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Issue Contents

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Powers of Appointment: Helpful But Can Be Treacherous

-by Neil E. Harl*

Powers of appointment add additional flexibility to the traditional estate planning tools but the various powers need to be approached with care and examined critically for unexpected consequences.[1] Powers of appointment involve powers given to another, usually to control the ultimate disposition of specified property, in contrast with those powers created or retained by a person.

General powers of appointment[2] are relatively well known and are included in many drafting guides and can be exercised to benefit the holder of the power; so-called "special" powers of appointment sidestep that major feature of general powers; powers limited as to exercise by an "ascertainable standard"[3] are distinguished, also, from general powers. A power giving the non-cumulative right to withdraw each year up to the greater of five percent of trust principal or $5,000[4] adds an additional element of financial security for the surviving spouse without causing inclusion in the surviving spouse's gross estate at death but may pose consequences in the year of death for withdrawal rights that had not been exercised in that year.[5]

General powers of appointment

The value of property over which the holder of the power possessed a general power of appointment at death is includible in the holder's gross estate for federal estate tax purposes, *whether or not the power was actually exercised*.[6] A general power of appointment is one which can be exercised in favor of the holder of the power, that individual's estate, the creditors of that individual or the creditors of that individual's estate.[7] In drafting wills and trusts, it is always important to review every clause in the document to see whether the language in that passage would allow an exercise of a power to benefit the holder of the power. Usually, that would be an unwelcome surprise if discovered after death. For example, in a 1994 private letter ruling, a power in a joint and mutual will to mortgage property was deemed to be a power to consume or dispose of the property and was properly characterized as a general power of appointment.[8]

It is important to note that the term "general power of appointment" does *not* include the power to consume, invade or appropriate property for the benefit of the holder of the power if the power is limited by an "ascertainable standard" relating to the "health, education, support, or maintenance" of the individual involved.[9]

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Special powers of appointment

Powers which cannot be exercised to benefit the holder of the power are commonly referred to as "special" powers of appointment. That category of power, which is unexercised at death, does not require inclusion in the gross estate. Likewise, exercise of the power in favor of someone other than the holder of the power does not have tax consequences for the holder of the power.

The IRS position is that exercise during life of what purports to be a limited power of appointment may be subject to federal gift tax where not exercising the power would benefit the holder of the power.[10]

So-called 5/5 powers

With this category of power, a non-cumulative right to withdraw up to the greater of $5,000 or five percent per year of the value of assets involved (such as in a bypass trust) can be given without subjecting the entire amount of assets involved to inclusion in the person's gross estate.[11] As noted above, this is a useful concept to include in a will or trust to provide an additional element of financial security to a surviving spouse, for example.

A key question: what is included in the beneficiary's gross estate in the year of death? Such a 5/5 power requires inclusion in the beneficiary's gross estate of the value of the rights that had not lapsed in the year of death.[12] The value of rights that had lapsed in prior years is not included in the gross estate, only the rights for the year of death. The withdrawals in years before the year of death are governed by the provision that mandates that the lapse of a power is considered a release of the power to the extent that the lapse exceeded in value the greater of $5,000 or five percent of the aggregate value of the assets out of which the exercise of the power could have been satisfied.[13]

However, the lapse for the year of death is governed by *general power of appointment* rules and the decedent's general power of appointment with respect to the withdrawals for the year in which death occurred had not lapsed at the time of death.[14] Therefore, the annual exemption based on the $5,000/five percent exemption rules do not apply.[15] This can lead to a sizeable inclusion in the gross estate for an estate of considerable size.

ENDNOTES

[1] I.R,C. § 2041. See generally 5 Harl, *Agricultural Law* § 43.02[7][c] (2013); Harl, *Agricultural Law Manual* § 5.02[6] (2013).

[2] I.R.C. § 2041(b)(1]).

[3] I.R.C. § 2041(b)(1)(A).

[4] I.R.C. § 2041(b)(2).

[5] See Estate of Dietz v. Comm'r, T.C. Memo. 1996-471.

[6] I.R.C. § 2041(a)(2).

[7] I.R.C. § 2041(b)(1).

[8] Ltr. Rul. 9431004, April 26, 1994 (ranch property included in the gross estate of the holder of the power).

[9] I.R.C. § 2041(b)(1)(A). See Forsee v. United States, 76 F. Supp. 2d 1135 (D. Kan. 1999) (right to invade corpus (principal) to enhance "happiness" not limited by ascertainable standard; corpus of trust included in gross estate). See also Ltr. Rul. 9344004, July 13, 1993 ("health, maintenance, support, comfort and welfare" not limited by ascertainable standard).

[10] Ltr. Rul. 9419007, Feb. 3, 1994.

[11] See I.R.C. § 2041(b)(2); Treas. Reg. § 20.2041-3(d)(3).

[12] See Estate of Dietz v. Comm'r, T.C. Memo. 1996-471.

[13] I.R.C. § 2041(b)(2).

[14] Estate of Dietz v. Comm'r, T.C. Memo. 1996-471.

[15] *Id*. See also Ltr. Rul. 201216034, Jan. 11, 2012.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAXES

DISCHARGE. The debtor filed for Chapter 7 in April 2011. In August 2011, the debtor received a refund check based on a return for 2005 which was sent in error by the IRS. The debtor sent the check back to the IRS but the trustee sought recovery of the refund as estate property. The court held that the 2004 taxes were non-dischargeable priority taxes because less than three years had passed in which the IRS had an opportunity to assess the taxes. The three-year limitation on pre-petition taxes was tolled by appeals filed by the debtor. In addition, the refund check was sent in error and was never estate property; therefore, the trustee could not recover the erroneous refund. On appeal, the appellate court reversed and remanded the case to determine whether the six year limitations period of I.R.C. § 6501(e)(1)(A) applied because the taxpayer omitted more than 25 percent of gross income on the applicable return. Because the amount of tax was not yet been determined in the case, the proper statute of limitations could not be determined so as to rule that the taxes were dischargeable. ***In re* Winters, 2013-2 U.S. Tax Cas. (CCH) ¶ 50,619 (Bankr. 6th Cir. 2013), *rev'g and rem'g*, 2013-1 U.S. Tax Cas. (CCH) ¶ 50,173 (Bankr. M.D. Tenn. 2013)**.