POWERS OF APPOINTMENT

A Selective Update on Property Law, Asset Protection

and Other Issues of Keen and Compelling Interest

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TABLE OF CONTENTS

I. INTRODUCTION 1

A. The Common Law Concept and Property Law Principles 2
B. The Tax Principles: Background and Philosophy 7

II. FEDERAL GIFT AND ESTATE TAX TREATMENT 9
A. Retained Interests Distinguished 9
B. An Analytical Approach 11
C. General Power Defined 12
D. Exceptions to the Rule 13
1. The Ascertainable Standard 13
2. Joint Powers 15
a. Pre-1942 Powers 15
b. Post-1942 Powers 16
c. Allocation 16
E. Intermediate Summary 17
F. Impact and Consequences 17
1. Exercise 18
2. Release 20
3. Disclaimer Distinguished 20
4. Lapse and the "5 and 5" Exception 22
5. Possession at Death 24
G. Exceptions Highlighted 25

III. PROBLEMS AND FOCUS 25
A. Income Tax Considerations 25
B Marital Deduction Trusts 26
C . The Generation Skipping Transfer Tax Connection 28
D. *Crummey* Trusts and Conflicts Among the Tax Preference Rules 31
E. Trusts and Individual Retirement Accounts 36
F. Some Asset Protection Notions 37
1. Gifts in Trust 37
2. Self Settled Iniatives 39

IV. PLANNING AND DRAFTING 42
A. Marital Deduction Trusts 43
B. Generation Skipping Trusts 46
C. Disability Provisions and Asset Protection 49
D. Quit Claim Deed With Retained Life Estate and Nongeneral Power of Appointment 53
E. Protective Drafting 53
1. Rule Against Perpetuities and Power Exercise Instructions 49
2. Legal Obligations of the Holder 56
F. Testamentary Exercise 56

POWERS OF APPOINTMENT

A Selective Update

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I. INTRODUCTION

Harvard's legendary property professor W. Barton Leach famously 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, indeed, but yet one well proved and sustained by centuries of practical experience. The fact is that a well considered, properly placed 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 generational moment when guess work and estimation have ripened into certainty. 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, a growing litigiousness, and new principles of social justice have combined to dramatically skew 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 what constitutes a lawful marriage today and next year is different from what it was just a short time back. Fewer grandchildren are being born, and more children are being adopted – often by non-traditional households. 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.

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Coupled with the need for flexibility is a growing appetite for effective asset protection procedures that provide a reasonable degree of protection and predictable access if not control. Several states have enacted self-settled asset protection trust statutes (frequently referred to as "domestic asset protection trusts" or "DAPTs"). But these statutes vary upon their schemes and requirements, are not always user friendly in terms of cost and application, and the relative effectiveness of these new laws is largely untested. Will an Illinois creditor be barred by a Wyoming barrier? Maybe, but maybe not.

So these factors, and others, have come to confound the familiar presumptions for the preservation, management, disposition and use of the family wealth. Short of doling outright, with concomitant risks of predation, loss, or dissipation, no fixed deferred distribution scheme, however broad its sprinkle authorities, can adequately anticipate all the pertinent consequences. Only the thoughtful use of powers of appointment -- usually nongeneral, sometimes general -- can protect in the players and their survivors the options for redefining terms and redirecting the flow of benefit in the course of events as they actually occur, later, when time and circumstance crystalize to form new actualities.

Now, however 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 consequences are legion. If Professor Leach was so perceptive about the "efficiency" of common law powers of appointment, he might also have warned us that in practice they can be tricky and confusing. And that intricacy may explain 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 structural rules are carefully observed, and appropriate boiler-plate language employed to prevent unintended constructions.

To illuminate and update some of those rules and language is the purpose of this article.

A. The Common Law Concept and Property Law Principles

Illinois does not (yet) have a comprehensive powers of appointment statute so, at least for now, the Illinois property law rules remain pretty much defined by a common law tradition that predates the Republic. Here are the core property law principles:

* 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 to such one or more persons as A may see fit to appoint.

* An essential concept: A power of appointment over property is *not* the same as an ownership interest in the property. Rather, a power of appointment is

  * A non-ownership *designation of authority* over the property,

* Created by its owner

  * mostly commonly by delegation to another person, but

  * occasionally reserved by the owner,

* Contemporaneous with the transfer of the appointive property from that owner to a new owner.

* A power of appointment can *only* be created by that original owner; the creation is 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 remains true even in those circumstances when an initial power is subsequently exercised to create a *successor or concurrent* power in another holder: The authority, and therefore the ultimate title, still flows from that original owner/creator/donor. This is sometimes referred to as the "relation back theory", as in the date of creation of the successor power relates back to and flows from the creation of the first power.

  * In this sense 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 "permissible 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.]

* For so long as the power to appoint is in place, and until the passage of indefeasible ownership is actually completed – either from the holder to the appointee, or by lapse or release or default, a process which may be deferred for generations:

  * ALL subsequent titles to the property will remain indeterminate because of the intervening potential contingency.

  * 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 pure 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 original owner/donor's name and behalf.

    * **A trustee is a fiduciary. The pure power holder is not.**

        * BUT, in some jurisdictions, under some facts, there are occasions where a power of appointment that runs with the office of trustee can be deemed merged into the fiduciary obligations. [*See, e.g.,* RESTATEMENT (THIRD) OF TRUSTS, § 50, general comment *a* (2003).] For interested trustees who also hold dispositive powers, it may be best to distinguish the fiduciary duties from the non-fiduciary powers to prevent that merger.

        * [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 (or successor holder) elects not to exercise the power, the authority "lapses", and the property interest passes to a "taker in default of appointment".

    * **Every competently written power of appointment provides for who or what takes in the event of default of appointment.**

    * Unless otherwise addressed, there will be confusion. For example, does release, lapse or default:

        * Create a reversionary interest in the donor or his/her successors?

        * Vest title in the power holder, or in the class of permissible appointees?

        * Is there a difference if it is a general or nongeneral power at play?

        * Confusion is bad.

* 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 a power of appointment the owner/donor is limited only by the extent of his/her ownership, imagination and willingness to delegate, the objects of his/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".] A power may be:

  * Given to another (the "donee") or retained by the original owner (sometimes called the "donor-donee")

  * Require irrevocable exercise (presumed) or allow an exercise to be in part or in whole, or allow an exercise to be revoked upon the holder's design

  * Presently exercisable, or subject to any number of conditions precedent, such as time, death, survivorship, another person's consent, an ascertainable standard, the rising of the moon, or the Cubs winning the pennant

  * Held by one or more successive or concurrent holders, with identical or different authorities

  * Exercisable to create successor powers, or barred from doing so

  * Limited to a class of appointees, or selective appointive property, or unlimited altogether

  * Exclusionary or inclusive among the members of a class of appointees

  * Included not only in trusts, and as components of deeds, but also membership interests in an LLC, or closely held corporations, or even promissory notes

* For property law (meaning creditors rights and asset protection) purposes, a general power of appointment has traditionally been a wholly unlimited power that could benefit anything or anyone in any way or any time, including the power holder.

  * Since a power of appointment, general or otherwise, is not an ownership interest in property, it once made little real difference whether the holder could benefit himself/herself, or his/her estate, or the creditors of either.

* That traditional protection of property subject to a general power has eroded, and there is a growing sense of distinction between a "general" power of appointment and a "nongeneral" power of appointment for property. (This distinction has some similarities with, and some important differences from the *tax* treatment of general and nongeneral powers):

  * A power of appointment is now considered "general" to the extent that the power can be exercised to benefit the holder/donee – either directly, or indirectly on behalf of his/her creditors or estate, or the creditors of his/her estate, irrespective of whether the power is also exercisable in favor of others.

    Property that is subject to a presently exercisable general power of appointment is construed to be the practical equivalent of an ownership interest in enough respects as to be vulnerable to the claims of the holder's creditors.

  * Conversely a "nongeneral" power of appointment (also referred to as a "limited" or "special" power of appointment) is expressly *not* presently exercisable for the benefit of the holder/donee, his/her estate or the creditors of either.

* Do not confuse the status of a "holder" of a power of appointment – general or non-general – with the status of being a permissible appointee. The owner of property may give that property to another, in trust or otherwise, subject to either a general or nongeneral power of appointment *by which the donor is a permissible appointee.* This is neither a retained interest for tax purposes, nor is it a property interest subject to the donor's claims.

* **Understanding the difference between a general and nongeneral power of appointment, and the parallel distinction between being a holder of a power and being a permissible appointee of a power, is the most important first step in grasping and implementing powers of appointment.**

In practice, the donor will usually limit the holder's discretion to a defined group of intended potential takers, and to one or more specific interests in the property, and frequently by imposing certain conditions precedent. 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. 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.

The National Conference of Commissioners on Uniform State Laws has approved and recommended for enactment in all States a Uniform Powers of Appointment Act (hereafter, the "Uniform Act"), which if enacted in Illinois would be of significant benefit in resolving a number of current uncertainties.

B. 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.

* Remember that 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 was effectively 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.

Given this premise, then a trust settlor could devise a a classic generation skipping transfer scheme by which first a spouse, then children, then grandchildren, each in succession or concurrently, could have authority *to use* – without owning – 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 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. By doing so we can strengthen the discretionary hand of our clients' beneficiaries down the road.

III. FEDERAL GIFT AND ESTATE TAX TREATMENT

A. Retained Interests Distinguished

The property law treatment of powers of appointment depends largely upon the distinction between *non-ownership authorities* that are delegated, 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's adoption of this exact property law distinction, and as a result there is a parallel difference in tax consequences that attach to:

* interests or benefits in, or powers over, property that are *retained* by the owner; compared to,

* powers *over* that property that its owner creates in another.

To first review and move on from the retained benefit rules: Remember that federal estate tax will be imposed on the value of property transferred by a decedent in his/her lifetime when these gifts are deemed to have been made in anticipation of death or to have afforded a 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 treatment, 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 contrast, the non-owner donee/holder of a power of appointment neither creates nor defines his or her authority. The powerholder 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 nongeneral (or, "special" or "limited") power of appointment, so useful in actual practice, will *not* be subject to taxation.

[This is a good time to point out that Treasury Regulations 25.2541-1(b)(2) and 20.2041-1(b)(2) both provide that: "the term 'power of appointment' does not include powers reserved by a [decedent/donor] to himself." That power is includible in her or his estate or taxable gifts "to the extent it would be includible under Section[s] [2033], 2511 or other provisions of the Internal Revenue Code." That is the fork in the road leading to some serious confusion over the distinction between property law general powers and tax law general powers.]

B. An Analytical Approach

The tax 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 its reputation. Its general definition, softened by exceptions, reduces 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 tax 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 current or permissibly appointable 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. General Power Defined

Internal Revenue Code Sections 2514(c) and 2041(b)(1) adopt an identical definition of a tax 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 crucial, particular, 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 tax 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). [This is a predictable substance over form approach, since powers may arise outside of express trusts or inter vivos conveyances. It is a question of authority in fact, not nominal designation.]

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 oneself as successor trustee (*if* the holder has an interest in the trust.)

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 his or 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 the individual pecuniary interest is insulated from benefitting from the property in question, then the holder cannot be fairly treated as though he or she were the effective owner of the subject property.

D. Exceptions to the Rule

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

1. 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 in cold black print:

* **The terms "support" and "maintenance" are "not limited to the bare necessities of life," and**

* **"[I]t is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised."** Treas. Reg. 25.2514-1(c)(2) and 20.2041-1(c)(2)

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 maintenance 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 own "happiness" or "best interests", or gifts to other natural objects of the beneficiary's bounty.

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. Treasury Regulation 25.2511-1(g)(2) provides:

> **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.**

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.**

The result will put little practical restraint on the beneficiary's access, and may well save someone from an unexpectedly bad construction.

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. Rely upon the specifically worded exceptions listed in the regulations, and don't tinker around.

And switching for a moment to consideration of applicable *property* law, it has been suggested that even the word "support" could be read by some courts as attributable not only to the support of the interested power holder, but also to the support of those that the powerholder has a legal obligation to support, such as his/her minor children, or spouse (estranged or otherwise) and the creditors of his/her children or spouse in a domestic relations context. Since "maintenance" and "support" are synonymous for the purposes of Treas. Reg. 25.2514-1(c)(2) and 20.2041-1(c)(2), some cautious practitioners may cut back further to limit distributions to the interested trustee merely for "education, maintenance and health in reasonable comfort" and drop reference to "support" altogether.

2. 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. 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. 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).

Again, look to the tax theory behind all this: With respect to the first exception, the donor's reservation of control will 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 not 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. 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. 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:**

   a. Such power is limited by an **ascertainable standard** relating to the health, education, support or maintenance of the holder, **or**

   b. The power may be exercised by the holder only **jointly** 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 unrestricted 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. 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. Exercise. This one is simple: 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). Or, put simply: exercise equals ownership.

That construct 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. 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."** Treas. Regs. 25.2514-1(d) and 20.2041-1(d).

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 exercise of a power of appointment to create another power of appointment (only) 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 subject property will pass according to the original donor's dictates 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. 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 he or 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 sufficient to bring the assets into the estate under Code Section 2036.

Conversely, if the holder does not have a continuing interest after the release there will be a taxable gift but 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. 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:

* be in writing and signed by the holder;
* refer specifically to the power or property being disclaimed;
* contain the holder's irrevocable and unqualified refusal to accept the power;
* 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,
* 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). These provisions make it 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 flawed 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? Probably not. 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.

Since a pure property power of appointment is not a fiduciary power that the permissible appointees can enforce, 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. 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 Section 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 that 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 illustrate 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 the expressly exempted amount. In practice, if access to principal is desired, the trust should contain a specific instruction for the 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. 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. 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. Consider the utility where 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 nongeneral 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. For non-marital deduction trusts the interested trustee/holder can even have an immediate, exclusionary, inter vivos nongeneral power to re-direct the property to any person other than herself, her creditors, her estate, or the creditors of her estate, (but in that case there may be gift tax consequences.)

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

III. PROBLEMS AND FOCUS

A. 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, within the principles of sections 671 to 677 inclusive, subject to** [the] **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. 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 and to the extent that 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).

In 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 $4,000,000." 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 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)(7) 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. 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 -- asset protected and transfer tax free -- for generations, limited only by the rule against perpetuities.

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:

* a transfer of property;

* that is subject to either gift or estate tax at the time of transfer;

* 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,

* 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:

* the person charged with transmitting the property, directly or indirectly,

* in a way that will (or might) avoid estate 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 focusing 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 2014 that exemption is equal to $5,340,000 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 general tax policy of estate and gift taxation with respect to general and nongeneral 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 nongeneral 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 nongeneral 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 nongeneral power of appointment used to create a successor nongeneral 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 nongeneral 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 nongeneral 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 nongeneral 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. 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, $14,000), 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 $28,000 for each intended beneficiary. Add four grandparents and $84,000.00 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) GST annual 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 is equivalent to exercise, creating a taxable transfer on the part of the withdrawal right holder. Another trap.

  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 $14,000 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 $14,000 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(s) has/have 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 Schedule 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 the *entire* withdrawal power to lapse (*i.e.,* there are no continuing "hanging powers" written into the transaction.) 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 general power or a nongeneral 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. 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 nongeneral 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.

The upshot: One should be *very cautious* in adding powers to an IRA beneficiary trust.

F. Some Asset Protection Notions

1. Gifts in Trust

The cornerstone of asset protection thinking is a childishly simple notion, too often forgotten:

What you don't own can't be taken from you.

That principle forms the foundation on which various practitioners have developed a number of long term, multi-tiered beneficial transfer techniques. Usually these plans involve one or more trusts (largely because trust law is so very flexible and accommodating), sometimes supplemented (not always, but increasingly) with various limited liability business entities. These tax advantaged, asset-protected transfers to or for the benefit of our clients' loved ones generally consolidate lawful protection from claims and taxes with substantial benefit, dominion and control for the intended beneficiaries along the following themes:

* Assuring all income for family members, including surviving spouses, descendants, and perhaps options for descendants' spouses

* Wiggle room to invade principal for real needs, per the conditional (nongeneral) power to consume only for reasons of health, education, maintenance and support

* Applying suitable tax/funding formulae to assure the best advantage of marital deduction, credit shelter and GST exemption amounts for maximum transfer tax avoidance and principal enhancement

* Insulating the trust property from the claims and demands of predators through tested and effective spend-thrift and catastrophe conversion provisions in the event of unexpected disability or financial crisis

Property subject to a nongeneral power of appointment is generally exempt from claims of the donee's creditors. The donee/holder of a nongeneral power of appointment is not considered to have a property interest in the appointive power because his/her access is substantially restrained from providing an immediate economic benefit of the donee. An ascertainable standard limitation

on present powers to withdraw, for example, is always reviewable by a court of competent jurisdiction. Since there is no property interest, the property subject to the nongeneral power is not includible for purposes of bankruptcy, garnishment, divorce, Medicaid eligibility, or other calculations of the vulnerable holder's own property. [*See, e.g.*, Uniform Act Section 504; 11 U.S.C. § 541(b)(1) (assets subject to a special power of appointment are not included in the bankruptcy debtor's estate.)]

Planning to avoid risks, while preserving benefit, access, and control in each immediately successive generation, and without undue taxation, can include procedures that:

* Name spouses/children as Trustees or Co-Trustees, or each child as Trustee or Co-Trustee of his or her own portion (a sub-divided trust)

* Allow an interested Trustee/beneficiary access to principal subject to an enforceable ascertainable standard limited to health, education, maintenance and support

* Gives each child/beneficiary one or more *nongeneral* power(s) of appointment to end the trust or continue it on – or to redirect or redefine it – as he or she thinks best.

  This option extends planning discretion to each successor generation and preserves priceless flexibility; however, this flexibility can also be limited by terms restricting the class of permissible appointees and other beneficial terms of the appointment.

The net effect is to give each tier of beneficiaries – spouses, children, appointees and/or grandchildren – substantially all of the practical benefit of outright ownership without the tax burdens or risks of loss. Since the beneficiary is not the outright owner:

* The trust assets can't be reached by the beneficiary's personal creditors

* The beneficiaries' spouses will normally not have a marital interest in the trust assets, which are thus exempt from divorce property settlements

* GST-exempt trust assets are not included in the child's (or grandchildren's) taxable estates, thereby avoiding duplicate taxation

Conceptually, the trust can endure indefinitely as a Qualified Perpetual Trust. A very simple opt-out from the Rule against Perpetuities will do, if desired:

> **This trust is a Qualified Perpetual Trust as defined and provided by 765 ILCS (a-5), and by these specific terms the rule against perpetuities does not apply. No Trustee's power to sell trust property shall be construed to the contrary.**

However, even if the trust does not qualify as a perpetual interest trust, it may endure for "lives in being plus 21 years", which under existing facts should be sufficient to cover two, three, four or more generations after the creator's death – an ample term.

Frequently, once these advantages are explained and considered, the children are often the most enthusiastic advocates of the plan, and are willing to endure the administrative requirements as a reasonable price for the protection provided.

2. Self Settled Initiatives

If the predators can't reach what you don't own, then the converse is also true:

> **That which you own (including that which you have unfettered access to) is fair game for the bad guys.**

Generally speaking, creditors can reach the assets of a self-settled trust in which the debtor retains a present right to access or control those assets, even if the trust is otherwise an irrevocable transfer. The trustee in bankruptcy is deemed to "stand in the shoes" of the debtor, and therefore capable of exercising the debtor's ownership prerogatives. Property that is subject to a presently exercisable general power of appointment is generally subject to the creditors of the donee because it is construed as the practical equivalent of an ownership interest. [11 U.S.C. § 541(b)(1); Uniform Act Sections 501 - 503.]

Several states (but not Illinois) have tried to help debtors protect their assets while retaining access and control by enacting "domestic asset protection trust" legislation, involving local trustees or co-trustees but affording the settlor a significant voice in investment and means of access. These statutory schemes vary widely, and have had varying degrees of success. They are also costly, and generally inconvenient for an Illinois investor.

Some commentators[2] are advancing an alternative to the self-settled asset protection trust in the form of what is called a "Lifetime Special Power of Appointment Trust" designed along the following lines:

* Settlor creates and funds an irrevocable trust, with discretionary sprinkle benefits among a class of preferred beneficiaries *other than* the settlor

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[2] Most of this discussion of power of appointment asset protection trust thinking and planning is distilled from these three excellent sources:

* Alexander Bove, Jr., "Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined," 36 ACTEC Journal 333 (Fall, 2010)
* Lee McCullough, III, "Use 'Powers' to Build a Better Asset Protection Trust," Estate Planning Journal (January, 2011)
* Mark J. Morrise, "Using the Lifetime Special Power of Appointment Trust in Asset Protection Planning." Unpublished presentation to the Estate Planning Section of the Utah State Bar (January, 2011)

* Some trusted party (friend, spouse, child, whether one or more) is vested with a non-fiduciary, inter vivos special power of appointment that

* Is broadly drawn to appoint to everyone or anyone *other than* the powerholder, his or her estate, or the creditors of either; meaning, that the settlor is a permissible appointee

* The transfer in trust can be designed to be either a presently completed gift, or incomplete for gift tax purposes, and can be designed as a grantor trust for income tax purposes so that trust income is taxed to the settlor. Those variables will depend on the settlor's other planning considerations

Part of the argument in favor of this arrangement is the relative uncertainty of existing DAPT laws compared to well founded "black letter" law on the limited exposure of property subject to a nongeneral power of appointment. Because the donor/settlor severs all ownership, dominion and control – immediate *and* prospective – over the transferred assets, they are protected from his or her later creditors. Since the permissible appointees include the entire world, no *de facto* ownership interests can be presumed among any one or more members of the class, with or without family attribution. And no court can force a non-interested, non-fiduciary power holder to exercise his or her discretionary power.

The asset protection provided by a special power of appointment trust is not dependent on the state where the parties reside or the state where claims might be adjudicated. Moreover, should the settlor later be forced to bankruptcy he or she can truthfully say that he/she is *not* a beneficiary of the trust, making its terms non-disclosable and irrelevant.

It is essential that the transfer in trust not be fraudulent in fact, or violate the Fraudulent Transfer Act (740 ILCS 160/1 - 12), which generally requires:

* That no claims be pending or threatened against the donor at the time of the transfer
* That the donor not be rendered insolvent by the transfer
* There is no intent to defraud, including an intent to incur debts in the future that will be beyond the donor's capacity to repay

Fraudulent transfers made less than four years before a claim is made can be clawed back by creditors from the trustee. Note that the four years begins to run upon transfer to the trust, and not upon a subsequent exercise of the power, which of course is a continuation of the donor's original transfer.

Boston attorney Bove suggests an even more aggressive approach by allowing the settlor to retain an income interest until the clouds begin to form. Consider Bove's example, as quoted by Provo attorney Morrise in his Utah bar presentation:

> **"[A] settlor establish[es] an income-only trust for his own benefit, giving another party, say, one of his children, a [lifetime] special power of appointment**

> **in favor of the settlor's spouse and issue (other than the powerholder). If the trust is attacked (or about to be) by a creditor, the child could exercise her power (reserving the right to revoke the exercise) and appoint the trust property to a new trust for the benefit of the settlor's spouse while she remains a spouse. When the coast became clear and the litigation against the settlor is resolved, the child could reexercise her power and appoint the property back to the original trust for the benefit of the settlor. Meanwhile, the income from the 'new' trust could be paid out to the settlor's spouse, presumably offering some benefit to the settlor. . . . To make matters more difficult for the settlor's creditors, the new trust could be settled in another state."**[3]

Conspiracy theorists abound in the creditor's rights world, especially when it comes to examining transactions among family and friends. If there is in fact a pre-existing understanding that the notionally independent power-holder will exercise upon the request or direction of the settlor/donor/creditor, it seems likely that the entire transaction could be voided as fraudulent *ab initio.* A creditor might argue that the power holder is acting as the donor's agent or that the arrangement is really a self-settled trust in sheep's clothing.

Whether there is a pre-existing understanding will in all events be a question of fact: A scheme can be inferred from facts, but it should not be presumed simply because a friend or family member independently follows the settlor's wishes without being legally obliged to do so.

There may be corollaries in some of the retained interest tax cases. Treasury Regulation 20.2036-1(c)(1)(i) provides:

> **An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.**

Such an understanding will be inferred from "the circumstances of the transfer and the manner in which the transferred property is used." *Estate of Paxton v. Commissioner,* 86 TC 875, (1986). The understanding need not be legally enforceable, but considerations such as multiple exercises in favor of the settlor, or the transfer into trust of substantially all of the settlor's property, could be damaging to the argument that there was no expectation of a later distribution, or that no continuing interest was retained.

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[3] Alexander Bove, Jr., "Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined," 36 ACTEC Journal 333 at 336; quoted in Mark J. Morrise, "Using the Lifetime Special Power of Appointment Trust in Asset Protection Planning" at pages 7 & 8.

IV. 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. In what manner, and to what degree, may the power be exercised? (Remember, these powers affect 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.)

6. Finally, **help your audience** who more likely than not will find powers of appointment confusing. Don't just refer to a "power of appointment" or "power to appoint" without adding one or the other crucial qualifying adjectives:

   * If the point is to create a *nongeneral* power, with very important limitations, then specifically include the reference to "the nongeneral power to appoint", or something grammatically consistent with the text

   * Similarly, if your plan requires a *general* power of appointment, then say so

   * And, if the power is held by a beneficiary who is also serving as trustee, it won't hurt to qualify a fully discretionary power as a "nonfiduciary" power.

   Sometimes that may be redundant, given other provisions several pages away, but a little redundancy can be a good thing sometimes.

In practice, the specific terms, limitations, discretions, and controls will vary from client to client, situation to situation, and thus will require quite a bit of selective drafting in the resulting dispositive articles.

That said, the following examples, and comments, are by no means authoritative, or exhaustive, and are included here more for the purpose of prodding the reader's own thinking on how best to apply these principles to your practical realities, styles, and preferences.

A. Marital Deduction Trusts

As suggested earlier, Code Section 2056(b)(7) "QTIP" trusts are an increasingly popular option for marital deduction planning. Nongeneral 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 broad options 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 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 maintenance and 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 shall at all times:

1. Adhere to this ascertainable standard; and,

2. Be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

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 nongeneral, nonfiduciary 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,

[option 1]

* **but only to or for the benefit of such one or more of Grantor's descendants then living or thereafter born.**

[option 2]

* **to or for the benefit of such one or more person(s) or entities *other than* Grantor's Spouse, his/her estate, or the creditors of either.**

This power of appointment may be exercised by the Grantor's Spouse in such portions, amounts or manner as he/she Spouse may appoint by

[option 1]

* **a Will**

[option 2]

***   a "valid testamentary instrument" (as that term is hereafter defined)**

that specifically refers to such nongeneral power of appointment, and may be exercised by the Grantor's Spouse in his/her sole and unfettered discretion, without obligation to act or not to act; 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. Note the subordination of all rights to principal to the self-amending special needs provision in the event of disability.

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, or none at all.) 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 nongeneral, nonfiduciary 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.

- Option 1 limits the class of permissible appointees to direct descendants.

- Option 2 opens the class to the entire world.

The missing "option 3" is everything in between, limited only by the client's desires and strategic intentions, and the drafter's skill in reducing those prerogatives to a rational and effective direction. [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.]

Because some jurisdictions (and the Restatement (Third) of Trusts) suggest that when a power of appointment runs with the office of trustee there is a presumption that the power is subject to fiduciary principles, an express disclaimer of fiduciary duty is added to the interested trustee's discretion.

Testamentary powers have traditionally been exercised by a Will. But a Will is non-dispositive unless admitted to probate, and sometimes probate is either undesirable or impracticable. A "valid testamentary instrument" could be defined:

> **A valid testamentary instrument is: (a) the holder's valid Last Will and Testament, including any codicils thereto, actually admitted to probate by a court of competent jurisdiction, if any; or, (b) in default of the foregoing, then a revocable trust agreement made by the holder in his or her lifetime that became irrevocable upon the holder's death and provides for the appointment upon the holder's death by specific reference.**

Finally, Paragraph F.2. provides one of many possible alternatives for the essential provision for distribution in default of appointment.

B. Generation Skipping Trusts

Ideally there should be but 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. To protect them from the GST tax a taxable general power of appointment is frequently imposed strategically 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 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 without the written consent and joinder of the then-acting president of the First State Bank of Allison, Denton, Illinois, or its corporate successor, which consent may be granted or withheld in his/her sole and unfettered non-fiduciary discretion, without obligation to consent or not to consent.]

2. Subject to the foregoing, the Beneficiary shall also have the nongeneral nonfiduciary 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 the Beneficiary's sole and unfettered discretion, without obligation to act or not to act, 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 nongeneral 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 nongeneral 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 Denton 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 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 nongeneral power flexibility built into the “Exempt” portion.

C. Disability Provisions and Asset Protection

Long term trusts require looking out for the unforeseeable, even the unimaginable, including the possibility that a tall strong healthy child or grandchild may fall victim to accident and permanent disability. Rather than cringe from the thought, we should address the problem by availing the "special needs and comforts" trusts for loved ones without exposing trust principal to seizure for reimbursement by public aid agencies that may have provided basic shelter, sustenance and medical care. Volumes have been written on the subject of drafting trusts for the benefit of third parties that can be used for special needs, and while Congress (and the assorted state agencies) are growing ever more aggressive in seeking recovery of assistance payments, it makes sense to at least try to anticipate the problem with self-amending disability provisions.

Similarly, this is a logical place to append traditional spendthrift and other specific asset protection directives.

ARTICLE NINE: Disability and Asset Protection

A. Wherever used in this instrument the term "disability" means any legal, mental or physical condition which renders a person less than fully able to manage his or her person or estate, or his or her medical, personal or financial affairs.

1. The term shall include, but is not limited to, the stricter standard of "a medically determinable physical or mental impairment which can be expected

to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months"; or, "any condition of comparable severity evidenced by marked functional limitations." Any person who has been determined to be disabled: (i) in the manner provided by Illinois statutes governing adjudication of disability [e.g., Article XIa of the Illinois Probate Act; 755 ILCS 5/11a-1 through 11a-23, or any similar or successor provision governing the same substantive topic]; (ii) for any purpose by the Social Security Administration; and/or, (iii) who has been determined (by any federal or state agency) to be disabled for Medicaid purposes, shall during the term of such determination be deemed to be disabled for the purposes of this instrument. Any person who has suffered a medically determinable condition of such severity as to be sufficient, in the judgment of his or her attending physician or physicians to require his or her institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis, shall during the term of such condition be deemed to be disabled for the purposes of this instrument.

2. To the extent a disability is not established by the findings set forth in Subparagraph A.1. immediately above, then:

a. The determination of a present disability, or the recovery from a past disability, affecting the Grantor or any person who is serving as Trustee shall be made in a signed writing by that person's attending physician after a personal examination. That written determination shall contain: (i) a description of the nature and type of the disability and an assessment of how the disability impacts on the ability of the person to make decisions; (ii) an analysis and results of evaluations of the person's mental and physical condition, and immediately apparent prospects for recovery; (iii) a statement expressing an opinion on whether the person shall require institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis; and, (iv) a conclusion and opinion on whether that person is disabled on the basis of the criteria herein provided. This written determination shall be delivered to the current and successor beneficiaries and, if applicable, to any person nominated as successor Trustee hereunder, who shall then assume the office of Trustee in the manner provided elsewhere in this instrument.

b. The determination of a present disability, or the recovery from a past disability, affecting any beneficiary other than a person who is serving as Trustee hereunder shall be made by the Trustee in his, her, or its sole discretion on the basis of the criteria herein provided and such reasonable inquiry as the Trustee deems appropriate in the circumstances.

B. Notwithstanding anything in this instrument to the contrary, in the event any beneficiary suffers a disability then the Trustee's powers, discretions and obligations under this instrument with respect to the disabled beneficiary shall thenceforth, immediately, and without additional acts in furtherance be amended,

restricted, and governed by the following provisions. These provisions shall apply through the entire period of disability, but shall end when the disabling condition ends and the trust administration shall revert to its status quo ante:

1. In the event that the disabled beneficiary is then serving as Trustee, he or she shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time the beneficiary may be restored as Trustee. The successor Trustee shall be as elsewhere provided in this instrument.

2. Commencing immediately upon the disabling event, and until the disability ends, the Trustee shall withhold payment of Trust principal or income for basic support requirements such as food, clothing, medical care and shelter which the disabled beneficiary is able to receive from any local, state or federal government agency or agencies or any other source, whether public or private, and the beneficiary's power to withdraw, and the Trustee's discretion to distribute principal from any Trust shall thenceforth be limited accordingly.

3. During such period as the disabled beneficiary is receiving or eligible to receive assistance from local, state or federal government sources, or from private agencies, Trust principal or income shall be distributed to or for the benefit of the disabled beneficiary, if at all, only for the special needs, comforts or luxuries suitable for the beneficiary's happiness (including but not limited to travel, expenses for traveling companions if requested or necessary, entertainment, supplemental medical and dental expenses, social services, and transportation) which will not otherwise be provided by any local, state or federal government agency or agencies, and no distribution shall be made for the basic support and care of the disabled beneficiary.

4. In no event may Trust principal or income be paid to, on the demand of, or for the benefit of any governmental agency or department and the Trustee shall do all things reasonable or necessary to at all times preserve the Trust Estate free of the claims of such governmental bodies.

C. The entitlement, discretion, privilege or interest of any beneficiary to make discretionary withdrawals or to receive distributions of the income or principal of any Trust Estate during his/her lifetime is contingent upon the restrictions hereinabove set forth. Any trust income which the Trustee does not distribute pursuant to the foregoing directions and restrictions shall be added to principal, and the Trustee shall pay currently any fiduciary income taxes accruing on said undistributed income.

D. In the event any proceeding is initiated by any governmental agency to breach, set aside, avoid, or otherwise revise these restrictions on any beneficiary's

interest for the purpose of seeking reimbursement from the principal of any Trust Estate for goods, care, or services provided by or at the expense of any governmental body, private agency, or individual, or for any other purpose, then in such event the Trustee's power to distribute principal of the Trust to or for the benefit of the disabled beneficiary at any time during the period of disability shall immediately and without further action by any person terminate, and in such event all provisions for the demand or distribution of principal free of trust to, on account for, or for the benefit of the disabled beneficiary (other than the provision pertaining to termination of the trust in compliance with the Illinois "Rule Against Perpetuities") shall be suspended during the period of disability. If the disability endures until the beneficiary's death, then the beneficiary shall be deemed to have predeceased the date stated for distribution of principal free of trust.

E. The provisions of this Article are subordinate to the requirements necessary to preserve the federal estate tax marital deduction anticipated elsewhere in this instrument. Those requirements, including the requirement for the annual distribution of the Marital Trust income to Grantor's Spouse, and that no successor beneficiary shall have any right to the principal or income of any Trust created for the exclusive benefit of Grantor's Spouse during the Grantor's Spouse's lifetime, shall supersede these provisions; and, to the extent these provisions are contrary to the requirements of said federal estate tax marital deduction, (but to such extent, only) the same shall, as and with respect to Grantor's Spouse, be deemed void.

F. Neither the principal nor the income of any Trust Estate (or any beneficial interest in any Trust Estate) shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary, or for any duty of support that may or may not be owed by a beneficiary, and no interest in a Trust Estate shall be subject to seizure or other process by any creditor of any beneficiary. No beneficiary shall have the power to compel any discretionary distribution, anticipate, petition for partition, encumber or transfer his or her interest in any Trust Estate in any manner, and any purported anticipation, partition, encumbrance or transfer shall be void *ab initio*. Except in the event of: (i) termination; (ii) a permitted distribution to or for the benefit of a beneficiary; or, (iii) as otherwise effectively appointed, no Trustee shall have the power to assign, convey, sell, encumber, hypothecate, pledge, transfer, give, devise, or otherwise dispose of any right, title or interest in or to any portion of the Trust Estate, except for fair value and duly entitled as a substitute asset of the subject Trust Estate, to which all of the provisions of this instrument, and specifically this Article, shall first attach as a condition of such transfer. Nothing in this Article shall limit the lawful exercise of any power of withdrawal retained by Grantor, or the effectiveness of any disclaimer.

D. Quit Claim Deed With Retained Life Estate and Nongeneral Power of Appointment

Consider a common small estate plan, where parents will convey their home to children, reserving a life estate, intending that the remainder will ripen and pass to the children outright upon the death of the last to die. In the interim, however, those remainder interests are vulnerable to the *children's* creditors, including claims for support and alimony, and under the worst of circumstances the home could be foreclosed and the value of the life interest paid off in non-Medicaid-exempt cash.

But what if a nongeneral power of appointment over the residence were retained in addition to the life estate? The remainder titles would be defeasible, meaning unmerchantable; the parents would have control in the event of hostile events; and, if appropriate, the remainder benefit(s) could be strategically shifted among the objects of the parents' bounty. Here's one approach:

QUIT CLAIM DEED –
Retained Life Estates and Nongeneral Power of Appointment

THE GRANTORS, _____________, of the City of __ and State of __, for good and valuable consideration in hand paid CONVEY and QUITCLAIM unto the GRANTEE, _______, all interest, specifically including any after-acquired title, in the following described real estate, to-wit:

LEGAL
P.I.N.:
Common address:

SUBJECT TO Grantors' joint reservation to themselves and the survivor of them: (1) to the entitlement to the quiet possession and use of said real estate and the improvements thereon for so long as either of them may live; and, (2) the nongeneral power to appoint said real estate, revocably or irrevocably, in part or in whole, to or for the benefit of such one or more person(s) or entities other than the Grantors, his/her/their estates, or the creditors of either.

Dated this ____ day of _______, A.D. 2014

E. 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. **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" (attached as Exhibit A) 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:

ARTICLE ELEVEN: 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. 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. Unless specifically provided otherwise, each general and nongeneral power of appointment held by a person who is also serving as a trustee shall be held and exercisable independent from the office of trustee and its duties. The powerholder may independently exercise or not exercise the power in whole or in part or not at all in the powerholder's sole and unfettered nonfiduciary discretion, without obligation to act or not to act, irrespective of the consequences upon any one or more of the permissible appointees, whether exclusive or inclusive, or upon any one or more of the takers in default of appointment, whether exclusive or inclusive.

C. 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 revocably or irrevocably, outright or in trust. If the appointment is in trust, the holder may select or extend an existing trust or trusts for the benefit of an appointee or create a different trust(s), 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.

D. 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.

E. 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. 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 "nongeneral" power or "nongeneral 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. **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.**

F. 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 might 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 Logan Bank and Trust Company, of McCann, 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 valid, partially valid, 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.