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Professor Elaine Gagliardi on The Magical Power of Appointment: Allows Trustor to Achieve Targeted Tax Consequences and Flexibility of Control

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Featured Articles

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By Professor Elaine Gagliardi[*]

§ 1.01 Introduction

As children, and sometimes as adults, we wish for magical powers to order the world in the way we want. Estate planners can make that wish come true for some clients and beneficiaries with judicious use of powers of appointment. Powers of appointment are uniquely suited to achieving targeted planning goals and increasing trust flexibility. Planning techniques, old and new, including the oft used *Crummey* trust[1] and the more recently developed array of acronym trusts designed to achieve specific tax consequences, such as the intentionally defective grantor trust (IDGT)[2] and the Delaware incomplete non-grantor trust (DING)[3] to name a few, rest in large part on creative uses of powers. The magic of the power of appointment lies in the fact that its form informs its substance. Powers of appointment can avoid the strictures of fiduciary duties and courts recognize the form of powers of appointment regardless of a decision to exercise the power. Powers of appointment designed to avoid characterization as general powers, can achieve beneficial income, estate, gift and generation-skipping transfer tax consequences, assist in the avoidance of creditor claims, provide for modification of trust terms, and center decision making in family members. Is there any other legally enforceable right over or interest in property that can be used to achieve such a broad array of planning goals?

The article begins by addressing the niche, historical and present, served by powers of appointment in Part 2. It moves to exploring the "magic" of the power of appointment which derives from its flexible nonfiduciary characteristics and also from the respect courts accord its form for tax purposes. The ability of planners to mesh substance in the design of the power's form yields a legally enforceable right with respect to property that can be used by clients to achieve targeted goals and flexibility to change with circumstances. Both state law and tax law work to implement these important characteristics, and the article discusses both in Parts 3 and 4, respectively. The

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[1] See Crummey v. Comm'r, TC Memo. 1966-144, aff'd in part and rev'd in part, 397 F.2d 82 (9th Cir 1968).

[2] "IDGT" refers to the intentionally defective grantor trust, designed to qualify for grantor trust status. The IDGT has become so ensconced in estate planning jargon that it has now become a defined term on investment websites, see, e.g., http://www.investopedia.com/terms/i/igdt.asp (accessed December 16, 2015).

[3] "DING" refers to the Delaware incomplete non-grantor trust designed to avoid state income tax. *See* J. Blattmachr and W. Lipkind, *Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust*, Vol. 26, No. 4 Probate and Practice Reporter 1 (April 2014).

article concludes with an analysis of how planners currently use powers to achieve a variety of client goals for flexibility, control and tax minimization in Part 5.

§ 1.02 The Niche of the Power of Appointment

Application of wealth transfer tax rules depends on the rights and interests in property as recognized by state law.[4] You may recall your law professor likening the concept of property to a bundle of sticks with each stick representing an interest in property, and later introducing the notion of a ball of strings with each string being tied to a stick and representing the right or power to tug on the stick and move it or, in other words, appoint it, in a certain manner and direction. Interests in property (the proverbial sticks) include, for example, the interest or ability to use the property, benefit from the income earned on the property, or sell or assign the property or interest in property. Interests differ from rights or powers over property. The law regarding "powers" addresses rights held by a person to direct the distribution and ultimate disposition of property (the proverbial strings) and thereby affect who may use or benefit from the underlying interests in property.[5] Powers may not be sold or assigned, and are personal to the holder. This distinction between interests in, and powers over, property is the foundation that makes powers so useful in the design of trusts and other planning techniques.

Powers are used by estate planners today to build flexibility into estate planning documents, particularly trusts, and in doing so to achieve certain planning goals such as family control, minimization of taxes and creditor protection. Historically, meaning in the early part of the 17th century, powers were invented as an estate planning tool to avoid legal limitations on the transfer of property interests at death.[6] Where at that time property interests could not be transferred at death, powers could "achieve the practical equivalent of a devise by granting the property in the owner's lifetime upon uses to be appointed by the owner's will."[7] It is fitting that powers continue to be a critical element in achieving a client's estate planning goals. The Internal Revenue Code, since its inception has recognized the differences between property interests that are transferable and powers of appointment granted to a person and specifically designed so as to control property within the limits set by the donor. The Code, thus, subjects property interests to different rules of taxation than it does powers.

While application of tax law rests on rights recognized and enforced for purposes of state law, tax law imposes a distinct set of rules and definitions with respect to the taxation of powers over property. Gaining an understanding of the distinctions as between state law definitions and treatment of powers and the tax law counterparts is an important starting point. From a planning perspective those distinctions prove critical for tax and creditor protection purposes. An important

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[4] See Comm'r v. Est. of Bosch, 387 US 456 (1967).
[5] Restat 3d Property: Wills and Other Donative Transfers, § 17.1 cmt. c (3rd ed. 2003).
[6] Restat 3d Property: Wills and Other Donative Transfers, Scope (3rd ed. 2003).
[7] *Id*.

aspect of the magic, if you will, in the power of appointment derives from its state law characteristics.

§ 1.03 The "Magic" Conferred by State Law

[1] Nonfiduciary Powers

Powers of appointment allow the transferor to grant tailored powers to control underlying property interests without subjecting exercise of the powers to fiduciary duties. Clients recognize the costs of fiduciary litigation and cringe at the possibility that the beneficiaries of their hard earned wealth in the end might be the litigators instead of the objects of their love and affection. The ability to create legally enforceable rights and powers that avoid the prospect of breach of duty suits recommends use of powers of appointment. Granting nonfiduciary powers of appointment may better achieve the protections provided by a trust protector or trust advisor, which under the Uniform Trust Code in some instances presumptively remain subject to fiduciary duties in the exercise of their powers.[8]

The essence of a power of appointment is its nonfiduciary status. The Uniform Powers of Appointment Act, modeled in large part after the Restatement 3d Property: Wills and Other Donative Transfers, specifically defines power of appointment as a "power that enables a powerholder acting in a *nonfiduciary capacity* to designate the recipient of an ownership interest in or another power of appointment over the appointive property."[9] Unlike the Uniform Power of Appointment Act, the Restatement 3d Property: Wills and Other Donative Transfers, which served as the model for the Act, does not specifically define "power of appointment" by limiting its application to nonfiduciary powers,[10] however, the comments to the Restatement indicate its discussion of powers of appointment generally does not apply to powers held in a fiduciary capacity, thereby likewise limiting application of its analysis of powers of appointment to those held in a nonfiduciary capacity.[11] The nonfiduciary nature of powers of appointment substantially increases flexibility to control distribution of property.

The nonfiduciary nature of the power of appointment allows the donor to effectively give the powerholder complete control to trump or modify trust terms by appointing to permissible appointees. A power granted to family members or other persons to appoint property in trust or otherwise to any persons other than the powerholder or creditors of the powerholder allows the powerholder without constraint to shift the appointive property in any manner the powerholder

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[8] Unif. Trust Code § 808(d) (2014). (Specifically, it provides: "(d) A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty.")
[9] Unif. Power of Appointment Act § 102(13) (2013) (emphasis added).
[10] Restat 3d Property: Wills and Other Donative Transfers, § 17.1 (3rd ed. 2003).
[11] Restat 3d Property: Wills and Other Donative Transfers, § 17.1 cmt. g. (3rd ed. 2003).

wishes among the broadly defined permissible appointees. The powerholder could thereby direct the appointive property pursuant to a new trust with different terms for the permissible appointees, or could direct distributions as the powerholder sees fit among the permissible appointees regardless of the other dispositive terms of the trust. Powers of appointment, thus, can avoid the need to rely on modification statutes or decanting statutes to affect a change in trust terms. Powers can also avoid the need to grant a trust protector or trust advisor power to direct the trustee as to use of the trust property, which in Uniform Trust Code states at least, must be exercised by non-beneficiaries subject to fiduciary duties.[12] Fiduciary duties encompass duties of loyalty and impartiality not inherent in the exercise of a nonfiduciary power of appointment. The nonfiduciary nature of the power of appointment allows the donor to repose power in a trusted person to change beneficiaries and standards of distribution, and to even transfer property to an entirely new trust without complaint by beneficiaries or the need to seek court approval provided the exercise falls within the parameters of the power of appointment as designated by the donor.

[2] Flexibility of Terms

State law generally allows the donor of a power of appointment to draft powers as broadly or narrowly as donor desires. Under state law the donor may retain the power or may grant it to another person.[13] The donor may specify when the power holder can exercise the power. A power of appointment may be presently exercisable, exercisable by testamentary instrument effective at the powerholder's death, or postponed until the occurrence of an event or satisfaction of a standard.[14] The donor may design the power to allow appointment of property outright or in further trust, to one or more permissible appointees and to be subject to specific conditions of exercise. The powerholder may have the right to specifically exclude any one or more of the permissible appointees from receipt of appointive property, called an exclusionary power.[15] These broad parameters allow the donor to tailor the power granted based on planning goals.

State law characterizes powers of appointment as general or nongeneral based on the type of permissible appointee. General powers are those where the powerholder may appoint to herself, her creditors, her estate or the creditors of her estate.[16] All other powers exercisable solely by the powerholder fall into the category of nongeneral powers, often referred to as "special" powers or "limited" powers. Nongeneral powers may include a broad range of permissible appointees, for example, all persons other than the powerholder, the power holder's estate or the creditors of either

[12] Unif. Trust Code § 808(d) (2014). Some states have chosen to vary the fiduciary nature of the power to direct by a trust advisor or trust protector.

[13] Restat 3d Property: Wills and Other Donative Transfers, § 17.2(a), (b) (3rd ed. 2003). See Unif. Powers of Appointment Act § 303(2).

[14] Unif. Powers of Appointment Act § 102(15); Restat 3d Property: Wills and Other Donative Transfers, § 17.4 (3rd ed. 2003).

[15] Unif. Powers of Appointment Act § 102(5).

[16] Unif. Powers of Appointment Act § 102(6); Restat 3d Property: Wills and Other Donative Transfers, § 17.3 (3rd ed. 2003).

one. They can also be more narrowly tailored both with respect to the range of permissible appointees and by imposition of a standard. State law also exempts certain joint powers from classification as general powers.[17] The Internal Revenue Code provides favorable transfer tax treatment for certain nongeneral powers. State law also provides favorable creditor protection for certain nongeneral powers. The ability to obtain tax savings and creditor protection by using nongeneral powers tends to favor their use. Both the tax code and the rules of the Uniform Trust Code also provide favorable treatment on the lapse of a general power of appointment if it does not trigger a taxable gift or inclusion in the gross estate.

[3] Creditor Protection

Not surprisingly, creditors of the powerholder under the Uniform Power of Appointment Act can reach the appointive property underlying a presently exercisable general power of appointment in light of its "ownership-equivalent" status.[18] Two important exceptions to this general rule subjecting property underlying a general power of appointment to creditors are provided by the Uniform Powers of Appointment Act – one exception deals with the ability of a powerholder to distribute property for the powerholder's health, education, support and maintenance,[19] and, the other exception, with the lapse of a general power within the greatest of the amount allowed without triggering a taxable transfer under the Internal Revenue Code and the gift tax annual exclusion amount.[20] General powers excepted are not within the reach of creditor claims under the Uniform Powers of Appointment Act, but notably these same exceptions are not recognized under the terms of the Restatement (Third) of Property and it remains to be seen whether the exceptions will be recognized for purposes of bankruptcy.[21]

In contrast to general powers, the appointive property subject to nongeneral powers avoids creditors of the powerholder provided that the taker in default of the power is not the powerholder or the powerholder's estate.[22] The theory underlying this rule rests on the fact that nongeneral powers do not bear an "ownership-equivalent" status as is the case with general powers. By definition the nongeneral power cannot be exercised for the benefit of the powerholder or powerholder's estate, or creditors of either.

Not only may creditors of the holder of a nongeneral power of appointment not reach appointive property, judicious use of nongeneral powers by persons who are not beneficial owners of the

[17] See Unif. Powers of Appointment Act § 205(b); Restat 3d Property: Wills and Other Donative Transfers, § 17.3 cmt. e (3rd ed. 2003).
[18] Unif. Powers of Appointment Act § 502, Comment.
[19] Unif. Powers of Appointment Act § 502(b).
[20] Unif. Powers of Appointment Act § 503.
[21] See infra note 24.
[22] Unif. Powers of Appointment Act § 504. *See also*, Restat 3d Property: Wills and Other Donative Transfers, § 22.1 (3rd ed. 2003) (citing similar protection provided by Section 541(b)(1) of the federal Bankruptcy Code of 1978 (11 USC § 541(b)(1)).

appointive property can provide flexibility to redirect property from a beneficial owner whose creditors might otherwise reach the appointive property. Nongeneral powers can be granted in such a manner as to allow redirection of property and the flexibility to change the rights of underlying beneficiaries to trust property. The powerholder, thus, can with some foresight wrest appointive property from a beneficiary and as a consequence the beneficiary's creditors.

§ 1.04 The "Magic" Conferred by the Tax Code

[1] Powers Taxed Separately from Property Interests

Federal wealth transfer tax consequences of a power of appointment depend on its form and classification as a general power of appointment. A general power of appointment, unlike a "special" or "limited" power of appointment, confers ownership-like rights to use the property for the powerholder's own benefit. Given that wealth transfer taxation depends on the economic rights and powers held or transferred by the decedent or donor,[23] it is not surprising the Code recognizes the differences in the economic characteristics conferred by a power of appointment as opposed to the transfer of an interest in property.[24] By specifically identifying the characteristics of general powers that cause inclusion in the gross estate or taxation as a taxable gift, Congress has provided a clear formula, if you will, for taxation of powers that generally avoids susceptibility to substance-over-form arguments applicable to transfers of interests in property.[25] The ability to draft a power and rely on the form specified in the Code allows for creative use of powers to achieve specific tax results thereby lending to the "magic" of the power of appointment.

The Supreme Court has chosen to interpret taxing statutes based on the economic rights in and powers over property held or transferred by the decedent or donor, focusing on the substance as opposed to the form of the transfer.[26] Property interests owned and transferred by taxpayer trigger application of wealth transfer taxes provisions.[27] Although powers of appointment can impact the valuable economic rights associated with property interests subject to appointment, the United States Supreme Court has long differentiated the taxation of powers of appointment from taxation of interests in property.[28] The Court in *United States v. Field*[29] held that the then counterpart to IRC Section 2033 did not include in the gross estate that property subject to a general power of appointment held by the decedent on the basis that it was not a property interest includible in the probate estate subject to creditor claims as required by the statutory language in effect at that time.

[23] Burnet v Guggenheim, 288 US 280, 283-284 (1933); Comm'r v Estate of Church, 335 US 632, 644-45 (1949). *See* Gagliardi, E., *Economic Substance Doctrine in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 Mont L Rev 389 (2003) discussing the cited cases.
[24] Compare IRC §§ 2033 and 2035-2038 applicable to transfers of interest in property to IRC § 2041 applicable to powers of appointment held by persons other than the donor of the power of appointment.
[25] IRC §§ 2014, 2514.
[26] *Supra*, note 24.
[27] IRC §§ 2033, 2501(a)(1).
[28] *Supra*, note 26.
[29] United States v Field, 255 US 257 (1921).

In an effort to reach property subject to general powers of appointment, Congress enacted a specific Code section taxing the appointive property of an *exercised* general power of appointment.[30]

Still struggling to include property subject to an *unexercised* general power of appointment, in *Helvering v. Safe Deposit and Trust Company*[31] the Commissioner, relying on the United States Supreme Court's growing focus on the substantive economic rights and interests transferred as opposed to the form of transfer, argued that an unexercised general power of appointment should be included in the gross estate under the antecedent Code Section to 2033 given the ownership-like rights of a general power of appointment. Specifically, the Commissioner urged: "at the time of his death the decedent had an 'interest' in the trust properties that should have been included in his gross estate, because he, to the exclusion of all other persons, could enjoy the income from them; would have received the corpus of one trust upon reaching the age of 28; and could alone decide to whom the benefits of all the trusts would pass at his death. These rights, it is said, were attributes of ownership substantially equivalent to a fee simple title, subject only to specified restrictions on alienation and the use of income."[32] The Court rejected the Commissioner's argument on the basis that "viewing § 302(a) in its background of legislative, judicial, and administrative history, we cannot reach the conclusion that the words 'interest . . . of the decedent at the time of his death' were intended by Congress to include property subject to a general testamentary power of appointment unexercised by the decedent."[33] This early holding sets the stage for taxing powers of appointment based on the definitional provisions of Code Sections 2041 and 2514 which determine tax consequences based on the specific terms of the power of appointment, essentially merging form with substance in determining whether the power is taxable as a general power of appointment.

[2] Terms of Power of Appointment Control

The Code specifies the tax consequences of a power of appointment based on whether the power meets the tax definition for a general power of appointment. The specific terms or, in other words, "form" of the power of appointment determines whether appointive property is subject to estate or gift tax. Powers of appointment do not "impliedly" arise in a person. State law generally provides that powers of appointment must be transferred to the powerholder by the owner of the appointive property,[34] and "[i]n order for a transfer to be effective, it must be properly executed…."[35] The economic substance of a power of appointment granted by a donor, thus, derives by definition from its terms as specified in the document governing the transferred property.[36]

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[30] See IRC § 2041(a)(1); Act of February 24, 1919, c. 18, 40 Stat. 1057, 1096, 1149 (changing language of Code addressed by the Court in US v Field, 255 U.S. 257 (1921).
[31] Helvering v Safe Deposit & Trust Co., 316 US 56, 58 (1942).
[32] *Id.*
[33] *Id.* at 59.
[34] Restat 3d Property: Wills and Other Donative Transfers, § 18.1 (3rd ed. 2003).
[35] Restat 3d Property: Wills and Other Donative Transfers, § 18.1 cmt. a (3rd ed. 2003).
[36] IRC §§ 2041, 2514.

[a] Third Party Powers Differentiated from Retained Powers

Unlike state law, Treasury regulations differentiate powers of appointment taxable pursuant to Code sections 2041 and 2514, from powers retained by the donor and taxable under other Code sections. The regulations specify: "[T]he term 'power of appointment' does not include powers reserved by the decedent to himself within the concept of sections 2036 to 2038."[37] Thus, unlike state law, retained powers for purposes of the Code are not referred to or taxed as "powers of appointment." The substantive focus in determining how to tax a power is on whether the powerholder is someone other than the donor of the power. If it is a third party powerholder, then the distinguishing factor for tax purposes becomes whether the power of appointment is general or special based on its terms.

A determination of whether a power is a retained power or one taxed as a power of appointment does depend, in the first instance, on a substantive analysis of the economic realities. The substantive analysis is used to determine the transferor for purposes of applying estate and gift tax rules and derives from the holding of the United States Supreme Court in *United States v. Estate of Grace.*[38] In *Grace*, the Court employed the reciprocal trust doctrine to uncross trusts created by spouses in order to determine in substance the identity of the transferor for purposes of applying the estate tax provisions to the trust property. The Court uncrossed essentially mirror image trusts created by spouses upon a finding that the creation of the respective trusts was interrelated and left the transferors to the extent of mutual value in similar economic positions following the transfers. Upon uncrossing the trusts, decedent was deemed the transferor of the trust over which he held a retained income interest and the value of the underlying property, thus, was included in his gross estate.[39] The *Grace* Court addressed retention of reciprocal interests in property and did not address retention of reciprocal powers.

The lower courts are divided as to whether the reciprocal trust doctrine should extend to a determination of whether a power of appointment has been created or whether instead a power has merely been retained by the donor of the underlying property. The Sixth Circuit in *Green v. United States*[40] narrowly construed the holding of *Grace* and declined to apply the reciprocal trust doctrine in analyzing mirror image powers over trust property granted by spouses to each other. By choosing to limit *Grace* to application of reciprocal property interests, the Sixth Circuit holding effectively resulted in the powers being classified as limited powers of appointment with respect to each spouse, thereby avoiding inclusion in the gross estate that would have resulted if the powers had been classified as retained powers. In contrast to the Sixth Circuit holding in *Green*, the Tax Court in *Bischoff v. Commissioner*[41] applied the reciprocal trust doctrine to powers in order to determine if the powers should be treated as the economic equivalent of retained powers as opposed to powers of appointment. The Tax Court reasoned that a failure to delve into a substantive analysis

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[37] Treas Reg § 20.2041-1(b)(2). See also Treas Reg § 25.2514-1(b)(2).
[38] US v Estate of Grace, 395 US 316 (1969).
[39] *Id*.
[40] Green v. US, 68 F3d 151(6th Cir 1995).
[41] Bischoff v Comm'r, 69 TC 32 (1977).

in favor of form would create a loophole in the taxing statutes.[42] It applied the reciprocal trust doctrine to powers by asking: (1) whether the transfers were interrelated and (2) whether the powers would have been taxed absent the reciprocal technique. The Federal Circuit has followed the holding of the Tax Court in *Bischoff*.[43] The initial determination of whether the power should be classified as a power of appointment and taxed under Code sections 2041 and 2514, thus, is likely to be subject to a substance over form analysis. Once a determination is made that the power is a power of appointment, as opposed to a retained power, the terms of the power control its classification as a general power of appointment.

[b] Nomenclature Irrelevant

In classifying powers, the Treasury Regulations also reject any reliance on the nomenclature used in referring to a power. Interestingly the Service in a recent ruling addresses what the trust calls a "Testamentary Limited Power of Appointment" that is in fact retained by the donor. The ruling correctly refrains from analyzing such retained power under Code section 2514 simply because of the name assigned by the trust terms, and instead analyzes the power as one retained by donor.[44] The fact that the trust calls the retained power a "limited power" does not exempt the underlying appointive property from taxation in the hands of the donor. Appropriately "nomenclature" does not control tax consequences. The "substance and effect" of the power controls, meaning that a power "to consume" or "to affect beneficial enjoyment" of property interests held by a person other than the donor of the power, is a "power of appointment."[45]

Not only does the name given to a power not control, but a failure to acknowledge a power as a power of appointment becomes irrelevant. Treasury regulations explain that the terms of a trust document may grant a power of appointment without calling it a power.[46] The regulations explain by example that a trust provision allowing the beneficiary to control consumption of trust property is a power of appointment regardless of whether the trust instrument uses the word "power."[47] At the same time the regulations indicate the grant of a "power" over management of the trust assets that does not allow the powerholder to shift beneficial interest is not a power of appointment regardless of the reference to a power granted.[48] It is the legal right to impact beneficial enjoyment of underlying trust property granted to the powerholder by another that is a power of appointment for purposes of the federal estate and gift tax.

[c] Classification as a General Power

If the terms of a post-October 21, 1942 power of appointment allow for its exercise "in favor of the [powerholder], his estate, his creditors, or the creditors of his estate"[49] the power is classified as a general power of appointment, and if held by the powerholder at death is includible in the gross

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[42] *Id.* at 48.
[43] Exchange Bank and Tr. Co. of Florida v US, 694 F2d 1261, 1269 (Fed Cir 1982).
[44] PLR 201507008.
[45] Treas Reg § 20.2041-1(b)(1). See also Treas Reg § 25.2514-1(b)(1)
[46] *Id*
[47] *Id.*
[48] *Id.*
[49] IRC §§ 2041(b)(1), 2514(c).

estate of the powerholder whether or not exercised, unless it falls within a specified exception.[50] Specifically excepted from the definition of post-October 21, 1942 general powers of appointment are those powers limited by an ascertainable standard relating to health, maintenance, education and support and exercisable in favor of the powerholder.[51] Also excepted are certain joint powers, including those exercisable only with the consent of the donor of the power, those exercisable only with a person holding a substantial adverse interest in the appointive property, and a portion of other jointly held powers not falling within one of the other exceptions applicable to joint powers.[52] To the extent the terms of the power granted to the powerholder by the donor do not meet the Code definition of general power of appointment, the power is deemed a "special" or a "limited" power and avoids taxation in the hands of the powerholder. Special rules also exempt from taxation certain "lapses" of a general power of appointment.[53] The wealth transfer taxation of powers of appointment, thus, depends on the terms or, in other words, form of the power meeting the definitional requirements of the Code.

Given the manner in which the Code specifically differentiates as between the transfer of property interests and the taxation of property subject to a power of appointment, and how it also differentiates as between powers retained by the donor and powers of appointment held by persons other than the donor, it makes sense that the substance over form doctrines employed by courts to transfers of property interests and retained powers over such property, on the one hand, would not similarly apply to powers of appointment, on the other. The question that arises when the donor transfers an interest in property is whether the donor has transferred all interests and control over the transferred property, or whether the donor has explicitly or implicitly retained valuable economic rights over the transferred property that would cause inclusion in the donor's gross estate pursuant to Code sections 2036 or 2038.[54] To determine if there has been an implicit retention, courts generally look to objective factors, such as the subsequent actions of the donor indicating an implied retention of economic interest by the donor.[55] Unlike retained powers over property previously owned by the donor, powers of appointment must be granted to a person other than the donor per the terms of the instrument of transfer in a manner that would allow recognition of the power under state law.[56] For that reason the notion of an implied retention of an economic right cannot arise as to powers of appointment. The extent of the power granted and its legal enforceability derives solely from the terms of the instrument of transfer. The question, however, becomes whether an implied agreement will be recognized to deny the terms of the power and its existence.

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[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] IRC §§ 2041(b)(2), 2514(e).
[54] See, e.g., Estate of Schauerhamer v. Comm'r, T.C. Memo 1997-242 and Estate of Guynn v. United States, 437 F.2d 1148 (4th Cir. 1971) discussed in Gagliardi, E., *Economic Substance Doctrine in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 Mont L Rev 389, 412-15 (2003).
[55] *Id.*
[56] *Supra,* notes 36 and 37.

[d] Inability to Ignore Terms of Power of Appointment

Consonant with the United States Supreme Court's holding in *Commissioner v. Estate of Noel*[57] that ruled legally enforceable rights set forth in an insurance contract defined economic substance for purposes of determining estate tax consequences, the courts in addressing powers of appointment also focus on the legally enforceable rights granted by the terms of the power of appointment. Despite the fact that in a long line of cases addressing *Crummey* withdrawal rights the courts have acknowledged the possibility of overlaying a substance over form analysis based on implied or express agreement to determine ultimate tax consequences, the courts to date have consistently refused to find such an agreement exists that would override the legally enforceable rights granted by the terms of the power of appointment.

Donors often use what have come to be known as *Crummey* withdrawal powers, which are general powers of appointment exercisable during a limited period of time, to make present interest gifts for purposes of obtaining an annual exclusion. Whether or not a present interest in the appointive property has been granted to the donee-powerholder depends on whether the powerholder in substance holds a general power of appointment. The Ninth Circuit in *Crummey v. Commissioner*[58] rejected the Service's argument that extrinsic circumstances and factors could be relied on to determine whether or not the powerholder has a general power of appointment.[59] Instead the court focused on the terms of the power of appointment specifically allowing "the child's guardian [to] make [] demand on behalf of the child."[60] The Ninth Circuit emphasized that it did not matter whether or not the demand will likely be exercised, but confirmed that the focus should be on whether the demand could in fact legally be exercised on behalf of the minor.[61] The court, thus, recognized that legal rights granted by the general power of appointment controlled tax implications.

The Internal Revenue Service attempted to distinguish the holding of *Crummey* in *Estate of Cristofani v. Commissioner*[62] on the basis that the contingent interests of grandchildren in the trust precludes a finding that the grandchildren received a present interest based on the withdrawal rights granted by the trust instrument. The Tax Court reaffirmed the focus on the terms of the legally enforceable rights in determining tax consequences:

> As discussed in *Crummey*, the likelihood that the beneficiary will actually receive present enjoyment of the property is not the test for determining whether a present interest was received. Rather, we must examine the ability of the beneficiaries, in a

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[57] Comm'r v Est of Noel, 280 US 678 (1965).
[58] Crummey v Comm'r, 397 F.2d 82 (9th Cir 1968).
[59] *Id.* at 89 (the court declined to adopt the holding of Stifel v Comm'r, 197 F2d 107 (2d Cir 1952)).
[60] *Id.* at 83.
[61] *Id.* at 87.
[62] 97 TC 74 (1991).

> legal sense, to exercise their right to withdraw trust corpus, and the trustee's right to legally resist a beneficiary's demand for payment. … Based upon the language of the trust instrument and stipulations of the parties, we believe that each grandchild possessed the legal right to withdraw trust corpus and that the trustees would be unable to legally resist a grandchild's withdrawal demand. We note that there was not agreement or understanding between decedent, the trustees, and the beneficiaries that the grandchildren would not exercise their withdrawal rights following a contribution to the [ ] Trust.[63]

By leaving open the possibility that an agreement or understanding among the parties could imply that the terms of the withdrawal right could be ignored in determining tax consequences, the Tax Court encouraged the Service to search for a case that would cause the court to find such an agreement.

Shortly after the Tax Court's decision in *Cristofani* the Service made two additional attempts at invoking a substance over form doctrine in interpreting the legal rights granted pursuant to the terms of the withdrawal right. In both attempts the Service failed. In both cases, *Estate of Kohlsaat v. Commissioner*[64] and *Estate of Holland v. Commissioner*,[65] the Tax Court issued memorandum decisions substantially limiting the possibility that a court would imply an understanding among the powerholder and the donor in a manner so as to limit the legally enforceable rights granted by the general power of appointment.

In *Kohlsaat*, the tax court rejected the Service's argument that "understandings existed between decedent and the 16 contingent beneficiaries of decedent's trust to the effect that the beneficiaries would not exercise their rights to demand distributions of trust property, that these understandings negate decedent's donative intent, and the substance-over-form doctrine should apply to deny the annual gift tax exclusions…."[66] The court explained: "the fact that none of the beneficiaries exercised their rights or that none of the beneficiaries requested notification of future transfers of property to the trust does not imply to us that the beneficiaries had agreed with decedent not to do so, and we refuse to infer any understanding."[67] The Tax Court's refusal to "infer" an understanding from a nonexercise of a power or even from a lack of notification to the powerholder limits substantially the ability of the Service to ignore the legal rights granted by the terms of a power of appointment based on a substance over form analysis.

The facts of *Holland* came closest to demonstrating an agreement not to exercise. Testimony showed that decedent and the children, who were granted the withdrawal rights, "discussed how the gifts were to be used prior to decedent's taking out the loan or making the gifts. … The donees

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[63] *Id.*
[64] Est. of Kohlsaat v Comm'r, TC Memo 1997-212.
[65] Est. of Holland v Comm'r, TC Memo 1997-302.
[66] Est of Kohlsaat v Comm'r, TC Memo 1997-212.
[67] *Id.*

unanimously agreed to pool their gifts in order to realize a greater return on their investments." Based on this agreement money transferred subject to the children's withdrawal rights was used to purchase certificates of deposit paying a favorable interest rate. In responding to the Commissioner's argument, the Tax Court stated: "There is no evidence to support a finding that the donee's legal ability to demand payment from the trustees was limited by their informal agreement to purchase a CD after the gifts were made. Nor is there any evidence that decedent would not have made the gifts to any donee who did not agree to invest rather than spend the gift."[68] The Tax Court's response results in an almost impossibly high hurdle for showing an implied agreement that overcomes the legally enforceable terms of a withdrawal right granting a general power of appointment.

The Tax Court again in 2015 reaffirms its earlier holdings in *Mikel v. Commissioner*[69] and upholds annual exclusion gifts of $1,440,000 to a trust pursuant to *Crummey* withdrawal rights granted to each of 60 beneficiaries. The terms of the trust also included an interrorem clause eliminating the interest of any beneficiary who questions the distribution decisions of the trustee and further required any dispute to be resolved by a "beth din." In *Mikel* the Service argues the withdrawal rights were illusory. The court notes: "Respondent concedes that the [trust] affords each beneficiary an unconditional right of withdrawal and suggests no colorable basis on which the trustees could properly refuse to honor a timely withdrawal demand. Respondent nevertheless contends that the beneficiaries did not receive a 'present interest in property' because their rights of withdrawal were not 'legally enforceable' in practical terms. According to respondent, a right of withdrawal is 'legally enforceable' only if the beneficiary can 'go before a state court to enforce that right.'"[70] The court upholds the withdrawal rights. It finds the rights can be legally enforced before the beth din, and that properly construed the in terrorem clause does not preclude a beneficiary's enforcement of the withdrawal right in state court. The court in *Mikel* once again rebuffs the Service's substance-over-form argument. *Mikel* demonstrates that the use of general powers of appointment can create rights in a targeted manner to achieve a specific tax result, here the ability to obtain multiple annual exclusions despite the fact that the underlying property interests remain under the discretionary control of a trustee.

[3] Terms Imbue Economic Substance

The fact that state law allows flexibility in the design of powers means that the terms of a power of appointment may be tailored to achieve a variety of tax results. Tax results depend on whether the power is held in a fiduciary or nonfiduciary matter,[71] whether at the time of transfer the powerholder "has" the power,[72] and who may receive appointed property.[73] State law conveniently

[68] Est of Holland v Comm'r, TC Memo 1997-302.
[69] Mikel v Comm'r, TC Memo 2015-64.
[70] *Id.*
[71] See PLR 201235006 (Feb. 27, 2012); PLR 9548013 (Aug. 29, 1995).
[72] See Est of Kurz v Comm'r, 68 F3d 1027 (7th Cir 1995).

allows the donor of the power to specify each of these characteristics. The terms of the power may specify when the powerholder may exercise the power, to whom the property may be appointed, how the property may be appointed (whether in further trust, subject to a standard or subject to a condition), and who takes in the event the powerholder fails to appoint.[74] This flexibility allows the estate planner to creatively design legally enforceable economic rights to control tax consequences.

In determining whether a power of appointment meets the definition of a general power, courts analyze whether the power granted to the powerholder in substance allows the powerholder to appoint property to herself, her creditors, her estate or the creditors of her estate. Courts acknowledge that the terms of the power control whether in fact the powerholder has a power and what powers or, in other words, what economic rights have been granted. In designing the power of appointment the estate planner must keep in mind whether the terms create the substantive economic rights desired.

The courts determine the tax consequences of powers based on the scope of the control in fact granted to the powerholder. For example, in *Estate of Kurz v. Commissioner*[75] the powerholder held a general power over a marital trust for the purpose of obtaining a marital deduction, and, in addition, held a power to appoint five percent of the property of the credit shelter trust on the condition that the assets of the marital trust were exhausted. In determining whether the powerholder had a general power of appointment over the credit shelter trust at her death that would result in inclusion of five percent of the trust assets in her estate, the court looked at the economic substance of the contingency. The court reasoned: "If only a lever must be pulled to dispense money, then the power is exercisable. The funds are effectively under the control of the [powerholder], which is enough to put them into the gross estate. Whether the lever is a single-clutch or double-clutch mechanism can't matter."[76] In focusing on the substantive economic rights held by the powerholder, the court specifically rejected the Tax Court's reasoning that the condition should be disregarded if it lacks any "significant non-tax consequence independent of the decedent's ability to exercise the power."[77] The *Kurz* holding clarifies that the economic rights to control provided by the specific terms of the power are determinative, and will not be tested based on a taxpayer's tax or non-tax motives or other implied understandings.

In designing powers to target a specific tax consequence, the terms of the power must grant enforceable economic rights consonant with those required to trigger the specified tax result. For example, in Private Letter Ruling 201544002 the terms of the powers, both retained powers and powers of appointment ensured grantor trust status for income tax purposes during the lives of both grantors and a step-up in basis on the respective deaths of the grantors. The retained power to revoke transfers to the spouse's respective shares of the trust results in grantor trust characterization,

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[73] See IRC § 2041(b)(1); Treas Reg § 20.2041-1(c)(1).
[74] See generally, Restat 3d Property: Wills and Other Donative Transfers, Chapter 19, Scope (3rd ed. 2003).
[75] Est of Kurz v Comm'r, 68 F3d 1027 (7th Cir 1995).
[76] *Id.* at 1029.
[77] *Id.*

and the general power of appointment over the marital trust results in a step-up in basis on the death of the surviving spouse provided the power is exercised. In issuing the private letter ruling the service recognizes the enforceable legal rights granted by the powers and acknowledges that tax consequences follow those rights.

§ 1.05 Using Powers to Achieve Client Goals

[1] Identifying Client Goals

While the desire of clients to minimize tax often provides the impetus to schedule an appointment with an estate planner, the typical client will also indicate a desire to accomplish other goals as well. Of concern to many clients is the desire to ensure certain beneficiaries ultimately receive the use and benefit of their hard earned assets and to protect those assets from creditor claims. Within these broad goals, clients typically want to provide a certain amount of flexibility to adapt to the changing needs and circumstances of beneficiaries. Powers of appointment can assist clients in achieving these goals.

[2] Minimizing Tax

Powers of appointment can be designed to achieve specific tax consequences. General powers of appointment typically cause inclusion of the appointive property in the gross estate at death or, if exercised during life, a gift on transfer of the appointive property during life.[78] As a result, if the transfer is to a skip person, the general power of appointment may also cause a generation skipping transfer.[79] For purposes of determining income tax consequences, a general power of appointment, in some instances may cause the trust to be treated as a grantor trust with respect to the powerholder for income tax purposes.[80] If the goal is to shelter the appointive property from transfer tax and from the possibility of taxation on trust income in the hands of the powerholder, planners generally should avoid using general powers of appointment in favor of limited powers of appointment, also referred to as special powers or, under state law, nongeneral powers.

Limited powers of appointment generally do not trigger gross estate inclusion or a taxable gift on exercise. The broadest limited power or appointment would allow the powerholder to appoint to anyone other than the powerholder, the powerholder's estate or the creditors of either. The powerholder does have flexibility to control and limit the class of permissible appointees.[81] The client can specify a more limited class, such as descendants, and thereby ensure the appointive property ultimately benefits family members. The major drawback of a limited power is that the powerholder cannot benefit herself in the exercise of the power unless discretion to do so is limited

[78] IRC §§ 2041(a)(2); 2514(a).
[79] See IRC § 2612.
[80] See IRC § 678.
[81] Treas Reg §§ 20.2041-1(c)(1), 25.2514-1(c).

by an ascertainable standard.[82] In addition, the holder of a limited power of appointment may not use property to satisfy an obligation of support owed by the powerholder as such discretion would cause the power to be classified as a general power of appointment.[83] Another major drawback to the lifetime exercise of a limited power of appointment arises when, in conjunction with the power of appointment, the powerholder has a mandatory income interest in the appointive property. In that event, on exercise of the limited power of appointment, the powerholder would also be deemed to make a gift of the income interest.[84] A grant of a testamentary limited power of appointment, however, could avoid this result. Despite the limitations associated with a limited power, a limited power of appointment can provide substantial flexibility to direct use of the appointive property without triggering a transfer tax or adverse income tax consequences.

It is possible in limited circumstances to grant a powerholder the ability to appoint property to herself and at the same time avoid triggering transfer tax. The powerholder may allow a general power of appointment to lapse without triggering transfer tax provided the property that could have been appointed did not exceed in value the greater of $5,000 or 5 percent of the aggregate value of the property out of which the exercise of the lapsed power could have been satisfied.[85] It is for this reason that many planners feel most comfortable limiting *Crummey* withdrawal rights to what is referred to as a "5 and 5" power, picking up on the statutory limits for a transfer tax free lapse. Creative use of the lapsing general power of appointment can provide opportunity to the powerholder to decide whether or not to withdraw trust assets for her own use without needing to rely on the exercise of discretion by a trustee and without concern of other fiduciary duties the trustee may owe. For example, a power may be designed so that the powerholder can annually appoint to herself up to the greater of (i) $5,000 and (ii) 5 percent of the trust property on the date that is January 5 of each year, with the power lapsing on that date if not exercised. If in this example the trust held $5 million in assets, the powerholder could annually withdraw up to $250,000 or, alternatively, could allow the power to lapse leaving the property in trust without gift tax consequence to the powerholder. Unless the powerholder dies on January 5, there also would be no inclusion in the transferor's gross estate.[86] The benefit and at the same time the drawback depending on the donor's desires in this example is that the powerholder can use the appointive property for whatever purpose she wants, and to the extent of the general power granted, the donor of the power of appointment effectively gives up direction and control over the appointive property much in the same way as if the donor had made an outright gift. The exception to transfer taxation for lapsing powers is limited by the $5,000 and 5 percent rule. Lapse of a general power of appointment in excess of these "5 and 5" limits, would trigger a taxable gift and likely inclusion in the gross estate to the extent of the proportionate value of the trust property associated with the lapsed general powers of appointment.

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[82] Treas Reg §§ 20.2041-1(c)(2), 25.2514-1(c)(2).
[83] Treas Reg §§ 20.2041-1(c)(1), 25.2514-1(c).
[84] Regester v Comm'r, 83 TC 1 (1984); Rev Rul 79-327, 1979-2 CB 342.
[85] IRC §§ 2041(b)(2), 2514(e).
[86] Treas Reg § 20.2041-3(d)(3).

Jointly held powers if properly designed can also allow appointment of property to the powerholder without triggering a taxable gift or inclusion in the gross estate. For example, a power held jointly with the donor of the power would avoid triggering gift tax on exercise of the power or estate tax on the death of the joint powerholder.[87] It is important to keep in mind, however, that the donor of the power, as contrasted from the powerholder, would be subject to gift tax and estate tax inclusion.[88] In addition, estate and gift tax may be avoided in the event a power can be exercised only with consent of a person holding a substantial adverse interest.[89] Carefully crafted jointly held powers, thus, can allow family members discretionary authority to control use of trust property and to benefit themselves if they so desire.[90]

Use of powers of appointment that avoid unfavorable transfer tax consequences can also achieve other common tax goals of clients including the flexibility to adapt to unexpected circumstances, the ability to preserve a semblance of control in the hands of family members or beneficiaries, and the possibility of avoiding appropriation of trust property by a beneficiary's or powerholder's creditors. The choice of whether to use a limited power of appointment, a special power subject to an ascertainable standard or a jointly held power depends on both tax goals and other planning goals of the client, such as creditor protection.

[3] Flexibility to Control or Modify Trust Provisions

The drafters of the first Restatement of Property, written almost a century ago, recognizing the need for flexibility of trust provisions eloquently stated:

> Owners often wish to control the devolution of their property through two or more generations; and the rule against perpetuities does not prevent an owner who is competently advised from exercising such control for about a century. Plainly no human foresight is adequate to frame in advance dispositions which will meet the exigencies of the maximum period of control…. Births and deaths in varying combinations, the commercial success of some family members and the failure of others, the varying capacities of individuals as to the husbanding of resources, fluctuation in income returns and the value of the monetary unit, legislative action and constitutional amendment reflecting social and political change -- all these are factors whose unpredictability indicates the folly of rigid predetermined future limitations and the desirability of gifts containing a substantial element of flexibility. The power of appointment, particularly the special power, is the most efficient device yet contrived by which an owner may obtain such flexibility while still controlling the general purposes to which his property shall be devoted. When A

[87] IRC §§ 2041(b)(1)(C)(i), 2514(c)(3); Treas Reg § 20.2041-3(c)(1).
[88] See IRC § 2036(a)(2), 2038; Treas Reg § 25.2511-2(f).
[89] IRC §§ 2041(b)(1(C)(ii), 2514(c)(3)(B).
[90] See PLR 201438012.

> leaves his property in trust for his son, B, for life and then in trust for such children of B as B shall by will appoint, he makes it possible for the manner of distribution among B's children to be determined in accordance with the changes which may occur during the rest of B's life while at the same time ensuring that the remainder interest will not be diverted from the children. In a sense the power of appointment extends the personality of A through the balance of the life of B.[91]

This statement proves even truer today as many states have chosen to either extend or eliminate any limit historically imposed by the rule against perpetuities.[92] In the current environment, providing opportunity to modify trust terms proves important as evidenced by the efforts undertaken by states to enact decanting statutes[93] and be estate planners to provide for use of trust advisors and trust protectors.[94]

Absent use of a nonfiduciary power of appointment, other methods for modification or reformation of a trust typically require court approval or require the person undertaking the modification to act subject to fiduciary constraints. Traditionally, courts may modify a trust based on whether the modification comports with the material purposes of a trust.[95] Undertaking modification requires incurring those expenses involved in petitioning the court, including in some circumstances the expenses associated with appointment of a guardian ad litem for unborn beneficiaries. Decanting statutes typically require trustees to act in conformance with trust purposes and fiduciary standards. The Uniform Trust Decanting Act specifically indicates that the power to decant is a "fiduciary" power, and must be exercised in accord with fiduciary duties, although the act provides that the trustee who holds the power to decant is not subject to a duty to exercise it.[96] Imposition of fiduciary duties can have a chilling effect on the exercise of the power, especially when the trustee can avoid imposition of those duties simply by choosing not to decant. Given the potential costs associated with trust modification or decanting, planners have chosen to proactively grant powers of appointment to modify or terminate trusts.

As the law has developed, both trust protectors and trust advisors also may be subject to fiduciary duties unless the terms of the trust direct otherwise. The Uniform Trust Code acknowledges the growing use of trust protectors and trust advisers. It describes these roles as follows: "'Advisers' have long been used for certain trustee functions, such as the power to direct investments or manage

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[91] Restat. 1st of Property, Ch. 25 Scope (1936).
[92] See Zaritsky, The Rule Against Perpetuities: A Survey of State (and D.C.) Law, http://www.actec.org/resources/state-surveys/ (for example, Alaska, Pennsylvania, Rhode Island, South Dakota).
[93] 23 states have enacted legislation addressing decanting. *See* M.P. Culler, List of States With Decanting Statutes Passed or Proposed, http://www.actec.org/resources/state-surveys/ (accessed Jan. 2, 2016). The Uniform Laws Commission has approved a Uniform Decanting Statute, not yet adopted by any states. Unif. Trust Decanting Act (2015), http://www.uniformlaws.org/Act.aspx?title=Trust%20Decanting (accessed Jan. 2, 2016).
[94] The Uniform Trust Code, adopted by 31 states, specifically addresses use of trust protectors and trust advisor. Unif. Trust Code § 808 (2010).
[95] Unif. Trust Code §§ 411, 412 (2010).
[96] Unif. Trust Decanting Act § 4 (2015).

a closely-held business. ‘Trust protector,’ a term largely associated with offshore trust practice, is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust.”[97] The Uniform Trust Code presumes trust advisors and trust protectors, who are not also trust beneficiaries, act subject to fiduciary duties.[98] In addition, it specifically provides: “The holder of a power to direct is liable for any loss that results.”[99] Essentially the Uniform Trust Code presumes any power of appointment to modify trust terms granted to a non-beneficiary is a fiduciary power. The purpose is to ensure that the non-beneficiary is duty bound to act in the best interests of the beneficiaries. Granting powers to a non-beneficiary allows the greatest flexibility to adapt to changed circumstances and upon modification to provide for all beneficiaries. The trust, by its terms, can specifically eliminate the fiduciary presumption and state that the trust advisor or protector holds a nonfiduciary power and can likewise eliminate any liability for loss. In eliminating fiduciary duties, the difficulty, however, is to choose someone who innately will act in the best interests of the beneficiaries. Naming a beneficiary as trust protector or trust advisor generally requires use of a limited power of appointment in order to avoid adverse transfer tax consequences in the hands of that beneficiary, and a limited power of appointment by its nature limits ability of the beneficiary to benefit herself or the persons to whom she owes a duty of support. Despite the trade-offs, the granting of nonfiduciary powers of appointment can accomplish modification of trust terms with fewer costs and less hesitation. A nice compromise exists in using a combination of powers – naming a trust protector who is not a beneficiary and who is subject to duties in the exercise of the modification powers, and granting a nonfiduciary limited power of appointment to a trusted beneficiary who is typically a family member. Use of multiple powers can provide substantial flexibility in how and when to modify trust provisions.

Carefully crafted joint powers of appointment provide an option for overcoming the limitations associated with limited power of appointment held by a trust beneficiary. Joint powers can allow the joint powerholders to exercise the power in a manner that benefits them without causing the power to be treated as a general power of appointment for transfer tax purposes. In recent private letter rulings joint powers have been used to place discretionary control in the hands of family members.[100] In this way, among others, the donor of the power can be assured that those persons who are the ultimate intended beneficiaries of the donor’s bounty in fact have control to make distributions, and as a result modification of trust terms, in the manner they deem most appropriate. In addition exercise of the jointly held power by trust beneficiaries is not subject to any fiduciary duties.

For a jointly held power not to be treated as a general power of appointment, the power must be held either with the grantor or with a beneficiary who has a substantial adverse interest. The jointly

[97] Unif. Trust Code § 808 comment (2010).
[98] *Id.*
[99] *Id.*
[100] See PLR 201438011 (May 2, 2014), 201438012 (May 2, 2014).

held powers in the private letter rulings is patterned after the example in the Treasury Regulations where the substantial adverse interest arises as a result of a continued power in other joint powerholders to distribute property among themselves.[101] The ruling specifically references:

> A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A co-holder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a co-holder of a power is considered as having an adverse interest where he may possess the power after the decedent's death and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate. Thus, for example, if X, Y, and Z held a power jointly to appoint among a group of persons which includes themselves and if on the death of X the power will pass to Y and Z jointly, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X. Similarly, if on Y's death the power will pass to Z, Z is considered to have an interest adverse to the exercise of the power in favor of Y.[102]

It then draws comparison to the joint power held by an "Approval Committee" composed of the decedent's four children who are the primary beneficiaries of four separate trusts:

> In this case, the Approval Committee is composed of only Grantor's four children. With respect to each of the Children's Trusts, the Approval Committee has broad powers to amend the trust, to alter distributions made by the distribution trustee, and to make distributions from the trusts. While the Approval Committee is acting, no funds can be distributed from any trust without the Approval Committee's consent.
>
> We conclude, therefore, that the members of the Approval Committee have interests that are adverse to the other members. Because every distribution is subject to Approval Committee consent, including the default allocations provided under the terms of Trust A, the Approval Committee is empowered to prevent all distributions from all of Children's Trusts 1 through 4. After Date 2, the Approval Committee has a jointly-held overriding power of appointment to appoint to any person or organization, including themselves. On the death of one child of Grantor, the power will pass jointly to the surviving three children of Grantor. Thus, as in the example in § 20.2041-3(c)(2), the surviving three children are considered to have interests adverse to the exercise of the power of the deceased child.[103]

Although the Service issues a limited ruling, it is a favorable one holding that the jointly held powers of the "Approval Committee" are not general powers of appointment so long as at least two

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[101] PLR 201438011 citing Treas Reg §§ 20.2041-3(c)(2), 25.2514-3(b)(2).
[102] *Id.*
[103] *Id.*

children serve on the committee. The difficulty emerges in that for the power not to be general there must be at least two children serving on the "Approval Committee."[104]

In a later ruling, similar jointly held powers, when used in tandem with joint powers held with trust grantors, achieved the targeted tax consequences sought when constructing a DING or NING trust, specifically nongrantor trust status, incomplete gift by the donor on creation, and a step-up in basis for trust assets on the grantor's death, and, in addition, the joint powers were determined to not be general powers of appointment.[105] While technically difficult to draft, jointly held powers allow donors to place control and flexibility over trust assets in the hands of their children and still afford the possibility of the children exercising the jointly held powers to benefit themselves. Use of jointly held powers, thus, can accomplish the typical client estate planning goals – targeted tax savings, family control, flexibility to modify, and the ability to protect against creditor claims. They can also be used to achieve state income tax savings as demonstrated by the NING and DING rulings discussed below.

[4] Flexibility to Control Behavior

Powers of appointment effectively grant control over property to the person or persons designated as the powerholder. The client should carefully choose who it is that should have control and also should consider the appropriate scope of the control granted. Persons holding a power of appointment in a nonfiduciary capacity have complete discretion to direct property to and among the permissible appointees unless the terms otherwise indicate. By granting a power of appointment, the client essentially shifts control over the property to the powerholder. This shift in control can impact relationships as between the powerholder and the permissible donees and takers in default in intended and unintended ways.

Powers can be used to encourage better behavior from the point of view of the powerholder. For example, by granting the surviving spouse a power of appointment, the spouse may be able to exert greater influence over the couple's children. In a second marriage situation a limited power of appointment may encourage a more civil interaction going forward as between the spouse and the children from a prior marriage. Limiting permissible beneficiaries to the client's descendants, however, ensures that at least one of client's descendants will eventually benefit from the appointive property and eliminates the possibility of a non-family member being the ultimate beneficiary of the client's assets in the event the powerholder becomes upset at one or all of the permissible appointee children. Judicious use of limited powers of appointment can result in some instances in keeping the peace and at the same time not triggering unwanted tax consequences.

Jointly held powers can also impact behavior. Joint powers can cause children who are joint powerholders to begin working as a team. Those powers, however, can also have the unintended

[104] *Id.*
[105] See PLRs 201550005 through 201550012.

consequence of bringing children to a stalemate when unanimity is required and one child simply refuses to get on board. Nevertheless, teamwork typically yields better financial results for all, and in that way encourages siblings to work in a mutually beneficial manner.

[5] Achieving Targeted Tax Results

Carefully crafted powers can assist in achieving targeted tax results. By exploiting differences in the income, estate and gift tax treatment of powers, specific tax consequences can be garnered. For example, in some instances a client may wish to create a trust that causes the donor to be taxed on the income of the trust, and yet is not included in the grantor's estate for estate tax purposes. Other clients may prefer to ensure that the income is taxed to the trust and trust beneficiaries, but that the underlying trust assets be included in the client's gross estate. The ability to grant powers of appointment in such a way that the terms of the power create legally enforceable rights so as to trigger or avoid income, estate, gift and generation-skipping transfer tax consequences make powers of appointment an invaluable estate planning tool. Deciding how to draft the powers of appointment necessary to achieve the targeted tax result also requires a careful weighing of the shift in control caused when a nonfiduciary power is granted.

The intentionally defective grantor trust or IDGT, which gained status as a common planning technique at a time when the applicable exclusion amount was relatively low and impacted many more taxpayers, relies on careful crafting of powers to achieve its tax minimization goals. The goal of the so-called IDGT is to cause the trust to be treated as a grantor trust for income tax purposes, and yet at the same time cause the transfer to be a completed gift and the assets subject to transfer excluded from grantor's gross estate. Thus, the reference to "defective" grantor trust alludes to the fact that this combination of tax attributes historically was not considered optimal. Yet by using an IDGT a client who wishes to decrease the value of her gross estate and at the same time benefit the trust beneficiaries can make the equivalent of a tax free transfer simply by structuring the trust as a grantor trust and remaining legally obligated to pay income tax on earnings of the trust assets. A similar technique is used in what has become known as the "super-charged" credit shelter trust.[106] Additional planning benefits also accrue from creation of a grantor trust, including the ability of the grantor to "sell" assets to the trust and not trigger gain on those assets.[107] It is notable, however, that the Service currently refuses to issue any ruling as to whether or not assets held in a grantor trust and not includible in a grantor's gross estate will receive a step up in basis for income tax purposes.[108] If in fact it is concluded that basis is adjusted under I.R.C. Section 1014, this planning technique may become even more popular.

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[106] Blattmachr, Gans, Zeydel, Super-Charged Credit Shelter Trust(SM) versus Portability, Probate & Property 10 (Mar/April 2014)(The authors' footnote indicates: "Super-Charged Credit Shelter Trust(SM) is a service mark of Ms. Zeydel, Mr. Blattmachr, and Mr. Gans who hereby grant permission for anyone to use it without charge provided appropriate attribution is given to them for its use." This parenthetical provides the attribution so requested.)
[107] Rev Rul 85-13, 1985-1 CB 184.
[108] Rev Proc 2015-37, 2015-26 IRB 1196.

The ability to obtain grantor trust treatment and at the same time escape inclusion in the gross estate derives from use of powers that trigger grantor trust treatment, but which do not trigger inclusion of assets in the gross estate. Retention of a nonfiduciary swap power whereby the grantor of a trust retains a power to "reacquire the trust corpus by substituting other property of an equivalent value" causes the trust to be a grantor trust for income tax purposes.[109] In the rulings, however, the Service implies that a facts and circumstances test will apply to determine if in fact a power is held in a nonfiduciary capacity. In this respect the Service raises the specter of a form or substance doctrine in the income tax context that is inapplicable to powers in the estate and gift tax context, as discussed above, as the terms of the power control for estate and gift tax and set the legally enforceable rights, including whether it is fiduciary or nonfiduciary power. Retention of such a power, however, does not trigger estate taxation as a "power of appointment" and is specifically excluded from such taxation as an administrative power because it is no more than "an administrative power" that cannot impact "beneficial enjoyment" of trust property.[110] Likewise it does not fall within the parameters of a retained power triggering inclusion in the gross estate for similar reasons.[111] It is these distinct differences in the treatment of such power that yields the opportunity to target tax consequences.

The DING and NING also capitalize on distinct differences in treatment of powers to obtain the targeted tax results that provide status as a regular (nongrantor) trust for income tax purposes, incomplete gift treatment, estate tax inclusion, and creditor protection for both grantor and beneficiaries.[112] Obtaining these targeted tax consequences rests on the disparate treatment of powers under the various tax rules. When the grantor retains rights to impact beneficial enjoyment, whether jointly held or not, those retained powers will cause inclusion in the gross estate of the grantor for estate tax purposes and incomplete gift status.[113] Those same jointly held powers, if the joint powerholder has a substantial adverse interest to the grantor, however, will not cause the powers to trigger grantor trust status for income tax purposes.[114] The intricate drafting of powers that will result in nongrantor status for income tax purposes and at the same time an incomplete transfer for gift tax purposes, and estate tax inclusion is not for the faint hearted.[115] It is, however, possible through the use of powers of appointment to achieve these results and at the same time not cause adverse tax consequences to the beneficiary joint powerholders whose powers are deemed to be limited powers of appointment.[116]

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[109] IRC § 675(4). See, e.g., Rev Proc 2008-45, 2008-2 CB 224; PLR 201235996 (Feb. 27, 2012).
[110] See Treas Reg § 20.2041-1(b)(1).
[111] See IRC §§ 2036(a)(2), 2038.
[112] See PLR 201410009 (Oct. 21, 2013). See also PLRs 201550005, 201550012, 201510006, 201510001, 201436008.
[113] See IRC §§ 2036, 2038; Treas Reg § 25.2511-2.
[114] Compare IRC §§ 674, 675, 676 and 677 with IRC §§ 2036, 2038.
[115] Jonathan Blattmachr and William Lipkind very generously explain how to construct powers to achieve the tax results of the NING, DING or AKING (Alaska Incomplete Nongrantor Trust), an understanding that cannot be gleaned simply by reading the Service's rulings, in their article: J. Blattmachr and W. Lipkind, Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust, Vol. 26, No. 4 Probate Practice Reporter 1 (April 2014).
[116] See PLR 201550005, 201410009.

§ 1.06 Conclusion

The legally enforceable rights created by powers of appointment, and the disparate treatment of powers under the Internal Revenue Code can accomplish a variety of tax goals. Powers of appointment can also achieve nontax goals of clients, including control, flexibility and ability to avoid creditors provided powers are drafted in a manner that lead to the intended result for both state law and tax law purposes. The immediate creative future of estate planners will likely focus on use of powers. The flexibility to draft terms of the power as necessary to achieve tax and non-tax results, and the knowledge that those terms inform the economic substance of the rights and powers granted, encourage innovative use of powers of appointment by estate planners.