POWERS OF APPOINTMENT

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I. [1.01] INTRODUCTION

Harvard's legendary property professor W. Barton Leach once proclaimed the common law power of appointment to be "the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out". 24 A.B.A.J. 807 (1938). Now that's quite a claim, for certain, but in this case one quite close to the very mark. The fact is that a well considered power of appointment can provide unique opportunity for multi-generational planning and management, because the power to appoint means the *power to decide* -- or better yet, to postpone decisions -- until that distant future moment when guess work and estimation have ripened into certain realities. No other estate planning device affords such exceptional flexibility; none is as "efficient.".

The need for such flexibility has probably never been greater. Breakthroughs in medical science, breakdowns in economic and social conditions, and a growing litigiousness have combined to skew dramatically our traditional notions for estate planning and distribution. Surviving spouses are surviving longer; adult children are finding themselves at financial risk long beyond the point of expected self-sufficiency; fewer of the children's first marriages survive, and fewer grandchildren are being born. One descendant may be wealthy, another incompetent; one may be a spendthrift, another sworn to public service, and who is to know one from the other when all are mere infants at the moment when the plan is prepared? And as for tax thinking, well, the ambivalent shadow of the federal and Illinois transfer tax system has thrown a lot of traditional transfer tax planning into a black hole of practical uncertainty.

These factors, and others, confound the familiar presumptions for the family wealth and no fixed distribution scheme, however broad its sprinkle authorities, can adequately anticipate all the consequences. Only the thoughtful use of powers of appointment -- usually limited, sometimes general -- can protect in the survivors the options to redirect future distributions in the light of circumstances as they actually occur, later, when the grantor herself is long gone.

Now, as attractive as the potential may seem in this light, there is no denying that the field for using powers of appointment is sowed well and thick with pitfalls. The cases of poorly drafted clauses providing disastrous tax consequences are legion; indeed, it may be that it is that very reason, more than any other, that explains why so few lawyers seem to be integrating powers into their current estate plans. But these problems are avoidable *if*, in the thinking and drafting stages, the predictable tax rules are carefully observed, and appropriate boiler-plate language employed to prevent unintended constructions.

To illuminate those rules and language is the purpose of this chapter.

A. [1.02] The Common Law Concept and Property Law Principles

Illinois does not have a specific powers of appointment statute (although the National Conference of Commissioners on Uniform State Laws are now circulating drafts of a proposed uniform powers of appointment act). So, at least for now, the Illinois property law rules remain defined by the common law experience.

For property law purposes a power of appointment can be defined as the power to direct the disposition or use of property that belongs to someone else:

I hereby give and devise Greenacre as A may see fit to appoint.

A power of appointment over property is *not* the same as an ownership interest in the property. Rather, it is a delegation of authority over the property, created by its owner in favor of another person, and can be created *only* by the owner as a function of the exercise of his or her ownership prerogatives. *Botzum v. Havana Nat'l. Bank*, 367 Ill.539, 12 N.E.2d 203 (1937). This is true even in those circumstances when an initial power is exercised to create a *second* power in another holder; the authority, and ultimate title, still flow from the original owner/creator/donor.

In many ways the power of appointment is akin to a type of agency, under which the benefit flows from the owner (the "donor" of the power) to the ultimate taker (the "appointee") directly, and not from the power "holder", who by his or her exercise merely facilitates the passing. Not surprisingly, the rules of agency, trusts and powers of appointment have all evolved from the common wellspring of the medieval Statute of Uses; s*ee*, *e.g.*, J. CRIBBET, PRINCIPLES OF THE LAW OF PROPERTY [3rd ed., 1989] 69-82.

Note that while the power to appoint is in place, and until the passage of vested ownership is actually completed -- from the donor of the power to the appointee of the property, a process which may be deferred for generations -- title to the subject property is suspended in express or implied trust. No interest in property that is subject to that power can fully vest until the power is exercised, or released, or it lapses upon its terms:

> **I hereby give and devise Greenacre to my child, C, for life, then to my grandchild, G, for life, with remainder as G may see fit to appoint.**

The power to appoint an interest in property is an inherently elective authority, and therefore a fully discretionary authority. The power holder has no obligation to exercise in favor of the permissible appointees, which distinguishes the power holder from the mere trustee: a trustee, even one vested with unlimited discretion, administers upon enforceable interests created by the trust settlor. The holder of the power of appointment, in contrast, has the discretionary authority to create, or to avoid the creation of, interests *ab initio*, albeit always in the owner/donor's name and behalf. A trustee is a fiduciary; the power holder is not. (Not surprisingly, the distinction between a trust and a power of appointment is a predictably litigated sore point when the drafting is less than precise, or when a permissible appointee finds himself to be an excluded "disappointee". See, *In re Estate of Schaaf*, 19 Ill. App. 3d 662, 312 N.E. 2d 348 (4th Dist. - 1974) and *In re Estate of Reiman*, 115 Ill. App. 3d 879, 450 N.E. 2d 928 (4th Dist. - 1983).)

If the holder elects not to exercise the power, the authority "lapses", and the property interest reverts or passes to a "taker in default of appointment". This taker may be the donor, his or her heirs or legatees, or a default taker specified when the power was created. Sometimes the default taker is unknown or unknowable, which creates a new set of problems. Consider the following italicized improvement to the previous example:

> **I hereby give and devise Greenacre to my child, C, for life, then to my grandchild, G, for life, with remainder as G may see fit to appoint; *but in default of appointment, the remainder shall pass to my descendants per stirpes living at G's death.***

In creating the power the owner/donor is limited only by the extent of her ownership, her willingness to delegate, the objects of her bounty, and any applicable rule against perpetuities (which is still the general rule of law in Illinois, despite 1997 amendments that provide for "qualified perpetual trusts"; 765 ILCS 305/1-6; see, *Martin v. Prairie Rod and Gun Club*, 39 Ill. App. 3d 33, 348 N.E. 2d 306 (3d Dist. - 1976); but see, *Deiss v. Deiss*, 180 Ill. App. 3d 600, 536 N.E. 2d 120 (4th Dist. - 1989); *First Nat'l. Bank of Joliet v. Hampson*, 88 Ill. App. 3d 1057, 410 N.E. 2d 1109 (3d. Dist. - 1980) [prudent savings clause preserves botched termination provision].)

An owner/donor may grant unlimited discretion in the holder to direct the property to any person in the world, including the holder himself, with leave to determine the portions, manner, and terms under which those property interests shall pass. More frequently the donor will limit that discretion by naming a class of potential takers, or a particular interest in the property, or by imposing certain conditions precedent. An unrestricted power is a common law "general" power of appointment. Any limitation on the discretion or the scope of appointable property interests results in the common law "limited" or "special" power of appointment.

Here is an extravagant example:

> **I hereby give and devise Greenacre as follows:**
>
> **A. In the event my daughter, Donna, survives me, she shall receive the net income from Greenacre for life.**
>
> **B. In addition, Donna shall have the general power to appoint all or any portion of Greenacre to or for the benefit of such person(s) or entity(ies), including herself, in such portions, amounts, and manner as she may direct by a signed, written instrument (including a Will) that specifically refers to this general power of appointment.**
>
> **C. In default of such appointment, Greenacre shall pass to my descendants *per stirpes* living at Donna's death.**
>
> **D. Should Donna predecease me leaving my son, Sam, surviving:**
>
> > **1. Sam shall receive the net income from Greenacre for life.**
> >
> > **2. In addition, Sam shall have the limited testamentary power to appoint the right to receive all or any portion of the income from Greenacre to or for the benefit of such one or more of my descendants who are living at Sam's death.**
> >
> > **3. Should Sam fail to exercise this limited testamentary power said power shall accrue and vest in Sam's spouse, Sally, if she survives Sam, but shall not be exercisable by Sally in favor of herself. In default of Sally's exercise, said power shall lapse.**
>
> **E. Subject to the foregoing, I give and devise that portion or all of Greenacre not otherwise conveyed or effectively appointed to my descendants, *per stirpes*, living at the date all of the foregoing provisions have been fulfilled or lapsed.**

For property law purposes the distinction between a general power of appointment and a limited power of appointment is important only in the sense that a power holder cannot direct property in a manner that exceeds his or her authority.

For tax purposes, that distinction is night and day.

B. [1.03] The Tax Principles: Background and Philosophy

Were it not for the artificial power of appointment tax rules it would be possible to defer not only the transfer of property but also the taxation on those transfers to an almost limitless degree.

The unified gift and estate tax scheme, being Internal Revenue Code Chapters 12 [Sections 2501 - 2524] and 11 [Sections 2001 - 2210], respectively, is geared to tax the *transfer* of property from its owner, but is *not* designed to encumber its subsequent beneficial use. Once launched into the course of its transfer -- which by no rule of law is required to be completed promptly – the subject property has traditionally been left alone, free from further tax until after it has vested in some new outright owner, and who would then be taxed only when he or she transfers it on again. The use of the property along the way, and the mere termination of each intervening limited interest, have traditionally been ignored. This ability to "shelter" property, by making it available in trust for the tax free use by others, defines the “credit shelter trust” that is so important for crafting tax efficient estate plans.

In this fashion, using a classic generation skipping transfer scheme, a trust settlor could authorize first a spouse, then children, then grandchildren, each in succession or concurrently, to use as much of the trust estate as needed, thereby commanding effective dominion and control over the property, yet none of these initial and successor beneficiaries would have a taxable "interest" in the property -- at least not until the trust terminated and the property finally settled in on some distant remainderman.

The source of this precept is, of course, the United States Supreme Court, which long ago ruled, quite conclusively, that even the broadest of general powers is not an "interest" in property within the scope of Internal Revenue Code Section 2033 (thereby avoiding the value of the appointable property from inclusion in the holder's taxable estate) nor is the exercise of a power a "transfer of property" by the holder on which the gift tax can be imposed under Code Section 2501. According to the Court, relying heavily on state property law constructs, a power to appoint property is not an ownership “interest” in property taxable in a decedent's estate irrespective of whether the power is exercised at death or not. *U.S. v. Field*, 255 U.S. 257, 41 S. Ct. 256 (1921); *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 62 S. Ct. 925 (1942).

In *Helvering*, the Court felt constricted by the language and legislative history of the precursor Revenue Act of 1926 from even considering the government's argument that the broad and exclusive enjoyment of the subject property was equivalent to fee simple title. However, in a striking footnote to this conclusion the Court invited revision to the law:

> **In declining to pass upon this issue,** [i.e., the economic equivalence of the general power to a title in property] **we do not reject the principle we have often recognized that the realties of the taxpayer's economic interest rather than the niceties of the conveyancer's art should determine the power to tax [citations omitted]....*Nor do we deny the relevance of this principle* as a guide to statutory interpretation where, unlike here, the language of a statute and its statutory history do not afford more specific indications of legislative intent. 62 S. Ct. 925, 927, N.1.** (Emphasis added.)

Congress predictably accepted this challenge [few common law property law rules have deflected Congress from its search for revenue; see, *e.g., Drye v. United States*, 528 U.S. 49, 145 L.Ed.2d 466, 120 S.Ct. 474 (1999)] and responded that very year with a general overhaul of the tax treatment of powers of appointment in the Revenue Act of 1942, which was effective on **October 21, 1942** (an important trigger date.) This overhaul, later fine tuned by the federal Power of Appointment Act of 1951, adopted as its foundation the legislative fiction that certain powers over property -- those which fall into the tortured definition of a tax "general power" -- shall be construed as the taxable equivalent of ownership, and the property subject to the general power shall be taxed accordingly:

* Under the resulting new Internal Revenue Code Section 2514, the lifetime exercise, lapse or release of a tax general power of appointment will be treated as a taxable gift/transfer by the holder much like a gift under Section 2501; and,

* Under Code Section 2041, if a holder dies possessed of a general power of appointment, or in his or her lifetime exercises a general power of appointment in a manner that violates the retained interest rules under Code Sections 2035-2038, the value of the subject property will be included in the holder's federal gross estate, more or less as the equivalent of a Section 2033 interest.

Tax general powers are systematically addressed in Part III below, but the most important point should be made now: **relatively few powers will trigger taxability.**

Although the tax rules are full of twists and turns, there is a remarkable philosophical consistency woven into the fabric. It is clearly possible to forecast, with substantial certainty, whether a power to appoint or withdraw property will be taxed as *de facto* ownership, or exempted as a non-taxable discretionary feature. This predictability in turn allows us to use powers to supplement our more rigid estate planning techniques – such as adding non-taxable testamentary powers to qualified terminable interest property ("QTIP") marital deduction trusts, or taxable testamentary powers to non-exempt generation skipping transfer tax trusts – and by doing so strengthen the discretionary hand of our clients' beneficiaries down the road.

III. [1.04] FEDERAL GIFT AND ESTATE TAX TREATMENT

A. [1.05] Retained Interests Distinguished

The property law treatment of powers of appointment depends largely upon the distinction between *non-ownership authorities* delegated to another, and *ownership rights* that are either: (i) retained by the owner after a partial gift or transfer, such as a gift with retained life estate; or, (ii) conveyed to a trustee with administrative instructions.

The complicated transfer tax treatment of powers of appointment results from Congress' adoption of this exact property law distinction, and as a result there is a parallel difference in tax consequences that attach to: (i) interests or benefits in property *retained* by the owner; compared to, (ii) powers *over* that property that its owner might create in another.

To review the retained benefit rules, remember that federal estate tax will be imposed on the value of property transferred by a decedent in her lifetime when these gifts are deemed to have been made in anticipation of death or to have afforded her benefit from or control over the property after the gift. Internal Revenue Code Sections 2035, 2036, 2037 and 2038 are complex provisions in their own right, and generally beyond the scope of this chapter, but bear mention here because the gift tax treatment of powers of appointment refers to all four as measuring standards:

* **Section 2035,** "Adjustments for certain gifts made within 3 years of decedent's death" refers to gifts of certain types of property made within three years of the death of the decedent, including life insurance and the property interests described in Sections 2036-2038 and 2042.

* **Section 2036**, "Transfers with retained life estate", requires that the decedent's gross estate include the value of all property in which she has retained the possession, enjoyment or right to income, or the right to designate who shall have its benefit.

* **Section 2037**, "Transfers taking effect at death", requires that the decedent's gross estate include the value of all property conditionally transferred prior to death where: (i) possession or enjoyment of the gift depends on surviving the grantor; and (ii) the grantor has retained a reversionary interest in the property which exceeds 5% of the value of such property.

* **Section 2038**, "Revocable transfers", requires that the value of the gross estate include the value of all property where the decedent has retained the power over the property to "alter, amend, revoke, or terminate" the transfer, and that power is not restricted by a restraining standard.

Since the owner/grantor has unrestricted control over the terms of his or her gifts, these lifetime transfer rules adopt a presumption that a decision to not "cut the strings" reflects an intended bargain, whereby taxability of the property is the price exchanged for the benefit retained by the donor.

In comparison, and in contrast, the holder of a power of appointment neither creates nor defines his or her authority. The holder is merely the nominee of the owner's discretion, and thus generally powerless to control the scope of that authority or its implications on her own tax burden.

The power of appointment tax rules reflect this contrast, and in their crazy-quilt fashion represent a key tax policy determination: powers given to others must rise to a more significant degree of control if they are to be taxed in the holder as the equivalent of an ownership interest. Powers that fall short of this threshold, such as the special or limited power of appointment, so useful in actual practice, will *not* be subject to taxation. As stated in Treas. Reg. 25.2541-1(b)(2) and 20.2041-1(b)(2): "the term 'power of appointment' does not include powers reserved by a [decedent/donor] to himself".

B. [1.06] An Analytical Approach

The general power of appointment is an elusive creature in the sense it can emerge unexpectedly, but face to face it is far less fearsome than first thought. Its general definition, softened by exceptions, reduce it to a relatively narrow and predictable beast identifiable from the following approach:

First: Does the authority over the property exist as a matter of delegation, or by reservation? If the power to consume, invade, alter, amend or distribute belongs to the original owner it is *not* a power of appointment. Treas. Reg. 25.2541-1(b)(2) and 20.2041-1(b)(2)

Second: If the authority is in a donee/holder, does that holder have any interest in the subject property? A disinterested trustee, acting strictly in a fiduciary capacity, to whom no benefit or interest can pass (nor be directed for his or her benefit, including the benefit of someone to whom the trustee owes a legal obligation of support) will not have a general power of appointment.

Third: If presented with an interested party/holder, when was the power created? Powers created or deemed created on or before October 21, 1942 (a "pre-1942 power") are treated more generously than those created after October

21, 1942 (a "post-1942 power").

Fourth: Does the holder have the power to distribute *to herself, her creditors, her estate or the creditors of her estate*? That is, does the holder's authority fall within the general power of appointment definitions set forth in Code Sections 2041(b)(1) and 2514(c) and their respective Regulations?

Finally: If confronted with a definitive general power, does it fall within one of the prescribed exceptions? Is it: (1) limited by an "ascertainable standard" or a "joint exercise" requirement; or, (2) muted by a non-cumulative "5 and 5" power?

After cataloguing the pedigree in this fashion, one may then determine the transfer tax consequences of the power's exercise, release, lapse, or disclaimer, or its mere possession by the holder at death.

C. [1.07] General Power Defined

Internal Revenue Code Sections 2514(c) and 2041(b)(1) adopt an identical definition of a general power of appointment:

> **The term "general power of appointment" means a power which is exercisable in favor of the decedent [possessor], his estate, his creditors, *or* the creditors of his estate.**

Catch the disjunctive form "or" in that definition: the unrestricted authority to appoint to any one of the four -- the holder, the holder's estate, the holder's creditors **or** the creditors of the holder's estate -- will be sufficient to constitute a general power of appointment. Moreover, the Regulations make it clear that this deceptively simple general instruction will in fact be broadly construed:

> **The term "power of appointment" includes and shall include all powers which are in substance and effect powers of appointment received by the donee of the power from another person, *regardless of the nomenclature used in creating the power and regardless of local property law connotations.*** Treas. Reg. 25.2514-1(b) and 20.2041-1(b).

By specific example, a power of appointment includes:

* the power to appropriate or consume the principal of a trust;

* the power to affect the beneficial enjoyment of a trust property or its income by altering, amending or revoking the trust instrument or terminating the trust; and

* the power to remove or discharge a trustee and appoint herself as successor trustee. *Id. See*, Rev. Rul. 79-353 and 95-98; *Estate of Wall v. Commissioner*, 10 I.T.C 300 (October 12, 1995)

The Regulations then specify that a **general** power of appointment includes:

* a power exercisable to meet the estate tax, or any other taxes, debts or charges which are enforceable against the possessor or his or her estate; and

* a power exercisable for the purpose of discharging a legal obligation of the possessor or for his pecuniary benefit. Treas. Regs. 25.2514-1(c) and 20.2041-1(c). (This can

be a trap: since adult parents owe a duty to support their children, a parent/trustee's fiduciary power to appoint trust corpus to his/her child can result in a general power over the child's trust estate.)

Conversely, a power of appointment shall *not* be considered a general power if by its terms it is either:

* Exercisable only in favor of one or more designated persons or classes *other than* the possessor/decedent or her creditors, or the possessor's/decedent's estate or the creditors of her estate; or

* Expressly *not* exercisable in favor of the decedent/possessor or his creditors, or the decedent's/possessor's estate or the creditors of his estate. *Id.* In this case the disjunctive "or" means that <u>none</u> of the four may be permissible appointees.

These definitions track the tax philosophy: If the holder has enough control to direct the property to his or her particular benefit, which clearly includes her creditors, then for gift or estate tax purposes the holder will be considered the actual owner of the property. If the holder lacks that degree of discretion, and her individual pecuniary interest is insulated from benefitting from the property in question, then the holder cannot be fairly treated as though she were the effective owner of the subject property.

D. [1.08] Exceptions to the Rule

These broad provisions for a general power of appointment are immediately followed by two exceptions to the tax treatment, both of which spring from the parallel principle that even authority to benefit the holder directly will be exempted from tax if that power is significantly restrained.

1. [1.10] The Ascertainable Standard. By far the most important practical protection from taxability is afforded by Code Sections 2514(c)(1) and 2041(b)(1)(A), which insulate any general power to appoint if that "power to consume, invade, or appropriate property...is limited by an *ascertainable standard* relating to the health, education, support, or maintenance" of the holder or decedent. Examples of ascertainable standards are set forth in Treas. Reg. 25.2514-1(c)(2) and 20.2041-1(c)(2) and include the following specific qualifiers:

* "support"
* "support in reasonable comfort"
* "maintenance and health in reasonable comfort"
* "support in his accustomed manner of living"
* "education, including college and professional education"
* "health"
* "medical, dental, hospital and nursing expenses and expenses of invalidism".

These standards are in fact more generous and less restrictive than may first appear. The terms "support" and "maintenance" are "not limited to the bare necessities of life," and "it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised." *Id.* Properly worded, the power to invade and distribute trust property (whether income, or income and principal) is wholly justified to provide all accustomed costs of support including, for example: all the costs of housing, taxes, utilities, insurance, education, transportation, food, clothing, medical care, and such -- in turn freeing the beneficiary's own resources for extras; *i.e.* for her "happiness" or "best interests".

The ascertainable standard exception also offers important protection under other Internal Revenue Code provisions. For example, if an interested trustee distributes trust corpus to another beneficiary under a fiduciary power, he or she will be making a taxable gift governed not only by

Code Section 2514 but by Code Section 2511 as well:

> **If a trustee has a beneficial interest in trust property, the transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or non-exercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument.** Treas. Reg. 25.2511-1(g)(2)

Imagine a trust created by deceased parent A, for the initial benefit of surviving spouse B, with adult child C being both the trustee and the vested remainderman. According to this Section 2511 gift tax standard, if C distributes principal to B then C is also making a taxable gift, because C has distributed property which C has an enforceable right to receive in the future. This trap can avoided only if the interested trustee's authority is limited by an ascertainable standard applicable to *B's* health, education and support.

Interestingly, this Section 2511 gift tax regulation does not adopt the Section 2514/2041 ascertainable standard definition verbatim, referring rather to a "clearly measurable standard under which the holder of a power is legally accountable", although "support", "maintenance", "health", "reasonable support and comfort", and "to maintain [the beneficiary's] accustomed standard of living" are listed as examples. The standard is a question of context, and includes the following startling qualifier:

> **If a trust instrument provides that the determination of the trustee shall be conclusive with respect to exercise or non-exercise of a power, the power is <u>not</u> limited by a reasonably definite standard.** Treas. Reg. 25.2511-1(g)(2)**.**

Thus, a frequently used "boilerplate" clause, intended to insulate the trustee's discretion from the complaints of a dissatisfied beneficiary, can void out other ascertainable standard language and result in fiduciary distributions being treated as taxable gifts. Such protective language as, "the good faith exercise of the trustee's powers hereunder shall be binding and conclusive on all persons" should always be modified to apply only to trustees not having a present or future interest in the trust property; either that, or deleted altogether.

The ascertainable standard exception offers substantial protection from unwanted (and unintended) tax burdens yet preserves tremendous opportunity for distribution, especially where the trustee has a current or potential beneficial interest in the trust property. Indeed, there is sound reason for including the ascertainable standard restraint on <u>every</u> distributive power held by an interested trustee unless it is intended that the property fall within the holder's tax orbit (as will be the case with "non-exempt" generation-skipping trusts, where intended taxability in each succeeding tier of beneficiaries will be preferable to facing the so-called "maximum alternative estate tax" imposed by Chapter 13 of the Code [see, Part III.C. below]). The result will put little practical restraint on the beneficiary's access, and may well encourage the cautious draftsman to use more deferred powers and family fiduciaries.

BUT NOTE WELL: The flexibility and protection inherent in these magic words are not an invitation to imaginative drafting. The consistency with which the Service and courts have attacked even the most modest modifying language demands strict adherence to the prescribed language. Limit the power to distribute/withdraw to purposes of "health, education, maintenance and support in reasonable comfort, only." Deviating from this stock phrase invites peril, and the wise practitioner will not tinker around. *See e.g., Estate of Vissering*, 96 TC No. 33, where the provision "for the continued comfort, support, maintenance or education of the beneficiary" was disallowed. Comfort as a modifier of support is authorized, but apparently "comfort" as a standard on its own comes too close to general happiness. *Cf.*, Revenue Ruling 77-60, 1977-1 C.B. 282 where a power to invade trust principal "to continue the donee's accustomed <u>standard</u> of living" [as distinct from manner?] was found to be too far removed from the four limitations of health, education, support or maintenance and resulted in a general power of appointment.

2. [1.10] Joint Powers. The second exception to what would otherwise be a taxable general power applies when that power may be exercised "only in conjunction with another person". But the scope of this protection depends on the date of the power's creation.

a. [1.11] Pre-1942 Powers that are exercisable by the decedent/holder only in conjunction with another person receive a blanket exemption from treatment as a general power:

> **A power of appointment created on or before October 21, 1942, which is exercisable by the possessor/decedent only in conjunction with another person shall not be deemed a general power of appointment.** Internal Revenue Code Sections 2514(c)(2) and 2041(b)(1)(B).

The relationship of the other person or his or her interest in the subject property is immaterial; if joint action on an old power is required, that power will not be deemed a taxable general power.

b. [1.12] For Post-1942 powers, the joint action exception is severely limited. A post-1942 power of appointment will avoid taxable treatment *only* upon the following conditions:

* if it may be exercised by the holder/decedent only in conjunction with the creator/donor of the power; or

* if it may be exercised by the holder/decedent only in conjunction with a person having both a *substantial* and *adverse* interest in the property subject to the power. Code Sections 2514(c)(3)(A) and (B) and2041(b)(1)(C)(i) and (ii).

With respect to the first exception, the donor's reservation of control will probably bring the value of the property into the donor's own tax package under Sections 2036 or 2038, thus diverting the burden from the encumbered holder. There can be no "general" power in fact if it is so clearly restricted by the donor's veto.

The second exception restrains the holder's exercise by the zero-sum principal that what serves the benefit of one detracts from the benefit of the other. An interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant." Treas. Regs. 20.2041-3(c)(2) and 25.2514-3(b)(2). An interest is "adverse" if the co-holder has a present *or future* opportunity to obtain a personal benefit from the property subject to the joint power. *Id.*

A taker in default of appointment clearly has an adverse interest, as does a successor to the unexercised power after the holder's death. But a co-holder has no adverse interest merely because of joint empowerment, or because he or she may be a *permissible* appointee. *Id.* And a mere co-trustee is not treated as having an interest in the property, adverse or substantial, notwithstanding that legal title may be vested in the co-trustee, and notwithstanding its enforceable fiduciary duty to protect the best interests of the remaindermen. *Estate of Towle v. Commissioner,* 54 TC 368 (1970); Rev.Rul. 79-63, 1979-1 CB 302. That common law standard is specifically ignored, which leads to an important warning to imaginative drafters:
Cloaking an interested trustee's general discretion with a non-interested trustee's nominal title will <u>not</u> shield the general power treatment. (However, if a general power is desirable for GST planning purposes, and the grantor does not want to risk the property to the beneficiary's discretion, a general power to appoint to the beneficiary's creditors can be shackled in practice by making the power's exercise dependent upon the consent and joinder of a disinterested person.)

c. [1.13] Allocation of the subject property represents a modifier of the joint power exception, and acts as a saving provision in the event of multiple holders who are also permissible appointees. In such case, the power shall be deemed a general power "only in respect of a fractional part of the property" corresponding with the number of multiple holders. Code Sections 2514(c)(3)(C) and 2041(b)(1)(C)(iii). For example, if the power of appointment held by one party may only be exercised in conjunction with three other persons, all of whom are permissible appointees lacking a substantial adverse interest, the holder is treated as having a general power over only one-fourth of the value of the property. *Id.*

E. [1.14] Intermediate Summary

Before proceeding to how these tax rules affect real life planning and practice, it seems worthwhile to review and summarize the total gift and estate tax equation that defines how powers over property are treated:

> 1. The power to withdraw or distribute principal or income from a trust (or other property) will be treated as a taxable general power of appointment if the trustee (or other power holder) may direct the property to herself, her creditors (including persons to whom she owes a legal obligation or for her pecuniary benefit), her estate <u>or</u> the creditors of her estate, **unless** such power is limited by an **ascertainable standard** relating to the health, education, support or maintenance of the holder **or** may be exercised by the holder only in conjunction with the creator of the power or someone possessed of a **substantial interest** in the property subject to the power that is **adverse** to the exercise of that power in favor of the holder.
>
> 2. This same equation applies to the power to affect the beneficial enjoyment of the trust property or its income by altering, amending or revoking the trust instrument, or to terminate the trust, or to remove or discharge a trustee and appoint the holder as trustee (if as trustee she would have the unlimited power to appoint trust principal to herself); that is, it will be treated as a taxable general power if such power may be exercised in favor of the holder, her creditors, her estate or the creditors of her estate **unless** the power may only be exercised by the holder in conjunction with the creator of the power **or** someone possessed of a **substantial interest** in the property subject to the power that is **adverse** to the exercise of that power in favor of the holder.

F. [1.15] Impact and Consequences

Once faced by a tax general power, loose from the leash of restrictions and exceptions, there is no choice but to address the resulting impact upon the *holder's* gift and estate tax burden. This treatment depends *first* upon whether the power is a pre-1942 power, or a post-1942 power; and *second*, upon whether the power is: (i) exercised; (ii) released; (iii) lapsed; (iv) disclaimed; or (v) merely in the holder's possession at the time of his or her death.

1. [1.16] Exercise. The exercise of a general power of appointment is deemed to be a transfer of the property by the holder of the power. Internal Revenue Code Section 2514(a) and (b).

This is the heart of the legislative fiction that the general power holder, with all the self-benefitting discretion that that term implies, is deemed to be the owner of the subject property:

- * If the power is exercised by the holder in his or her lifetime, and as a result the subject property passes in a fashion contemplated by Code Section 2511, then gift tax analysis will apply. Of course, not every transfer constitutes a taxable gift, and Code Section 2514 must be analyzed in coordination with the remaining gift tax principles of Section 2511. For example, if the exercise of the general power is made in a fashion reserving to the holder dominion and control over the disposition of the property, the transfer is incomplete. Or, if the holder exercises the general power in favor of herself, there is no taxable gift because one cannot make gifts to oneself. If the power is exercised irrevocably but for consideration received, the taxable value is reduced by the value of the consideration. Finally, if the power is exercised only at death, the transfer is subject to estate tax rules not gift tax rules; the gift tax applies only to inter vivos transfers.

* If the power is exercised at death, the value of the subject property is included in the decedent's estate under Code Section 2041. In such case the basis of the property over which the general power is exercised (or deemed exercised, as results from a release or possession at death) will generally be the same as if the property were owned outright by the holder. If passing by lifetime exercise, the appointee or taker in default takes the donor's basis. If the value of the property is pulled into the holder's estate, however, the appointee or other successor in interest generally will receive the holder's final estate tax basis. Code Section 1014.

For both gift and estate tax purposes, exercise is broadly construed. Treas. Regs. 25.2514-1(d) and 20.2041-1(d). Whether the power has in fact been validly exercised may be determined by local law (as can result from an over-broad residuary clause in a will) but regardless of local law the power will be treated as exercised even if the result is the same as a default in appointment, or the appointee renounces any right to take under the appointment, or the disposition cannot take effect until some condition subsequent:

> **[R]egardless of local law, a power of appointment is considered as exercised for purposes of Section 2514 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment.** *Id.*

All that is required is that the exercise be "irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence." *Id.*

In the event the holder possesses both a general and a limited power of appointment over the same property, the exercise of the limited power will be considered an exercise of the general power, first, *if and to the extent* that immediately after the exercise of the limited power the amount of money or property subject to the general power is decreased. Treas. Reg. 25.2514-1(d) provides:

> **For example, assume A has a non-cumulative annual power to withdraw the greater of $5,000 or 5% of the value of the trust having a value of $300,000 and a lifetime non-general power to appoint all or a portion of the trust corpus to A's child or grandchildren. If A exercises the non-general power by appointing $150,000 to A's child, the exercise of the non-general power is treated as the exercise of the general power to the extent of $7,500 (maximum exercise of general power before the exercise of a non-general power, 5% of $300,000 or $15,000, less maximum exercise of the general power after the exercise of the non-general power, 5% of $150,000 or $7,500).**

A double peril attaches to the lifetime exercise of a general power of appointment. In addition to the immediate gift tax consequences, if, after the lifetime exercise (or release; see below) of the general power, the holder has a retained benefit corresponding with the lifetime transfer rules under Code Sections 2035-38, the property subject to the power will also be brought back into the holder's taxable estate. Code Section 2041(a)(2); Treas. Reg. 20.2041-3(d)(1). Thus, exercise of a general power of appointment over property whereby the holder retains a lifetime right of enjoyment or income, or a reversionary interest, or the power to alter, amend, revoke or terminate the trust, can result in *both* a taxable gift and inclusion of some or all of the property in her gross estate at death.

Conversely, if the exercise (or release) is sufficient to cut off the continued benefit from the property, the subject property will *not* be includible in the taxable estate. If the donee/holder dies more than three years after having completely released a general power, and as a result retained no interest in or control over the property, the appointed property will not be included in the estate of the holder. Treas. Reg. 20.2041-3(d)(2).

With one narrow exception, the mere creation of a power of appointment is *not* a taxable transfer; the property has not passed, merely the power to direct the property, and if the power expires or is released the donor will not have given up anything and the subject property will remain in the donor's own name for the transfer tax purposes of Code Section 2033. The narrow exception to this general rule lies under Code Sections 2514(d) and 2041(a)(3), which provide that in the event a post-1942 power is exercised by creating a new power of appointment "which, under the applicable local law" can have the effect of extending exercise beyond the period prescribed by the rule against perpetuities, this second creation will be deemed an exercise. This can cause trouble with generation-skipping "dynasty" trusts, as discussed under Part III.C. below.

2. [1.17] Release. For **a pre-1942 general power**, the release by its holder yields no tax consequence. Only the actual exercise of a pre-1942 general power results in liability, and the Code is clear that a complete release shall not be deemed an exercise. (Imaginative thinkers wishing to expand this loophole by partially releasing a general power in such fashion as to narrow it down to a limited power, thereby preserving the non-tax benefits of continuing control and direction, will find this expressly barred by the Regulations. The exercise of the resulting limited power will be treated as if it were still a general power of appointment. Treas. Regs. 20.2041-2(e) and 25.2514-2(d).)

Post-1942 general powers do not share this shelter. Such powers may be released, of course, as a matter of the holder's discretion, but by definition the release of a post-1942 general power is treated as the equivalent of the exercise of that power in favor of the taker in default. Code Sections 2514(b) and 2041(a)(2); Treas. Regs. 25.2514-3(c)(1) and (4), and 20.2041-3(a) and (d). The tax consequences are equivalent as well; that is, whether the release causes gift (inter vivos) or estate (testamentary) tax, liability depends upon the application of the same gift tax, retained interest, or estate tax rules mentioned above.

For example, if the holder is an income beneficiary of a trust over which she has a general power of appointment, her inter vivos release of the power is treated as a transfer under Section 2514(b) (a gift over to the takers in default) *and*, upon the holder's later death the subject property will also be included in her estate by virtue of Code Section 2041(a)(2) because her retained income interest is includable as a Code Section 2036(a) asset. Conversely, if the holder does not have a continuing interest after the release there will be no estate tax liability, even if that release occurs within three years after the power holder's death. Analysis in this case always depends on whether the retained interest rules of Code Sections 2035 - 2038 apply, or not.

The point to remember is that once a post-1942 general power is placed in (or found by) the holder, he or she cannot avoid the transfer tax consequences merely by renouncing or releasing the authority. Any estate tax liability avoided will generally be offset by the present gift tax treatment.

3. [1.18] Disclaimer Distinguished. A "qualified disclaimer" of a general power is not treated as the exercise, release or lapse of the power, and the disclaimer option may be the reluctant holder's best defense. The disclaimer rules (Code Section 2518 and Treas. Regs. 25.2518-2, -3; 755 ILCS 5/2-7 and 765 ILCS 25/1) apply to all taxable transfers in property including specifically powers with respect to property, even though the power is extinguished as a result. To qualify the disclaimer must: (i) be in writing and signed by the holder; (ii) refer specifically to the power or property being disclaimed; (iii) contain the holder's irrevocable and unqualified refusal to accept the power; (iv) be delivered to the donor or the donor's legal representative not later than nine months after the taxable transfer is made (or nine months after the day on which the holder attains age 21); and, (v) the disclaimant may not have accepted the power or exercised any of its prerogatives. *See,* Hirsch, *The Problem of the Insolvent Heir*, 74 Cornell L. Rev. 587 (1989) for an influential if controversial analogy between property law disclaimers and general powers of appointment, and *Drye v. United States*, 528 U.S. 49, 145 L.Ed.2d 466, 120 S.Ct. 474 (1999) where, in a disclaimer context, Professor Hirsch's theories were given great credence by a unanimous Supreme Court.)

The qualified disclaimer principles are brought into the power of appointment regulations by an express reference. Treas. Reg. 25.2514-3(c)(5) and (6). Similarly, powers over property are specifically addressed in the disclaimer rules. *e.g.* Treas. Reg. 25.2518-2(e)(1)(ii), 25.2518-2(e)(5), Examples (11) – (12), 25.2518-3(a)(iii), and 25.2518-3(d), Examples (9) and (21). From these provisions it is clear that a power over the property may be disclaimed as to all or a portion of the property, but only on condition that any power or interest retained over or in that portion of the property is limited by an ascertainable standard.

A recurring problem is a non-ascertainable standard sprinkle authority that the surviving spouse-trustee wishes to trim to an ascertainable standard without resigning as trustee or surrendering the sprinkle authority in full. An example would be a credit-shield trust affording the surviving spouse-trustee the power to distribute income or principal to self or children for their "health, maintenance, support, *and general happiness*." Can the surviving spouse-trustee partially disclaim the "and general happiness" portion of this directive and in effect convert the non-ascertainable standard into an ascertainable standard? The answer is not clear, but it seems doubtful. Treas. Reg. §20.2041-3(d)(6) alludes to disclaimer of a power of appointment as to only a portion of the property subject to the power, but not to a portion of the scope of the power. (Note that the December, 1997, revised Regulations also amended the first two sentences of Treas. Reg. §20.2041-3(d)(6)(i) and the first two sentences of Treas. Reg. §25.2514-3(c)(5)(i) to directly tie the effect of disclaiming a post-October 21, 1942, power of appointment to Code §2518 and its regulations.)

A pure property power of appointment is not a fiduciary power that the permissible appointees can enforce, and therefore its holder may timely disclaim the power with absolute discretion. But disclaiming fiduciary powers is more problematic. Such fiduciary powers, no matter how broadly drawn in their discretionary authority, pertain to beneficial interests created by the original grantor and are enforceable by the beneficiaries whether or not the trustee wishes to disclaim them.

4. [1.19] Lapse and the "5 and 5" Exception. The lapse of a power of appointment created after October 21, 1942, is considered a release of the power; meaning, in effect, that a lapse shall be treated the same as an exercise. Code Sections 2514(e) and 2041(b)(2). (The lapse of a pre-1942 general power is of no consequence.) The theory for treating lapse as equivalent to exercise continues to follow the tax philosophy: By foregoing the benefits that would inure upon exercising the power, the holder has facilitated a valuable transfer of the appointable (or, withdrawable) portion to benefit the remainderman.

Accordingly:

* For gift tax purposes an inter vivos lapse will be treated as a completed taxable transfer/gift, and not necessarily an excludable gift for the purposes of Code 2503(b), which of course depends upon the lapse creating a transfer of a *present* interest; and,

* For estate tax purposes, the value of the subject property will be included in the holder's estate if the holder retains some interest in or over the lapsed property

sufficient to invoke tax treatment within the principles of our now-familiar Code Sections 2036-2038.

Gift tax Regulation 25.2514-3(c)(4) protects a lapse from being treated as a taxable transfer if the holder "is incapable of validly exercising or releasing a power, by reason of minority, or otherwise, and the power may not be validly exercised or released on his behalf". There is no comparable protection for *estate* tax treatment under Code Section 2041, and lapse at death will result in inclusion of the subject property without regard to the holder's capacity.

Fortunately, Code Sections 2041 and 2514 both create a convenient exception to this general treatment for lapsed powers: Tax treatment shall apply

> **with respect to the lapse of powers during any *calendar year* only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of . . . :**
>
> **(A) $5,000, or**
>
> **(B) 5 percent of the aggregate value [of the property].** Code Sections 2514(e) and 2041(b)(2).

The Regulations illuminate this treatment with the following example:

> **[I]f an individual has a non-cumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000 the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5% of a fund of $100,000.** Treas. Reg. 25.2514-3(c)(4).

This exception offers obvious advantages for gift tax purposes, but the estate tax treatment is a little trickier, since each lapse of a power over property valued in excess of the $5,000/5% limit, in a trust in which the holder has the continuing right to benefit, carries the retained-benefit burden of Sections 2036 and 2038. This can result in later estate tax that is in addition to current gift tax on the value of the excess, and is also in addition to the estate tax on the remaining property that remains subject to the power at death. Moreover, this exception to the lapse rule applies only to lifetime lapses; the failure to exercise a non-cumulative power in lifetime results in the holder holding the power at death, and the value of the property subject to the power is included in the holder's gross estate under Section 2041.

The calculation of successive lapses in excess of the so-called "5 and 5" allowance is the complex subject of Regulation 20.2041-3(d)(4) which requires, in essence, that an annual determination be made of the percentages of the trust fund (valued at the date of the lapse of the power) that could have been appointed under the lapsed power in excess of the allowed 5 and 5 exemption. These percentages are to be aggregated and applied to the date of death or alternate date value of the trust at the holder's death to determine the includible amount, which cannot exceed 100% of the total value of the trust. For this purpose the Regulation contains the following example:

> **[I]f the life beneficiary of a trust had a right exercisable only during one calendar year to draw down $50,000 from the corpus of a trust, which he did not exercise, and if at the end of the year the corpus was worth $800,000, the taxable portion over which the power lapsed is $10,000 (the excess of $50,000 over 5% of the corpus) or 1/80 of the total value. On the decedent's death, if the**

total value of the corpus of the trust (excluding income accumulated after the lapse of the power) on the applicable valuation date was $1,200,000, $15,000 (1/80 of $1,200,000) would be includible in the decedent's gross estate. However, if the total was then $600,000, only $7,500 (1/80 of $600,000) would be includible. *Id.*

The 5 and 5 exception is aimed at assuring beneficiaries access to sufficient assets for their reasonable support, presumably on the same theory built into the ascertainable standard exception. The dismal mathematics of excessive lapses apply only if the power of invasion is in excess of this expressly exempted amount. In practice, if access to principal is desired, the trust should contain a specific instruction for the express allowable withdrawal provision and prohibiting further rights of invasion.

Controlled lapse is the theory behind so-called "Crummey" children's trusts (named after the famous tax case, *Crummey v. Commissioner*, 397 F 2d. 82, 68-2 USTC ¶12, 541, 22 AFTR 2d 6023 (CA-9, 1968)). Parents and grandparents frequently want to use their annual exclusion gifts to pass funds to minor children, but prefer that control or benefit be deferred until maturity. Unfortunately, Code Section 2503(b) prevents gifts of future interests from qualifying for the annual exclusion. Among the ways devised to get around this restriction is to give the minor, through his parent or guardian, a right of withdrawal limited by a relatively short period of time. When the power lapses, only that portion of the funding in excess of $5,000 or 5% is treated as a taxable gift by the beneficiary to the trust remainderman. When the gift is in excess of $5,000, as many are, the withdrawal right for the excess may be suspended - - or "hang" - - until future years when its lapse will fall under the 5 and 5 shelter. While popular, this technique can cause some unexpected problems, as discussed in Part III.D. below.

5. [1.20] Possession at Death. Internal Revenue Code Section 2041 defines the extent by which property subject to a general power of appointment held by a decedent at death will be included in the holder's gross estate for federal estate tax purposes. As mentioned before, this taxability depends on whether the power is a pre-1942 or post-1942 power, and whether the power has been exercised in the decedent's lifetime in such fashion "that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under Sections 2035 to 2038, inclusive." Code Section 2041(a)(2).

The estate of a decedent holding a **pre-1942** general power of appointment will bear estate tax only if the power is exercised at death, or by an inter vivos disposition resulting in a retained interest. Code Section 2041(a)(1). As a practical matter, such powers should be left alone unless a small estate, sheltered by the unified credit, offers the income tax advantage to the beneficiaries of using the step up in basis generally afforded under Code Section 1014.

For **post-1942** powers the result is predictably different. The possession of the general power, regardless of exercise, or even the ability to exercise the power, is treated as the equivalent of ownership of the property subjecting the value of the property to the holder's estate tax calculation. It is important to remember that the exercise, release or lapse of the general power of appointment is a <u>gift</u> tax transfer, and the value of the subject property is only brought back into the estate if there is a retained interest. Exercise, release or lapse in a fashion sufficient to remove the power holder's retained interest or power over the property will not subject the property to taxation in the decedent's estate. Under those circumstances, taxability is imposed strictly as a function of possession at death..

Mere possession is a strict standard. The property subject to the power will be taxable "even though the exercise of the power is subject to the precedent giving of notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised." Treas. Reg. 20.2041-3(b). However, if the power is conditional, or may only be exercised upon an occurrence beyond the holder's control – such as attaining a certain age, surviving another person, or death without descendants -- and the power in fact has not ripened, then the power is deemed not to be in existence at the decedent's death. On the other hand, there is no requirement that the holder even know of the existence of the power, or be legally competent to exercise the power. *Estate of Freeman v. Commissioner*, 67 TC 202 (1976).

G. [1.21] Exceptions Highlighted

The several exceptions to treatment of otherwise taxable general powers of appointment amount in the aggregate to a remarkably generous dispositive arrangement that still avoids transfer tax treatment. The trust beneficiary (or interested trustee) may:

1. Have access to all of the principal or income necessary for his or her health, maintenance, education and support, without being limited to the bare necessities of life, and without the requirement that he/she exhaust her other resources first;

2. Withdraw an additional amount equal to the greater of $5,000 or 5% of the corpus annually; and,

3. Possess the testamentary power to direct the property to any person other than herself, her creditors, her estate, or the creditors of her estate, without exposing the holder's estate to taxation, or endangering the marital deduction.

On balance, the availability of these withdrawal and directive options makes it clear that limited powers can be used to great advantage while avoiding unwanted general power tax treatment.

III. [1.22] PROBLEMS AND FOCUS

A. [1.23] Income Tax Considerations

The grantor trust rules (generally, Internal Revenue Code Sections 671 - 677) and Code Section 678 and its Regulations can create an income tax problem for those beneficiaries who allow a power of withdrawal to lapse in their lifetimes. Code Section 678 provides:

> **(a) General rule.**
>
> **A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:**
>
> > **(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or**
> >
> > **(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, with the principles of sections 671 to 677 inclusive, subject to grantor of a trust to treatment as the owner thereof.**

Thus, during the withdrawal period the power holder is deemed to be the owner of the subject portion available for withdrawal, and is to be taxed on trust income attributable to that portion. The formula for calculating this deemed income (and pro rated share of deductions and credits) is generally set forth in the Regulations. See, *e.g.,* Treas. Reg. 1.671 - 3. Where the beneficiary is to receive all of the income of the trust -- such as in the typical QTIP (qualified terminable income property) marital deduction trust -- it would seem that the deemed income earned should be subsumed into the actual annual distributions, but for trusts which provide only discretionary income distributions the 5 and 5 option can cause tortuous calculations, and taxation to the beneficiary for funds not actually received.

B. [1.24] Marital Deduction Trusts

Internal Revenue Code Section 2056 governs the estate tax marital deduction. Manipulating its provisions in order to benefit from the deduction while preserving ultimate dispositive control proved to be an art form that, ultimately, led to the amendment adding the "Qualified Terminable Interest Property" provisions of Code Section 2056 (b)(7). Before QTIP, property in which the surviving spouse received a life interest, with remainder in others, would qualify for the marital deduction only if the surviving spouse had the sole, unrestricted general power to appoint the property either to herself or her estate. Code Section 2056(b)(5); Treas. Reg. 20.2056(b)-5. *With* QTIP, all that is now required to secure the marital deduction for the estate of the first spouse to die is:

1. The trust property must have passed from the decedent/donor;

2. The beneficiary spouse must be a U.S. citizen, receive all of the income from the property at least annually, and have the power to convert non-productive property to productive property upon request;

3. No person may have the power to appoint any of the trust property to anyone other than the surviving spouse during his or her lifetime (a "qualifying income interest for life"); and,

4. An election to qualify all *or any part* of the transfer must be made on a timely filed federal gift or estate tax return.

Subject to these requirements the remainder of the QTIP trust can fall in according to the prescriptions of the first to die.

Two features make QTIP trusts immensely flexible: First, the election to treat the trust as marital deduction property is optional. While other marital deduction plans automatically pass as part of the marital deduction (and risk over-funding), a QTIP qualifying trust can be used to fund the credit sheltered "family trust" so long as the QTIP election is not made. Second, the election may apply to only a part of the trust, meaning the decedent's executor or personal representative may "zero out" the taxable estate by electing only so much marital deduction as is actually needed and leave the balance to be sheltered by the unified credit then available. Treas. Reg. 20.2056(b)-7(b)(2). requires that any partial election must be on a fractional basis, which "may be defined by formula". The resulting division of the trust must also be on fractional basis, but the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust." Treas. Reg. 20.2056(b)-7(b)(2)(ii). By thus making only a partial election on the appropriate gift or estate tax return, the marital deduction and credit shelter portions can be calculated to a statistical certainty. This approach has the charm of simplicity and is attractive in those situations where the family is determined that the surviving spouse should have the benefit of all of the family wealth until the death of the survivor before any descendants step up to take an interest.

Effective January 1, 2011, Illinois re-instated its estate tax (Illinois Public Act 096-1496, the "Taxpayer Accountability and Budget Stabilization Act", amending the Illinois Estate and Generation Skipping Transfer Tax Act [35 ILCS 405/1 - 18]). Like many states, Illinois "decoupled" itself from the federal tax scheme, and in the process allowed a maximum state death tax "exclusion amount of only $2,000,000." 35 ILCS 405/2(b) However, Illinois also restored its own version of the QTIP rule under 35 ILCS 405/2(b-1):

> **(b-1) The person required to file the Illinois return may elect on a timely filed Illinois return a marital deduction for qualified terminable interest property under Section 2056(b)(7) of the Internal Revenue Code for purposes of the Illinois estate tax that is separate and independent of any qualified terminable**

interest property election for federal estate tax purposes. For purposes of the Illinois estate tax, the inclusion of property in the gross estate of a surviving spouse is the same as under Section 2044 of the Internal Revenue Code. In the case of any trust for which a State or federal qualified terminable interest property election is made, the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.

The practical result of this legislation is to make QTIP trusts – now anticipating a three trust format instead of the traditional, federal, credit-shelter/marital trust two-step – more important and commonplace.

Some commentators have pointed to the new QTIP option as a partial cause for the reduced use of dispositive powers of appointment: armed with this quick and easy formula for securing the marital deduction, enamored by the elective feature, confronted by the clients' frequently-voiced desire to rule from the grave, and somewhat fearful of what a misplaced power of appointment can do, too many lawyers have been locking into plans fixing disposition to the distant descendants and ignoring the tool which the QTIP rules still allow: **the restriction against a power to appoint the property to someone other than the surviving spouse does "not apply to a power exercisable only <u>at or after the death</u> of the surviving spouse."** Code Section 2056(b)(7)(B)(ii).

There is no technical impediment to including a limited power of appointment in the surviving spouse as part of the Section 2056(b)(5) QTIP marital deduction formula. In doing so:

* no options are lost; and,

* greater options are created.

Of course, there will always be non-tax reasons for limiting the surviving spouse’s discretionary authority, and no stock formula ever applies universally. Still, for that majority of cases where future flexibility bodes well for the extended family, it would seem that including the power in the standard format will generally do more good than not.

C. [1.25] The Generation Skipping Transfer Tax Connection

In an ideal situation, where the opportunity exists to counsel multiple generations of the same family, we could do our clients proud by providing that each maturing generation devise all property into trust with limited powers to invade and appoint. By avoiding the general power traps discussed above we could provide for virtually unfettered access, dominion and direction over the trust property -- transfer tax free -- for generations. Alas, Congress has effectively limited this discretion with the generation skipping transfer tax provisions of Chapter 13 of the Internal Revenue Code (Code Sections 2601 - 2663.)

The generation skipping transfer tax represents Congress' conclusion that multi-generational suspended transfers are unfair, and that, *except as exempted*, property that is not subject to transfer tax in each successive generation should -- must -- face its own, separate GST tax equal to the maximum estate tax rate (currently, 35%). Code Section 2601 imposes this tax on every "generation-skipping transfer", which is defined as: (i) a transfer of property; (ii) that is subject to gift or estate tax at the time of transfer; (iii) to or for the benefit of someone who is (or is deemed to be) two or more generations younger than the person charged with the tax; and (iv) without a second gift or estate tax being assessed on the property along the way.

In GST jargon the donor of that property is called the "Transferor", a technical term that applies to: (i) the person charged with transmitting the property, directly or indirectly; (ii) in a way that will (or might) avoid tax in the next generation. This generally will include the owner of the property (whether as decedent or inter vivos donor); the surviving spouse beneficiary of a marital deduction trust taxable in the surviving spouse's estate; or, for our purposes, those burdened with a taxable general power of appointment over the property. All GST analysis returns, eventually, to the question: "Who is – or who will be – the Transferor?" The answer will almost always be found by focussing on where the gift and estate tax burden last fell, or will next fall, and thus requires careful attention to these power of appointment rules.

Integral to all GST planning is the individual exemption from the GST tax allowed by Code Section 2631(a). For 2011 and 2012 that exemption is equal to $5,000,000 worth of combined transfers made at any time during the Transferor's lifetime or at death. The exemption may be allocated to any property with respect to which any individual is the "Transferor"; *i.e.*, for which he or she may be charged with gift or estate tax upon the transfer (*including,*especially, as a result of the exercise, lapse, renunciation or possession of a taxable general power of appointment). Once allocated, the exemption value is elastic, matching all increases or decreases in the trust value. A wholly exempt trust (one with an "inclusion ratio" of zero) will never be exposed to GST tax, no matter how large it grows before termination/distribution. The exemption is also indefinite, at least so long as the trust property maintains its tax nexus with the original Transferor. *If, however,* exempt trust property is somehow taxed to a beneficiary under Chapter 11 or 12, as will occur with a general power of appointment, that just-taxed beneficiary will step into the box as the new Transferor and the prior exemption will vanish. That is rarely a welcome event.

Chapter 13 has resulted in extravagant planning both to properly preserve the GST exemption amount in each spouse and to avoid undesirable transfers for the estate in excess of this threshold. This is a complicated topic itself but the role of powers of appointment within multi-generational planning requires at least this much highlighting:

- **First,** the policy of estate and gift taxation with respect to general and limited powers of appointment is carried over into the Chapter 13 treatment. A person who holds a presently exercisable general power of appointment over trust income or principal has a Chapter 13 interest, while a person holding only a limited power has no such interest. Code Section 2652(c)(1)(A). So, in the case of a classic GST exemption trust, general powers should be avoided throughout if the desired result of avoiding taxation in successor estates is to be preserved.

- **Second,** in planning for trusts *not* sheltered by the exemption, powers may be structured to include technical general powers of appointment causing inclusion in non-skip persons, on the presumption that regular estate tax rates are preferable to the punitive maximum rate imposed upon non-exempt trusts with inclusion ratio of "one". Remember that if a technical general power is needed, but a limited discretion *in fact* is desired, authority in the successor generation may be limited to the power to appoint to the creditors of the holder's estate, supplemented with a limited power to appoint to certain classes of beneficiaries, descendants or gift over charities. Another alternative is to make the exercise of the general power subject to the consent of a person who has neither a substantial nor adverse interest in the trust estate. See, Code Sections 2514(c)(3)(A) and (B) and 2041(b)(1)(C)(i) and (ii).

- **Third,** Code Sections 2514(d) and 2041(a)(3) impose a transfer tax on the exercise of a limited power of appointment used to create a successor limited power, "which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power"; that is, beyond the applicable rule against perpetuities. Since Illinois, along with an increasing number of states, allows an "opt out" from the rule against perpetuities under the "Qualified Perpetual Trust" provisions of 765 ILCS 305/3(a-5), the unthinking exercise of a limited power could cost the GST exemption of a previously exempt trust. Treas. Reg. 26.2601-1(b)(v)(B) similarly provides that the release, exercise or lapse of a non-general power of appointment is not treated as a constructive addition to a trust if such power of appointment is created in a gst-exempt irrevocable trust and a power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the perpetuities period applicable to the original trust (with a safe harbor 90-year perpetuities period). In practice, if the trust remains subject to the common law rule, then this trap is avoided; however, if the opt out to form a qualified perpetual trust is selected, then a savings clause prohibiting the exercise of a limited power that would trigger Sections 2514(d) and 2041(a)(3) should be included in the trust terms. *See*, Item IV.C.1 below.

D. [1.26] Crummey Trusts and Conflicts Among the Tax Preferences Rules

"Crummey" trusts -- those short term "window of withdrawal" arrangements, designed to qualify for the annual gift tax exclusion while deferring benefits *de facto* – are now widely employed for a host of estate planning purposes. They are especially popular for irrevocable life insurance trusts, where the present annual exclusion gifts can combine with the later policy payouts to leverage immense wealth transfer at significant estate tax and GST tax savings.

The *Crummey* case, of course, stands for the proposition that the present interest gift tax requirement of Code Section 2503(b) is fully satisfied with an actual, if brief, "unrestricted right to the immediate use, possession, or enjoyment of property" transferred in trust. Treas. Reg. 25.2503-3(a) and (b). That that right may promptly lapse by its terms, and by design, is the whole point of the *Crummey* case and its progeny, and the technique is now well refined:

* Some valuable property -- frequently cash, but not always -- is transferred by a donor to the trustee of an irrevocable inter vivos trust.

* That trust agreement will provide that some beneficiary (or, beneficiar<u>ies</u>; *see*, *Cristofani v. Commissioner,* 97 T.C. 74 and AOD 1992 -09)

* Will have an immediate and unrestricted right to withdraw the property from the trust, but only for a limited period of time (and how long that period for withdrawal should be is the subject of some debate. Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 83-108, 1983-2 C.B. 167; *Cristofani v. Commissioner, supra.*)

* When the stated withdrawal period ends, *or lapses,* it then falls to the Trustee to administer that property according to the terms of trust. The specific provisions can vary widely, reflecting each donor's purpose and circumstances, but generally the trust will provide for deferring the beneficiary's ultimate benefit until some future event, such as the beneficiary's majority, or the death of the insured(s). Until that payout date, the Trustee will invest the contributions in some prudent fashion, which may (and often does) include insurance premiums.

Properly structured these plans can work like a charm, but like so-many innovative tax strategies there is more to the process than first meets the eye, and carelessness can create some daunting tax surprises. For example, this technique involves more than one set of tax preference rules, which are not necessarily complementary:

* **The annual gift tax exclusion under Code Section 2503(b).** This annual exclusion applies to each *donor*, but not to the donee. So long as the transfer qualifies as a present interest, any number of benefactors may contribute up to the annual exclusion amount (currently, $13,000), on behalf of each withdrawal right holder, without any

reportable gift tax treatment. Typically, an affluent husband and wife will want to place their combined maximum of $26,000 for each intended beneficiary. Add four grandparents and $78,000.00 can be contributed to each donee.

* **The annual GST non-taxable transfer exclusion under Code Section 2642(c).** This GST exemption rule is similar to, *but far more restricted* than the Section 2503(b) exclusion. Gift tax excludable gifts into trust will not qualify for this GST exclusion unless: (i) during the beneficiary's life no portion of the trust corpus may pass to anyone other than the beneficiary; *and,* (ii) if the trust does not terminate until the beneficiary's death the trust corpus must be includible in the beneficiary's Chapter 11 taxable estate. Code Section 2642(c)(1); Treas. Reg. 26.2642-1(c)(3).

  To shelter most gifts in trust a portion of the grantor's GST exemption will need be allocated on a timely filed gift tax return. Failure to do so can result in the entire trust having an inclusion ratio of "one" upon termination/distribution, producing a massive GST tax due. FOR PRACTICAL PURPOSES, PLEASE NOTE: the Section 2642(c) exception will <u>never</u> apply to a gift to a trust that is not a "Skip Person", *i.e.*, a trust where all current and potential beneficiaries are deemed to be at least two generations younger than the transferor. This is a frequent source of practitioner confusion and error.

* **The "5 and 5" general power of appointment exclusion.** A *Crummey* withdrawal right is nothing more or less than a general power of appointment over the contributed property. Code Section 2042(b) provides that the lapse of a general power shall be treated as a taxable release of the power. Taxability is avoided only when the lapsing power is limited to the right to withdraw no more than the greater of $5,000 and 5% of the corpus. Lapses are sheltered by this "5 and 5" safe harbor, but releases are not, so a written waiver or release of a withdrawal power – a common mistake among the untrained or inexperienced – is equivalent to exercise, and a taxable transfer on the part of the withdrawal right holder.

  Moreover, it bears emphasizing that, in opposition to the Section 2503(b) rule, the Section 2042(b) benefit is limited to $5,000 per **holder**, not donor. If both parents use a Crummey right in order to transfer $13,000 each per child to an insurance trust, the total amount that the child can lapse during the calendar year without a taxable release occurring is still limited to $5,000 or 5%. The shortfall between the $13,000 gift tax amount, available to each donor, and the annual lapse limit of $5,000/5% for each donee, is also the source of a lot of confusion and error.

The divergence in benefit and impact among these tax preference rules begins to appear when you consider the tax treatment after the contribution has been made and the withdrawal right created:

1. While the power to withdraw is pending, the grantor trust rules mentioned earlier require that a portion of the trust's income be chargeable to and reported by the donee/holder. This may be less of a concern when the holder/donee is also the current income beneficiary, but in instances illustrated by the *Cristofani* case, where several of the holders were only remaindermen, this can produce a surprising and not necessarily welcome Form K-1 in the following year's mail.

2. Similarly, if the holder/donee dies during the withdrawal period:

   * The property subject to the withdrawal right will be includible in his or her gross estate as an unexercised power of appointment in possession at death (the "5 and 5" exclusion applies only to inter vivos lapses and does *not* apply to general powers in possession at death); and,

   * Even more frequently overlooked, the donee/holder's death during the withdrawal term will make the decedent the GST "Transferor" of the

includible property, for which his or her executor may need to allocate GST exemption to protect the interests of the contingent beneficiaries.

3. When the withdrawal right lapses, then to the degree that the withdrawal right exceeds the 5 and 5 safe harbor allowance ($5,000, or 5% of the trust estate) the holder/donee will be treated as if he or she had contributed the excess *from his or her own property*, and the GST tax implications of this deemed transfer will follow by application of other existing tax principles.

To illustrate, assume a *Crummey*-style gift of $8,000 to an existing trust having a present value of $90,000, and assume further that the holder/donee allows this withdrawal power to lapse. The 5 and 5 safe harbor will treat $5,000 [the greater of $5,000 over $4,500 (5 percent x $90,000 = $4,500)] as a nontaxable lapse, but the remaining $3,000 will be the object of a release of a taxable general power of appointment. Since a release equals exercise, and exercise equals a taxable transfer, that extra $3,000 will be treated as the practical equivalent of a gift by the holder to the trust. The tax consequences of that excessive lapse/gift could include any one or more of the following results:

* If the holder/donee possesses **no** other beneficial interest in the trust, the release will be a taxable gift.

  If the trust beneficiaries do not have immediate unrestricted rights to the income or principal of the trust, the gift will not qualify for the annual exclusion, and the holder/donee/grantor will need to report the gift on his or her current gift tax return.

  As the gift-tax grantor, the power holder will also be the GST transferor for that fractional portion of the trust. If it is possible that any vested or contingent interest holder in the trust would be deemed a "skip person", determined in relation to the holder/donee, he or she will need to allocate a portion of his or her GST exemption on a timely filed gift tax return to protect the zero inclusion ratio of the trust.

* If the holder/donee possesses a testamentary power of appointment over the trust, however, the transfer will be incomplete for gift tax purposes. Treas. Reg 25.2511-2(b). This is true irrespective of whether the testamentary power is a limited power or a general power.

* If the holder/donee continues after the fact to be entitled to the use or enjoyment of the income and/or principal of the trust, a taxable release will be equivalent to a retained interest transfer subject to Code Section 2036(a)(1), causing the proportionate portion of the entire fund to be includible in the holder's gross estate at death. Since it is more common than not that the holder will have an income or remainder interest in the trust, excessive lapses/releases will frequently invoke Section 2036(a)(1).

* If the holder/donee is entitled to all of the income of the trust for life but does not possess a testamentary power of appointment, a gift will occur of the actuarial value of the remainder interest attributable to the released portion of the property deemed to have been transferred by the donee. Treas. Reg. 25.2511-1(e). This actuarial value is calculated in accordance with Code Section 7520(a), which requires that 120% of the federal midterm rate in effect for the month of valuation be applied with other mortality data to the appropriate schedule set out in Internal Revenue Service valuation table "S".

* If the holder/donee is a current income beneficiary but will receive principal only by virtue of surviving a condition precedent (such as the death of an insured), the lapse of a withdrawal power appears to be a transfer with a retained reversionary interest. If the value of that reversionary interest exceeds 5 percent, Internal Revenue Code Section 2037 would call for including the released interest in the holder/donee's estate. If the released interest is includible in the donee's gross estate the value of the

included interest is determined by multiplying the fair market value of the trust corpus at the applicable valuation date by a fraction, the numerator of which is the value of the property subject to the released power and the denominator of which is the fair market value of the entire trust corpus at the time of the release. Treasury Regulation 20.2041-3(d)(4).

* If the trust estate will be distributed to the holder/donee upon attainment of a designated age, or to his or her estate if he or she dies before attaining such age, no gift will have occurred, because you cannot make a gift to yourself. Taxation of the entire trust estate to the holder/donee is a core requirement for the *GST* $13,000 annual exclusion for gifts in trust under Code §2642(c).

* To the degree either: (i) the released portion is deemed a taxable gift transfer by the holder/donee; or (ii) a portion of the trust is includible in the holder/donee's estate at his or her death, the holder shall become the "Transferor" of that property for GST purposes. Any exemption previously allocated to the fund by its original donor shall, to the degree of that taxability, vanish, meaning that a fund once wholly exempt could have an inclusion ratio significantly greater than 0 upon its final distribution. If the trust is an insurance trust it is possible that the total payout may exceed that holder's own remaining GST exemption amount.

In light of these implications, not all of which are obvious, it seems safe to say that excessive lapses/taxable releases should be studiously avoided, unless for one reason or another it is intended to trigger these results.

As suggested earlier, a popular method for avoiding taxable releases while taking maximum advantage of the Section 2503(b) annual exclusion amount has been to limit the amount of the withdrawal power that would lapse each year to the 5 and 5 amount. Excess contributions would "hang" -- meaning, remain subject to the withdrawal power -- for an extended period until the trust value grew to the point that the 5% value would absorb all past excess portions. In the meantime, the holder/donee would continue to hold a general power over the excess portions. This period can, and often will, last for several years.

While attractive and useful in many respects this "hanging power" tactic still leaves the holder/donee exposed to serious tax harm in the event he or she should die during the hanging period. And for generation skipping transfer trusts, especially insurance trusts where the large ultimate fund is supposed to be sheltered by the donor's limited exemption allocation when the premiums are contributed, there is the potential for exposing the entire resulting fund -- the policy proceeds -- to significant GST tax.

There is no stock answer or formula around this conundrum. Like every estate planning project the best approach must depend upon each client's priorities and circumstances. However, the two common scenarios lend themselves to two distinctly different rules of thumb:

1. Where the trust is intended to be includible in the holder/donee's estate. Avoiding potential taxation to the holder is no longer a worry here, since that is part of the original plan. Generation skipping will be limited to direct transfers for the benefit of living persons two or more generations down, but "dynasty" treatment is necessarily avoided by drafting a general power of appointment into the trust charging the entire fund to the holder/donee's estate at death. Thus, large annual gifts can be made; the Section 2642(c) GST annual exclusion will be available (provided there is only one beneficiary for each trust); and the bugaboos resulting from excess releases by the holder will cause few present or future problems that cannot be handled.

2. Where the trust is NOT intended to be includible in the holder/donee's estate. The converse is true if the purpose is to create a generation skipping transfer tax exempt fund, one which is to benefit successor generations without being subject to gift or estate tax in each tier of descending benefit. In this case *almost all* of the problems associated with excess releases discussed above could be present, in one form or the other. This will lead the cautious planner to avoid hanging powers altogether, and limit each power holder's right of withdrawal to that year's calculable 5 and 5 amount.

E. [1.27] Trusts and Individual Retirement Accounts

Individual retirement accounts are governed by minimum distribution rules. Very complex in their own right, these rules nevertheless begin with a general provision that if the plan participant should pass away before his or her required beginning date (generally, April 1 of the year following the year in which he or she attains the age of 70½ [Code Section 401(a)(9)(C)(i)]), the plan benefits must be totally distributed within five years after the participant's death. Code Section 401(a)(9)(B)(ii); Treas. Reg. 1.401(a)(9)-3, A-2.

The exception to this five-year rule is when the plan is payable to a "designated beneficiary" – traditionally a named individual, or group of individuals -- in which case the benefits can, instead, be distributed over the designated beneficiary's/ies' own life expectancy/ies. Code Section 401(a)(9)(B)(iii). In most cases, clients will prefer the longer payout, and thus generally prefer that named beneficiaries be "designated beneficiaries."

Since January 1, 2003, that "designated beneficiary" can be a trust, not just a living individual, if certain requirements are observed. Treas. Reg. 1.401(a)(9)-4 and Q & A - 5(a) provides:

* The trust must be a valid trust under state law, or would be but for the fact that there is no corpus

* The trust is irrevocable or will, by its terms, become irrevocable upon the death of the account owner

* The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the account are identifiable from the trust instrument

* Documentation of the trust as a beneficiary must be provided to the plan administrator no later than October 31of the year following the account owner's death, unless the spouse is the sole trust beneficiary, in which case the documentation must be provided to the plan administrator during the participant's life

* All beneficiaries with respect to the trust's interest in the account must be individuals

* No person may be granted the power to change the beneficiary after the owner's death

The trip-up for our purposes is the requirement that all "beneficiaries . . . be identifiable". The purpose of this requirement is to establish the oldest living member of the class of beneficiaries who may take under the trust, because it is that oldest member who will establish the new life expectancy/measuring term for the new minimum distribution standards. It is also clear that all of the beneficiaries must ultimately be identified as *individuals*, so probate estates, foundations, and charities *do not* qualify as designated beneficiaries and would trigger the general "B.(ii)" 5-year rule.

Thus, the question then emerges: Is it possible to add a power of appointment to any of the designated trust's beneficiary's interests without disqualifying the trust as a designated beneficiary?

As might be expected, the answer is both yes and no. Yes, in the sense that a limited power of appointment that is tightly drafted to include only a narrowly defined group of identifiable individuals who are younger than the oldest beneficiary whose life is used for measuring the distribution period and resulting minimum distribution payments will not disqualify the trust as a designated beneficiary. But "no" in the sense that this will add much flexibility to what can already be written in as vested remaindermen. And, an overbroad power that *does not* adhere to these limitations could disqualify the trust. One should be very cautious in adding powers to an IRA beneficiary trust.

IV. [1.28] PLANNING AND DRAFTING

As is always the case, there is no substitute for careful, even detailed planning and drafting when including powers of appointment within the estate plan. Key issues that should always be considered include:

1. What power, or powers, over what interests in property, is/are being created?

2. Who is to have the power, and what limits are to apply over the scope and manner of its exercise?

3. In whose favor may the power be exercised and under what conditions, if any?

4. To whom will the property pass in the event of default of appointment?

5. Finally, in what manner, and to what degree, may the power be exercised? (Remember, this power affects titles, which some non-expert is going to examine someday, and that non-expert is going to require a reasonably reliable standard of proof before acting upon the holder's direction.)

The specifics will vary each time, and will be set out in the resulting dispositive articles. The following examples, and comments, are by no means exhaustive, and are included here more for the purpose of prodding the reader's own thinking on how best to apply these tax principles to your practical realities, styles, and preferences.

A. [1.29[Marital Deduction Trusts.

As suggested earlier, Code Section 2056(b)(7) "QTIP" trusts are an increasingly popular option for marital deduction planning, and essential for most generation-skipping transfer tax planning. Moreover, it was earlier demonstrated that limited powers can be added to the stock QTIP formula to allow the surviving spouse much more flexibility over the trust estate during his or her lifetime, and a testamentary limited power of appointment can be appended to the terminable interest to allow the surviving spouse the extra flexibility to rewrite the plan in light of circumstances not evident at the time of the first spouse's death.

Here is one way to do it:

ARTICLE EIGHT: The Marital Trust Provisions.

The Trustee shall hold and administer the Marital Trust estate for the exclusive lifetime benefit of Grantor's Spouse in conformity with Grantor's intention to establish a transfer in trust of qualified terminable interest property that is eligible for the federal and Illinois estate tax marital deduction within the meaning of Internal Revenue Code Section 2056(b)(7). All references in this instrument that are

inconsistent with this overriding intention shall be deemed amended or, if necessary, deleted, in order to conform with this overriding intention. Except for the power to make tax elections [including specifically but without limitation the power to make partial or formula elections for qualified terminable interest property in order to obtain maximum lawful transfer tax advantage, which power is hereby specifically created in the Trustee] the Trustee shall have no power over the Trust Estate which if exercised could defeat the federal and Illinois estate tax marital deduction eligibility anticipated by this instrument.

A. Commencing upon Grantor's death, the Trustee shall pay to or for the benefit of Grantor's Spouse all of the net income of the Marital Trust in regular monthly or other convenient installments, and at least annually.

B. The Trustee shall also pay to or for the benefit of the Grantor's Spouse so much of the Marital Trust principal as may be required from time to time to provide for his/her health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of his/her spouse is for his/her support in reasonable comfort, without regard to his/her other assets or income, and in priority over the interest of any potential successor beneficiary; provided, that all distributions of principal made pursuant to this paragraph hall at all times adhere to this ascertainable standard.

C. In addition, and during the month of June of each calendar year only, the Grantor's Spouse shall have the right to withdraw or demand distribution, free from trust, an amount of trust principal that does not exceed the greater of: (i) FIVE THOUSAND DOLLARS ($5,000.00); or, (ii) FIVE PERCENT (5%) of the value of the Marital Trust Estate on June 1 of each year. This right of withdrawal shall be non-cumulative, may be exercised only by a signed written instrument delivered to the Trustee during the month of June of each calendar year, and shall lapse if not exercised on or before June 30 of each year.

D. The Trustee shall make no unsecured loans from the Marital Trust Estate without the written consent of Grantor's Spouse, and any unproductive property held in the Marital Trust shall be sold by the Trustee upon being directed to do so by the Grantor's spouse.

E. Upon the death of Grantor's Spouse the accrued and undistributed income of the Marital Trust shall be paid to the estate of Grantor's Spouse.

F. The Marital Trust shall terminate upon the death of Grantor's Spouse, whereupon the Trustee shall then distribute the Marital Trust Estate remaining in compliance with the following provisions:

1. The Grantor's Spouse shall have the limited testamentary power to appoint all, any portion of, or any beneficial interest in the Marital Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants then living or thereafter born. This power of appointment may be exercised by the Grantor's Spouse in such portions, amounts or manner as Grantor's Spouse may appoint by a Will that specifically refers to such limited power of appointment, and may be exercised by the Grantor's Spouse in his/her sole and unfettered discretion and without application of any fiduciary principles or standard of reasonableness; provided, however, that no such appointment shall be effective: (i) to appoint such Trust property in a manner resulting in any Trust having a federal generation-skipping transfer tax inclusion ratio greater than zero; or (ii) to allow the

distribution of Trust principal free of trust to any person who has not attained the age of 30 years. [other restrictions?]

2. Subject to the foregoing, and except as otherwise effectively appointed, the Trustee shall then distribute the Marital Trust Estate remaining to the Grantor's then living descendants, per stirpes and not per capita, subject only to the Holdback Trust Provisions of Article _____ below.

Paragraph A., of course, is a QTIP mandatory income requirement. But Paragraph B. is a discretionary option creating a power of withdrawal over principal that is subject to an ascertainable standard, suitable for practical purposes by either a corporate fiduciary or the surviving spouse as his or her own trustee. The statement of the grantor's priority of purposes instructs the trustee to be generous within the confines of this standard, and provides the trustee some shelter from the remaindermen's impatience to get their hands on the money.

Paragraph C. is intended to strike a compromise between the grantor's desire to provide generous access, while limiting the period during which the 5 and 5 amount will be vulnerable to inclusion in the survivor's gross estate. (Of course, if the entire trust is elected for QTIP treatment it is going to be includible in the spouse's estate anyway; the protection is more important for those instances where the single trust receives a fractional QTIP election.) In targeting the mid-year, 30-day term of June, the thought is that the survivor can plan for this withdrawal if he or she wants some extra cash, or let it lapse (with relief) on July 1, if not. The grantor trust income tax rules cannot be ignored for this period, but since the survivor has a mandatory income right anyway it would seem that in all but the very largest trusts that burden can be handled with skilled tax reporting on the fiduciary income tax return.

The limited testamentary power of appointment in Paragraph F.1. provides a dispositional control mechanism for the survivor. He or she will have the opportunity, presumably many years after the death of the grantor, to reconsider the needs, desires and deserts of the family, and to adjust the distribution of the fund as circumstances may then indicate. The limitation on the class of permissible appointees is inserted as an example, and need not be so limited; it would be equally effective (for tax purposes, if not family sociology) to limit the class to "**such persons or entities other than the grantor's spouse, his or her estate, his or her creditors, or the creditors of his or her estate**". Another advantage of placing this power in the survivor is to encourage the children and grand children to be kind to the power holder. Cynics can have a field day with this one, but there are plenty of times when the first spouse’s primary purpose is to extract that very contribution -- of kindness and attention -- from the potential takers.

Finally, Paragraph F.2. provides one of many possible alternatives for distribution in default of appointment. The fact is that the vast majority of powers are never exercised, and a clear statement of who takes in default of appointment is always desirable.

B. [1.30] Generation Skipping Trusts

There are two kinds of generation skipping trusts: (i) those that are intended to be wholly exempt, and thus insulated from GST tax and estate tax for more than one generation; and (ii) those that are not.

Exempt trusts will have an inclusion ratio of “0", and remain exempt so long as no beneficiary is charged with gift or estate tax during its term.

Non-exempt trusts will have an inclusion ratio of “1", and each taxable distribution and taxable termination will subject the fund to the maximum GST equivalent tax. Non-exempt trusts are employed more for their asset protection features than for tax planning, and need to be protected from the GST tax by applying a taxable general power of appointment upon each successor beneficiary.

Assume that a single trust instrument contains formula language to divide the common fund into exempt and non-exempt portions. Here is one example of how a single beneficiary might be empowered to redirect the funds at his or her death, with maximum discretion and flexibility, but without exposing the exempt fund to estate tax, or the non-exempt fund to GST tax:

F. Upon the death of the Beneficiary the Trust Estate shall pass as follows:

1. The Beneficiary shall have the general testamentary power to appoint any part or all of the "Non-Exempt Portion" of the Trust to or for the benefit of the creditors of his or her estate, but only by a Will which specifically refers to this general power of appointment [; provided, however, that the exercise of said power shall not be effective absent the written consent of the then-acting president of the First State Bank, of Hometown, Illinois, or its corporate successor, which consent may be granted or withheld without application of any fiduciary principles or standards of reasonableness.]

2. Subject to the foregoing, the Beneficiary shall also have the limited testamentary powers:

a. To appoint the right to receive any part or all of the income from the "Exempt Portion" of his or her Trust Estate, and from that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.1. above, to or for the benefit of his or her spouse for any period of time not to exceed the spouse's lifetime.

b. To appoint all, any portion of, or any beneficial interest in the Exempt Portion, and that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.1. above, of his or her Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, the power to create successive limited or general powers of appointment, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants (other than the beneficiary/power holder) then living or thereafter born.

c. In each case these powers may be exercised in such portions, amounts or manner as the Beneficiary may appoint by a Will which specifically refers to the power of appointment being exercised; provided, however, that no exercise of a limited power of appointment shall be effective:

i. to appoint the Exempt Portion of the Trust property in a manner resulting in any trust having a federal generation-skipping transfer tax inclusion ratio greater than zero;

ii. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

iii. to direct the sale, partition, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

iv. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

v. (other personal restrictions that the client may wish to

apply, such as holding a farm business together, preserving environmental preferences, etc.)

3. Except as otherwise effectively appointed, the Trustee shall collect all the property remaining in or passing to the Descendant's Trust pursuant to the foregoing; reapportion the Exempt Portion and Non-Exempt Portion property to reflect any allocations of generation skipping transfer tax exemption taking effect upon the death of the Beneficiary, if any; and then divide all the "Exempt Portion" and "Non-exempt Portion" property (while maintaining the distinction between the Exempt Portions and Non-exempt Portions) into equal shares of each Portion so as to provide:

a. One such share of the Exempt Portion and one such share of the Non-Exempt Portion for each living child of the deceased Beneficiary, and one such share of each Portion for each deceased child of the deceased Beneficiary who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes; or

b. If the Beneficiary is not survived by any descendants, then to provide one such share of the Exempt Portion and one such share of the Non-Exempt Portion for each surviving sibling of the Beneficiary, and one such share of each Portion for each deceased sibling who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes.

c. If the Beneficiary is not survived by any descendants or siblings, then to provide shares of each such portion for those persons who would inherit from the Beneficiary's intestate estate, in the manner and proportions prescribed by the Illinois rules of descent and distribution.

d. Each share allocated to one of the Grantor's descendants for whom a Descendant's Trust then exists shall be added to his or her Trust Estate. Each share allocated to a new descendant beneficiary shall thereafter be held and administered as a new Descendant's Trust. The Trustee shall administer the Exempt Portion and Non-Exempt Portion of that new Descendant's Trust, and shall distribute the income and principal thereof to or for the benefit of that beneficiary in the same portions, amounts or manner, and subject to the same restrictions, prerogatives and powers of appointment (including specifically the defined general power of appointment over the Non-Exempt Portion and the defined limited powers of appointment over the Exempt Portion) accorded by this instrument to each of the Descendant's Trust's beneficiaries initially.

Paragraph 1 is a classic general power of appointment, limited to one of the four named appointees set forth in Code Sections 2514 and 2041, and intended to assure that the non-exempt portion of the fund will be taxed at the Beneficiary's death (thereby avoiding a generation skipping transfer). The additional bracketed restriction is intended to mute the power holder's authority in fact by restricting the power's effective use to the consent of someone who has neither a substantial or adverse interest in the fund. If the donor has more faith in the beneficiary, this narrow general power can be rewritten to broaden the class of appointees to "**such one or more persons or entities, including the Beneficiary's estate**", and, of course, strike the reference to the President of the Home Town Bank.

Conversely, Paragraph 2 is a classic limited power over the exempt fund, and that part of the non-exempt portion not effectively appointed under Paragraph 1, which also gives the Beneficiary a second, limited, bite at redirecting the non-exempt fund among different family members without risking a taxable transfer, rotation of the applicable GST “Transferor” or risking the exempt fund’s exempt status.

Paragraph 3 reflects the method and manner for exercise, with such structural limitations as the client may require; Paragraph 4 provides the default provisions; and both Paragraphs continue the distinction between the general power-burdened "Non-Exempt" Portion and the limited power flexibility built into the "Exempt" portion.

C. [1.31] Protective Drafting.

All of us forget things sometimes, or draft or review when we are tired, and like a reserve parachute to a skydiver it is a calming thing to incorporate some safeguard provisions into our boiler-plate provisions. Here are a couple that may be worth considering:

1. **[1.32] The Rule Against Perpetuities and Power Exercise Instructions.** It is easy to get carried away with the long-term possibilities of a GST exempt trust and in the process forget the Rule against Perpetuities. An accidental violation of the Rule can still void the most well considered plan of deferred entitlement, and a savings clause requiring vesting within the applicable period should be considered for every trust instrument providing for multi-generational benefit that is not otherwise intended to be a qualified perpetual trust.

Section 4-2 of the Probate Act (755 ILCS 4-2) "Testamentary powers of appointment" and Section 1 of the Power of Appointment Exercise Act (765 ILCS 320/1) "Non-testamentary powers of appointment" offer a lot of support in this area, but sometimes a comprehensive provision on how powers of appointment are to be construed and exercised, with a built in Rule Against Perpetuities savings clause, might be desired. Here is one possibility:

<u>ARTICLE ELEVEN</u>: Powers of Appointment and Rule Against Perpetuities.

A. Each power of appointment created in this instrument is conditional upon the substantive limitations incorporated in the terms creating the power, and may be exercised only in conformity with those restrictions, conditions and limitations. [No such power may be exercised so as to create a new power of appointment in another holder that is not subject to the same substantive limitations created in the first power holder initially.] Any exercise of a power that otherwise complies with the prescribed method of exercise but which exceeds the scope of the terms creating the power shall to the extent possible be deemed reformed and amended to comply with those restrictions, conditions and limitations and as so reformed and amended given full force and effect. Nevertheless, the purported exercise of a power that cannot through liberal construction be reformed and amended in compliance with the restrictions, conditions and limitations of the power shall be void.

B. Subject always to the restrictions, conditions and limitations incorporated in the powers to appoint herein created, any holder of a power of appointment created in this instrument may within the scope of those limitations exercise such power either outright or in trust. If the appointment is in trust, the holder may select or extend an existing trust for the benefit of an appointee or create a different trust, select trustees, create new powers of appointment in the trustee or in the appointee which are no more broad than (and subject to the same restrictions, conditions and limitations of) the power being exercised, and establish such administrative powers or restrictions for a trustee as the holder deems appropriate.

C. The holder may create life estates, rights to income or principal, or other limited interests in an appointee with future interests in favor of other appointees, impose lawful conditions on an appointment, appoint different types of interests to selected appointees, impose lawful spendthrift provisions, and, in general, appoint to or among the permissible appointees in any manner not prohibited by applicable law or the terms creating the power initially.

D. In determining whether, in what manner, and to what extent a testamentary power of appointment has been exercised by a holder, the Trustee may act in reliance upon a court admitting an instrument to probate as the holder's last will or an order finding that the holder died intestate. Unless within six months after the holder's death the Trustee has actual notice of the existence of proceedings to probate a will of the holder, the Trustee shall assume the holder died intestate.

E. In determining whether, in what manner, and to what extent an inter vivos power of appointment has been exercised by a holder, the Trustee may act in reliance upon the holder's signed written instrument that is actually delivered to the Trustee. Absent proof of delivery the Trustee shall assume the power has not been exercised.

F. Notwithstanding the foregoing, or any provision of this instrument to the contrary:

1. No holder shall have the power to exercise a power of appointment in a manner that would result in the suspending of the vesting, absolute ownership or power of alienation in any property governed by this instrument for one moment beyond the date for final termination of every trust created hereunder and for the distribution of the Trust Estate, outright and free of trust. No right, title, interest or power of any kind contained in or governed by this instrument shall be construed as to violate the applicable Rule Against Perpetuities as that Rule is applied in the State of Illinois, and any provision of this instrument to the contrary shall be deemed amended as necessary to comply with said Rule.

2. Each Trust or Trust Estate created pursuant to or as a result of this instrument shall terminate at the end of twenty-one (21) years after the death of the last to die of all of Grantor's descendants who are living at the date this instrument becomes irrevocable. Upon such termination the Trustee shall distribute each Trust Estate outright and free of trust to those persons then eligible to receive or have the benefit of its income in proportion to their income interests, or if their interests are indefinite then in equal shares.

G. All references in this instrument to a "limited" power or "limited power of appointment" shall be conclusively construed (together with all other specific restrictions, conditions and limitations pertaining to such power) as being expressly not exercisable in favor of the power holder or his or her creditors, the power holder's estate, or the creditors of his or her estate.

This provision avoids the general power tax trap under Code Sections 2514(d) and 2041(a)(3) altogether by conforming with the Illinois Rule Against Perpetuities. However, more and more Illinois trusts are now opting out of the Rule by designating the intention that each trust be a "Qualified Perpetual Trust" as now allowed under 765 ILCS 305/1-6. Electing out allows dynasty treatment, but the GST planning will still require that the scope of the limited power(s) remain leashed. In such case, Paragraph F would be rewritten:

F. Each Trust created pursuant to or as a result of this instrument shall be a "Qualified Perpetual Trust" to the extent allowed by Illinois law; provided, however, that for the purposes of Internal Revenue Code Section 2514(d) no holder shall have the power to exercise a power of appointment to create another power which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, such exercise of the first power shall, to the extent of the property subject to the second

power, be deemed a transfer of property by the individual possessing such power.

Most of that language, of course, is lifted verbatim from Code Section 2514(d)

2. **[1.33] Legal Obligations of the Holder.** Surprise general power of appointment treatment can emerge when a holder has a discretionary power for the benefit of persons toward whom he or she has a legally enforceable duty or obligation. This is especially so when a grandparent names a parent as custodian or trustee for the grandchild. Here is one approach at a protective provision:

Any power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, shall be exercisable solely by the Trustee or Trustees other than that person. If no other Trustee is then serving, such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited: (i) by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations; or, (ii) to a non-cumulative right to withdraw or demand distribution of no more than the greater of $5,000.00 or five per cent of the aggregate value of a Trust Estate during any calendar year.

D. [1.34] Testamentary Exercise

Suppose the life-interest beneficiary of the GST trust provisions mentioned in Item IV. B above elects to exercise one or another of his or her powers to provide: (i) a successor Trustee; (ii) income to his/her spouse: (iii) for an early termination of the dynasty; and, (iv), a disproportionate allocation of principal among the children or their descendants. This calls for touching a lot of bases, and drafting the exercise can be as thought-provoking as preparing the beneficiary's estate plan *de novo*. A suitable set of will provisions could be drafted as follows:

LAST WILL AND TESTAMENT
DUTIFUL LEE FARMING

* * * *

ARTICLE FOUR: I hereby declare that I am the current beneficiary, and the Trustee, of the Dutiful Lee Farming Descendant's Trust (EIN: xx-xxx4567), which was created under and is governed by ARTICLE EIGHT of the Father Farming Trust Agreement dated October 17, 2007. This Trust consists of two components:

- **An "Exempt Portion", so-called because it is exempt from generation skipping transfer tax; and,**

- **A "Non-Exempt Portion", which is not yet exempt from generation skipping transfer tax.**

A. ARTICLE THREE ("Trustees"), Paragraph B.3 of the agreement confirms my appointment as Trustee of my Descendant's Trust, and Paragraph C provides that as such I have

"the limited power to appoint any one or more persons who

has/have attained the age of 30, or a corporate fiduciary, as his or her* [my] *Co-Trustee or as successor Trustee for any Trust for which he or she is serving as Trustee or Co-Trustee. This power may be exercised at any time, from time to time, or upon the Trustee's death, by a signed instrument in writing (including a Will) specifically referring to this limited power of appointment."

I hereby exercise that limited power of appointment by specific reference as follows:

Upon my death the successor Trustee shall be my Spouse, Faithful Lee Farming, with full power to nominate and appoint her successor under the same provisions of said ARTICLE THREE, Paragraph C. or any other provision of the agreement as if originally named Trustee or beneficiary of a Descendant's Trust. In default of her appointment the successor Trustee shall be the Home Town Bank and Trust Company, of Home Town, Illinois, or its corporate successor.

B. Subparagraphs F. 1 and F.2 of said ARTICLE EIGHT of the Agreement provide in their entirety as follows:

"F. Upon the death of the Beneficiary [me] the Trust Estate shall pass as follows:

[quote verbatim]

I hereby exercise, or decline to exercise, the above-described powers of appointment, by specific reference, as follows:

1. I hereby decline to exercise the general power of appointment provided in said Subparagraph F.1., with the knowledge that said general power shall lapse upon my death; that the lapse of this general power may, under the provisions of Internal Revenue Code Section 2041, cause the value of the Non-Exempt Portion to be includible in my gross estate for federal estate tax purposes as provided by Internal Revenue Code Section 2031; and, that upon my death I may then be deemed to be the "transferor" of the Non-Exempt Portion for the purposes of Internal Revenue Code Section 2652. In such case, I suggest but do not absolutely direct that my Executor first allocate so much of my generation skipping transfer tax exemption remaining at my death to as much of, or if possible all of, said Non-Exempt Portion, in order that as much of or if possible all of said Non-Exempt Portion may be added to the "Exempt Portion" with a continuing inclusion ratio for the Exempt Portion of zero.

2. I hereby exercise the limited power of appointment provided in said Subparagraph F.2.a. as follows:

Commencing upon my death leaving my said Spouse surviving, the Trustee shall pay to or for the benefit of my said Spouse ONE-HALF (½) of the net income of the Trust, from both the Exempt and Non-Exempt Portions, in regular monthly or other convenient installments, and at least annually, until my Spouse's death.

3. I hereby exercise the limited power of appointment provided in said Subparagraph F.2.b. as follows:

a. Commencing upon my death leaving my said Spouse surviving, the Trustee shall pay to or for the benefit of my descendants *per stirpes* living from time to time ONE-HALF (½) of the net income of the Trust, from both the Exempt and Non-Exempt Portions, in regular monthly or other convenient installments, and at least annually, until my Spouse's death.

b. Upon the death of the last to die of my said Spouse and me, the Dutiful Lee Farming Descendant's Trust shall terminate, whereupon the Trustee shall promptly wind up the Trust's affairs; pay any final administrative costs or taxes that may arise first from the Exempt Portion and then from the Non-Exempt Portion; and then, distribute the net Trust Estate remaining as follows:

(1) TWO-THIRDS (2/3) thereof to my daughter, Donna Farming, if then living and if not then living to her descendants per stirpes then living, and if there be no Donna Farming nor any of her descendants then living then this portion shall pass as part of the appointment made under Subparagraph (2) immediately following;

(2) ONE-THIRD (1/3) thereof to my son, Samuel Farming, if then living and if not then living to his descendants per stirpes then living, and if there be no Samuel Farming nor any of his descendants then living then this portion shall pass as part of the appointment made under Subparagraph (1) immediately above; and,

(3) Should there be none of my descendants then living the Trustee shall distribute the net Trust Estate remaining to the then-living descendants *per stirpes* of my parents, Father and Mother Farming.

c. Each of the foregoing distributions shall be outright and free of trust except for the continuing application of the minor's Holdback Trust provisions set forth in ARTICLE TEN of said trust agreement.

D. Except as otherwise appointed by the foregoing, the Dutiful Lee Farming Descendant's Trust shall in all other ways continue to be administered pursuant to the provisions of the "Father Farming Trust Agreement dated October 17, 2007".

Here there is no claim nor suggestion that these appointments as drafted necessarily make good tax or estate planning sense. Instead, the point is merely to demonstrate a format, and to try to tie up as many loose ends with the appointment as possible in order to avoid both of the two most common failings:

1. Appointing – or rather, attempting to appoint – beyond the scope of the power created in the holder; and

2. Making only a partial appointment that does not address all the property and power interests in play.

Each failing creates a mess: An attempted excessive appointment will require construction of whether it is partially valid, or void, or merely voidable. In comparison, a partial appointment creates something akin to partial intestacy, to be construed in part from the Holder's Will, and in part from the predecessor trust agreement, to similarly determine the degree of validity and application. In either case, there is a dangerously high potential that a court is going to have to sort things out, and a professional liability claim could follow.

As always, there is no substitute to clear thinking and careful, comprehensive drafting in exercising a power of appointment.

V. [1.35] CONCLUSION

A testamentary plan embracing limited powers of appointment can: preserve family flexibility over multiple generations; provide ample benefit for immediate and successor beneficiaries; and contribute to the avoidance of unnecessary transfer tax. They can and should be used more often.

EXHIBIT A

Internal Revenue Code Section 2514
Powers of Appointment

Sec. 2514. Powers of appointment.

(a) Powers created on or before October 21, 1942.

An exercise of a general power of appointment created on or before October 21, 1942, shall be deemed a transfer of property by the individual possessing such power; but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof. If a general power of appointment created on or before October 21, 1942, has been partially released so that it is no longer a general power of appointment, the subsequent exercise of such power shall not be deemed to be the exercise of a general power of appointment if --

(1) such partial release occurred before November 1, 1951, or

(2) the donee of such power was under a legal disability to release such power on October 21, 1942, and such partial release occurred not later than six months after the termination of such legal disability.

(b) Powers created after October 21, 1942.

The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power.

(c) Definition of general power of appointment.

For purposes of this section, the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power (hereafter in this subsection referred to as the "possessor"), his estate, his creditors, or the creditors of his estate; except that --

(1) A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.

(2) A power of appointment created on or before October 21, 1942, which is exercisable by the possessor only in conjunction with another person shall not be deemed a general power of appointment.

(3) In the case of a power of appointment created after October 21, 1942, which is exercisable by the possessor only in conjunction with another person --

(A) if the power is not exercisable by the possessor except in conjunction with the creator of the power -- such power shall not be deemed a general power of appointment;

(B) if the power is not exercisable by the possessor except in conjunction with a person having a substantial interest, in the property subject to the power, which is adverse to exercise of the power in favor of the possessor -- such power shall not be deemed a general power of appointment. For the purposes of this subparagraph a person who, after the death of the possessor, may be possessed of a power of appointment (with respect to the property subject to the possessor's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the possessor's power;

(C) if (after the application of subparagraphs (A) and (B)) the power is a general power of appointment and is exercisable in favor of such other person -- such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the possessor) in favor of whom such power is exercisable.

For the purposes of subparagraphs (B) and (C), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(d) Creation of another power in certain cases.

If a power of appointment created after October 21, 1942, is exercised by creating another power of appointment which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, such exercise of the first power shall, to the extent of the property subject to the second power, be deemed a transfer of property by the individual possessing such power.

(e) Lapse of power.

The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

(f) Date of creation of power.

For purposes of this section a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will dies before July 1, 1949, without having republished such will, by codicil or otherwise, after October 21, 1942.

EXHIBIT B

Internal Revenue Code Section 2041
Powers of Appointment

Sec. 2041. Powers of appointment.

(a) In general.

The value of the gross estate shall include the value of all property.

(1) Powers of appointment created on or before October 21, 1942. To the extent of any property with respect to which a general power of appointment created on or before October 21, 1942, is exercised by the decedent --

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive; but the failure to exercise such a power or the complete release of such a power shall not be deemed an exercise thereof. If a general power of appointment created on or before October 21, 1942, has been partially released so that it is no longer a general power of appointment, the exercise of such power shall not be deemed to be the exercise of a general power of appointment if --

(i) such partial release occurred before November 1, 1951, or

(ii) the donee of such power was under a legal disability to release such power on October 21, 1942, and such partial release occurred not later than 6 months after the termination of such legal disability.

(2) Powers created after October 21, 1942. To the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive. For purposes of this paragraph (2), the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised.

(3) Creation of another power in certain cases. To the extent of any property with respect to which the decedent --

(A) by will, or

(B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037,

exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

(b) Definitions.

For purposes of subsection (a) --

(1) General power of appointment. The term "general power of appointment' means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate; except that --

(A) A power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent shall not be deemed a general power of appointment.

(B) A power of appointment created on or before October 21, 1942, which is exercisable by the decedent only in conjunction with another person shall not be deemed a general power of appointment.

(C) In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person --

(i) If the power is not exercisable by the decedent except in conjunction with the creator of the power -- such power shall not be deemed a general power of appointment.

(ii) If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent -- such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power.

(iii) If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person -- such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.

For purposes of clauses (ii) and (iii), a power shall be deemed to be exercisable in favor of a person if it is exercisable in favor of such person, his estate, his creditors, or the creditors of his estate.

(2) Lapse of power. The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of the following amounts:

(A) $5,000, or

(B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied.

(3) Date of creation of power. For purposes of this section, a power of appointment created by a will executed on or before October 21, 1942, shall be considered a power created on or before such date if the person executing such will dies before July 1, 1949, without having republished such will, by codicil or otherwise after October 21, 1942.