If this suits the needs of the client's situation, then it is an added assurance that the power will be kept out of the gross estate for estate tax purposes. Section 2041(b)(2) makes it clear that if a power holder can divert property for himself, but only with another person, it will not be included in the gross estate. A power of appointment that is exercisable "in conjunction with the creator of the power" is not a general power (and is therefore "special").[14]

Likewise, a power that is exercisable "with a person having a substantial interest in the property, subject to the power, which is adverse" to the holder is not includible in the holder/decedent's gross estate.[15] For example, if the power holder had to make decisions about how to sprinkle funds among possible beneficiaries, including himself, but one of the beneficiaries had joint decision-making power with him, then the power is not includible. This stands to reason, because the decedent/power holder could not simply invade funds or property for himself without facing a real adversarial discussion with another party first.

Where Trustee committees share decision-making authority, the terms of the instrument will tell whether a true adversarial interest exists.[16]

[13] Rev. Proc. 94-11, 1994-2 CB 683.
[14] IRC §2041(b)(1)(C).
[15] IRC §2041(b)(1)(C)(ii).
[16] See Rev. Rul. 77-158, 1977-1 C.B. 285 and IR-2007-127, wherein the Service found differing conclusions about the adversarial nature found in in the power of appointment due to the terms of each respective trustee committee.

b. Income Tax

Taxable income is received when a special power holder invades property subject to the power for his own benefit. Simply put, income from "any source derived" is inclusive of these types of distributions.[17] However, if the power is "special" and not general, then assets are out of the taxpayer's reach unless an ascertainable standard is met and/or another party has agreed to a distribution. As such, the grantor trust rules should not normally apply by virtue of the power itself, making income of assets in a trust (that has a power) not subject to income tax until withdrawn.

c. Gift Tax

i. Power of Appointment and Lapses

Consider the holder of a power of appointment who has the right to withdraw from a trust but does not exercise his ability to invade or consume the property during the year allowed. This is considered a "lapse" of the power.[18] This "lapse" or "release" may be considered a transfer, since another person has a right to the property in lieu of the power holder. If the power of appointment is general, then the transfer is subject to gift tax, if no exception is met. A transfer of the right to withdraw has been made from the power holder to whomever the taker in default of the power would have been. This is another example of why it is important to draft the power of appointment so that it is "special" rather than general.

ii. Lapse Exception: The "5 or 5" Power

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[17] IRC §61.
[18] IRC §2041(b)(2).

A general power of appointment that lapses will not result in a "release" and resultant gift tax to the extent that property that could have been appointed by an effective exercise of the lapsed power does not exceed the greater of: 1) $5,000 or 2) five percent (5%) of the aggregate value as of the date of the lapse, of the property from which the exercise of the lapsed power could have been taken.[19] For example, a beneficiary who holds a power of appointment and allows it to lapse will be assessed gift tax only to the extent that the release covers $5,000 or 5% of a trust.

Upon what body of assets will the $5,000 or 5% power be assessed? It need not be the entire trust corpus. In fact, it may be a much more limited amount. The trust or granting instrument may define the power as a right to invade the income interest in a given year. As a result, the $5,000 or 5% would be calculated based on one year's income interest. "It is the power of distribution that determines the taxability, for purposes of section 2041, of value of the property subject to the power."[20]

A "taker in default" receives a gift when a power holder allows a lapse or release. The annual gift tax exclusion is available for the holder to in this context.

As an example, consider that a mother (M) creates a trust for her son (S). Under the terms of the trust, all the income must be distributed currently, and the corpus can be withdrawn for his health, education, maintenance and support. S is permitted to withdraw the greater of $5,000 or five percent of the corpus annually. He did not withdraw any of the principal in 2017, so the power lapsed. The lapse here is *not* a release of the power of appointment due to the inclusion of the "5 or 5" power in the trust terms. As such, S will not be taxed on property that he could have taken but chose not to take.

[19] *Id*.
[20] Rev. Rul. 79-373, 1979-2 C.B. 331.

d. Generation-Skipping Tax

In a multi-generational trust, when the settlor funds the trust, he may or may not have generation-skipping exclusion amounts available. If he does have this exclusion available, it will be applied to the amount funded.[21] If there is no exclusion left, then new transferors may be taxed each time that a transfer is made in the future.[22]

[21] See IRC §2632.

[22] IRC §2652(a)(1). Note that It may be possible to permit an independent trustee the power to convert a special power of appointment held by a beneficiary to a general power of appointment in order to shift the burden of the generation-skipping tax. Alternately, such an independent trustee may be given the power to grant a general power of appointment to a beneficiary altogether for the same purpose. See Bridgers, Boothby and Willcox, *Powers of Appointment Primer, Part 2: Powers of Appointment*, Colorado Lawyer, August/September 2018, at 61.