The Use of Powers of Appointment to Achieve a Stepped-Up Basis on the Death of a Trust Beneficiary (Including a Grantor)

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I. Introduction

An important question every individual must ask when transferring property, especially by gift, is the control and flexibility they would like to retain or grant to others. Too much retained control by the settlor could defeat the gift or cause estate tax inclusion under IRC §2036-§2038. On the other hand, too much control granted to the trustee or beneficiary may cause the loss of tax exempt status or the loss of creditor protection. However, beneficiaries and trustees can be granted certain powers without loss of tax exempt and asset protected status. Most commonly this is achieved through the use of powers of appointment. Although this is a viable avenue to achieve the goal of control over the transferred property, a poorly drafted power of appointment may cause adverse tax and creditor protection effects from those hoped. Even though there are traps for the unwary surrounding powers of appointment, it has been said that "The power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out,"[1] and that "no other device can be used to postpone the exercise of discretion as to the identity of the taker and the time that he takes."[2]

[1] Bloom, I. and Brewer, J., 2012. *Powers of Appointment Under The Restatement (Third) of Property: Wills and Other Donative Transfers*. [online] Nycbar.org. Available at: https://www.nycbar.org/images/stories/pdfs/lecture/hesspaperfinal.pdf>

[2] Lawrence Berger, *The General Power of Appointment as an Interest in Property*, 4 Neb. L. Rev. 104, 127 (1961).

According to Black's Law Dictionary, powers of appointment are defined as "a power created or reserved by a person having property subject to disposition, enabling the donee of the power to designate transferees of the property or shares in which it will be received; esp., a power conferred on a donee by will or deed to select and determine one or more recipients of the donor's estate or income."[3] Powers of appointment "allow the power holder "to determine: 1) the persons entitled to receive the beneficial interest; and 2) the extent to which the beneficial interest may be received."[4] A power of appointment can either be general or non-general. IRC §2036, §2038, and §2041 specifically tax the value of such property where prohibited powers are retained by a grantor of property or held by another. This paper will focus on the estate, gift, and generation skipping taxation of powers created post October 21, 1942 and the useful tool these powers can become in the arsenal of the modern day estate planner. In particular it will address how powers can be used to gain tax advantages that were not originally planned by granting powers through modification or otherwise.

[3] Blacks Law Dictionary, 11th edition, *Powers of Appointment*, at 1416.
[4] BNA Portfolio 871-2nd: Trust Decanting, Working Papers, Worksheet 8 Summary of Tax Implications of Decanting

II. Background

A. Historic Perspective

The estate and gift taxes under the Internal Revenue Code "are excise taxes on the passage of property."[5] Thus, the right to tax is extended to the privilege of passing property by gift or at death. Although this paper will not discuss powers created on or before October 21, 1942, it should be noted that a key difference between pre and post October 21, 1942 powers is that "the mere possession of a post-October 21, 1942 general power by a decedent at the time of his or her death results in the inclusion of the property subject to the power in the decedent's estate under IRC §2041(a)(2).[6]

The history of powers of appointment are the best insight to determining the concepts behind the utilization and taxation of such powers. Before the implementation of the Statutes of Uses and Wills, "there were few places in England where land was devisable at common law according to local custom."[7] In the cases in which the law allowed for such disposition it allowed the "devisor to give his executor a power to sell the lands though the executor had no interest in the land."[8] This was the start of the legal concept that "a person who had no property interest in the land could cause the estate to move from one person to another."[9] The power to appoint was developed in Chancery through the vehicle of the use and was mainly utilized in places where land was not devisable in order to make it devisable.[10]

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[5] *Bromley v. McCaughn* 280 US 124, 74 L ED 226, 50 S CT 46 (1929)
[6] BNA Portfolio 825-4th: Powers of Appointment- Estate, Gift, and Income Tax Considerations, Detailed Analysis (SEE *Fish v. United States*, 432 F.2d 1278, 1280 (9th Cir. 1970) the court held that the mere possession of a general power at death will cause inclusion in the decedents estate and it is immaterial whether it "occurred through a designed failure to exercise the power or through the indifference or incompetency of the decedent."
[7] Lawrence Berger, *The General Power of Appointment as an Interest in Property*, 4 Neb. L. Rev. 104, 107 (1961)
[8] Id.
[9] Id.
[10] Id.

After the Statutes of Use and Wills was implemented in 1540, these powers were used for similar purposes as "only 2/3 of the land held in knight service could be devised."[11] The *Sir Edward Clere's* case is the first case in which a power of appointment was recognized by the court as the court held that the inhibition of the 2/3 statute could be evaded by a use of the power and thus classified such power as a general power.[12] As time progressed to the 18th and 19th centuries, the general power of appointment began to be "used by conveyancers to give flexibility to the land law system and also skirt other inconvenient rules of law . . . [such as] dower or curtsey" by use of the relation back doctrine.[13] This doctrine was the crux of the earlier structure of the law relating to the powers of appointment and "is the hoary theoretical mainstay for those rules of law which treat the donee as a mere agent with no property interest."[14] The exercise of a power of appointment was viewed under the relation back doctrine as a "shifting event" which gave the taker in default "a vested remainder subject to complete defeasance."[15]

Prior to the 1900's, there was very little use of powers of appointment within the United States, however, three recognized advantages to their use have driven powers of appointment to become one of the most powerful tools in a modern day estate planners tool box. First, these powers allow for the ability to postpone making the final decision regarding the taker of the property which adds flexibility;[16] second, they provide a vehicle for tax avoidance;[17] and third,

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[11] Id.
[12] Id. (See *Sir Edward Clere's* case, 6 Co. Rep. 17b, 77 Eng. Rep 179 (1599) (NOTE: This inhibition changed in 1660 when the knight tenure changed to socage tenure and allowed for full division of land held in socage tenure)
[13] Lawrence Berger, *The General Power of Appointment as an Interest in Property*, 4 Neb. L. Rev. 104, 108 (1961)
[14] Id.
[15] Id.
[16] Id. at 109
[17] Id.

they serve as a means to "block the operation of those rules of law which impose burdens upon the owner of property."[18]

The current law governing the estate and gift taxation of powers of appointment is found in the Powers of Appointment Act of 1941.[19] By enacting this Act, Congress intended "to make the law simple and definite enough to be understood and applied by the average lawyer. . . and to provide a test of taxability which is simple, clear cut, and easy to apply."[20] Within the act Congress differentiated between pre and post October 21, 1942 powers as well as general and non-general powers.[21] Although Congress' intention was to free this section of the Code from complication, "simplicity and certainty have not been achieved in the taxation of all powers."[22]

The Constitution of the United States requires that the estate and gift taxes be "excises taxes on the passage of property."[23] As a prerequisite to the taxation of a power of appointment, there needs to be a transfer of property. Treasury Regulations §25.2514-3(a) provides that "the exercise, release, or lapse… of a general power of appointment created post 1942 is deemed to be a transfer of property by the individual possessing the power"[24] and further provides that the exercise of a non-general power can still be considered a transfer of property under certain circumstances. The possession of a general power that lapses at death is a taxable privilege of the recognition that the decedent held a taxable right to trust property.

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[18] Id.
[19] John G. Steinkamp, *Estate and Gift Taxation of Powers of Appointment limited by Ascertainable Standards*, 79 Marq. L. Rev. 195 (1995).
[20] Id. at 199
[21] Id.
[22] Id. at 199-200.
[23] Treatise: Gratuitous Transfers Affecting the Taxable Estate, §27:13(See Bromley v. McCaughn 280 US 124, 74 L ED 226, 50 S CT 46 (1929)
[24] Treas. Reg. §25-2514-3(a). See also: *Commissioner v. Walston*, 168 F.2d 211, 216 (4th Cir. 1948), where the court held "an exercise or release of a power of appointment should be deemed a transfer of property by the individual possessing the power," and *Fish v. United States*, 432 F.2d 1278, 1279-1270 (9th Cir. 1970)).

For the purposes of this paper, there will be a presumption that "senior family members" desire to reduce their estates by gift and use their generation-skipping tax exemption to pass wealth to "junior family members" in trust. It will further be assumed that the senior family members would not desire to provide powers to junior family members that would cause any estate tax inclusion in the junior family members estates.

Senior family members would also desire assets of their estate to receive a basis step-up whenever possible to minimize the possible tax burden on the junior family member beneficiaries, provided there are no adverse estate or generation-skipping tax consequences. The basis rules governing property acquired from a decedent can be found in IRC §1014(a)(1). It provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall be. . . the fair market value of the property at the decedents death."[25] Consequently, if the decedent were to exercise, release, or allow a general power lapse it would be included in their estate under IRC §2041 or IRC §2514 at the fair market value. Therefore, the person or persons who subsequently acquire the property from the decedent will receive either a stepped-up or stepped-down basis to fair market value under IRC §1014(a)(1). A step-up in basis occurs if the property has a value that is greater than the owners basis in the property and a step-down in basis will occur if the owners basis in the property is above the fair market value.

[25] IRC §2014(a)(1)

B. General Power of Appointment

IRC §2041(b)(1) and the regulations thereunder define a general power of appointment as "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate."[26] If the powerholder is able to exercise the power in favor of any of those four, commonly known as the "Big Four," it will be considered a general power. This is an important concept as it "includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations."[27] There are two main types of general powers of appointment: 1) presently exercisable general powers ("PEG's"); and 2) not presently exercisable general powers (usually testamentary).[28] Courts have ruled that although a general power of appointment "does not have the elements of a title, estate, or ownership in the property…considering it as an unrestricted power to transfer the property, there inheres in it a measure of control proprietary in nature and normally incident to ownership. Thus, in the field of transfer inheritance taxation it is deemed the equivalent of ownership."[29] However, the Code does give certain exceptions under IRC §2041(b)(1)(A,C) and IRC §2514(c)(1,3). IRC §2041(b)(1)(B) and IRC §2514(c)(2) relate to powers created on or before October 21, 1942 and will not be discussed in this paper.

Excluded from the definition of a general power of appointment is "a power to consume, invade, or appropriate property for the benefit of the decedent [possessor] which is limited by an ascertainable standard relating to the health, education, support, or maintenance "HEMS" of

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[26] IRC §2041(b)(1)
[27] Treas. Reg. §20.2041-1(b)(1)
[28] Les Raatz, *Trust Power Holders and Their Creditors- Asset Protection committee* (March 7, 2018)
[29] *Laffey Estate v. Taxation Div. Director*, 8 N.J. Tax 100, 105 (N.J. Tax 1986)

the decedent [possessor]."[30] This commonly used trust standard limits and restricts a beneficiary's proprietary control to such a degree that it is not the equivalent of ownership because the power holder is not able to exercise the power in favor of any of the "Big Four" and will normally not be found as the holder of a general power. When looking to what is meant by "support" and "maintenance," it should be recognized that their meaning is not limited to the bare necessities of life.[31] However, Reg. §20.2041-1(c)(2) provides that "a power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite [restrictive "HEMS"] standard"[32] and thus the standard of comfort, welfare, or happiness is too subjective to ascertain objectively. Planners should be very cautious when limiting powers to such standards as the diction used in drafting these powers can cause significant estate and gift tax consequences if determined not to be limited by such standards.

Another exception to the general rule can be found in both IRC §2514(c)(3) and §2041(b)(1)(C) and relate specifically to powers created after October 21, 1942 and exclude from the definition of a general power, powers which are exercisable by the decedent only in conjunction with another person in three circumstances:[33] A power is excluded "if the power is not exercisable by the decedent [possessor] except in conjunction with the creator of the power."[34] A power is also excluded from the definition of a general power "if the power is not exercisable by the decedent [possessor] except in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise of the power in favor

[30] IRC §2041(b)(1)(A); IRC §2514(c)(1)
[31] Treas. Reg. §20.2041-1(c)(2)
[32] Id.
[33] IRC §2041(b)(1)(C); IRC §2514(c)(3)
[34] IRC §2041(b)(1)(c)(i); IRC §2514(c)(3)(A). Note, this would potentially also cause any related property transferred to be taxed in the estate of the grantor under IRC §2036.

of the decedent [possessor]."[35] This would include someone who may be possessed of a general power of appointment after the death of the decedent.[36] The final exception is a limiting provision which provides that if the power is a general power, after the application of the previous two exceptions, the power will be deemed a general power, but only to the extent of the fractional part of the property subject to the power.[37] This value is determined by taking the value of the property and dividing it by the number of persons in favor of whom the power is exercisable,[38] or the fractional part of the property over which the power exists.

Some examples of general powers given under Reg §20.2041-1(b)(1) are as follows:

1) the power held by a trust beneficiary to "appropriate or consume the principal of the trust;"[39]

2) the power to "affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust;"[40] and

3) the power, in certain cases, of a donee to "remove or discharge a trustee and appoint the donee."[41]

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[35] IRC §2041(b)(1)(c)(ii); IRC §2514(c)(3)(B)
[36] IRC §2041(b)(1)(C)(ii)
[37] IRC §2041(b)(1)(C)(iii); IRC §2514(c)(3)(C)
[38] Id.
[39] Treas. Reg. §20.2041-1(b)(1)
[40] Id.
[41] Id. NOTE: This can be done if the power holder beneficiary appoints himself trustee, if the trustees power to distribute is limited by "HEMS" and no §2041 inclusion will result.

C. State Law

State law plays a very important part in the taxation of powers of appointment and can have differing definitions of, as well as tax effects relating to, powers of appointments. For purposes of this paper, Florida law will be used.

Florida statute §731.201(30) defines a power of appointment as “an authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property.” [42] The Florida statute and the Restatement 3rd of Property are consistent as they both differentiate between “beneficial ownership” and a “power of appointment.” A power is not generally considered an interest in property. The restatement provides that the power of appointment “traditionally confers the authority to designate recipients of beneficial ownership interest in or powers of appointment over property that the donee does not own;”[43] while the beneficial owner of an interest in property “ordinarily has the power to transfer ownership interests in or confer powers of appointment over that property. . . .”[44] Florida courts have made it clear that strict adherence to the instrument and intent of the original donor of the power must be followed regardless of the intent of the donee on the subsequent apparent exercise of the power. Cases such as *Talcott* and *Cessac* speak directly to this.[45] The time of creation of a power

[42] Fla. Stat. §731.201(30)
[43] Restatement 3rd of Property- Wills and other Donative Transfers §17.1(c)
[44] Id.
[45] In *Talcott*, a widow tried to enforce her rights to a trust created by her deceased husbands father (also deceased). Trust required Widow’s late husband to exercise his power by making specific reference to it in his will. The husband left Widow his entire estate but made no specific mention to the trust or the power. Widow tried to offer extrinsic evidence but the court found in immaterial and inadmissible in light of the late husband’s father’s intent in the trust document. Talcott v. Talcott 453 So.2d 951 (Fla. 3d DCA 1982). In *Cessac*, the decedent died testate and her will left everything in her estate, including a specified trust and where it was held and the location of another, to Cessac. The trusts contained powers of appointment and the documents required the decedent to exercise the power by will, by specifically appointing the property to a named individual and referencing the power. The trust contained another provision stating that if this was not done the property would pass in equal shares to the original donors children. The court held that although the decedent had the intent to confer the power of appointment, the intent of the original donor was clear and needed to be strictly followed. Because the decedent did not exercise in accordance

of appointment under Florida law is largely governed under general property principles. However, there are specific sections in the Florida statutes covered under Fla. Stat. §689.225(3)(b-e) that specifically address this.[46] This is important to note for some of the planning discussed further below.

III. Taxing Powers Holders

A. Estate Tax

IRC §2041(a)(2) states "the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections §2035 to §2038, inclusive."[47] Therefore, according to IRC §2041(a)(2), only general powers of appointment and the exercise, lapse, or release of a power which would cause inclusion in the decedents estate under IRC §2035-§2038 are taxable.[48] Exercise and release are discussed further below.

with the trust documents the assets revert to the original donors children. *Cessac v. Stevens*, LEXIS (Fla. Dist. Ct. App. 1st Dist. 2013)

[46] Fla. Stat. §689.225(3)

[47] IRC §2041(a)(2)

[48] Note that certain non-general powers can still be treated as general powers and taxed as such.

B. Gift Tax

IRC §2514 governs the gift taxation of powers of appointment. The general rule under IRC §2514 relating to post 1942 powers states: "The exercise or release of a general power of appointment created after October 21, 1942, shall be deemed a transfer of property by the individual possessing such power."[49] If a power holder exercises a general power "regardless of the date on which it was created, such exercise is deemed a transfer of property by the donee" and subject to gift tax.[50] The exercise of a power to create another power is also a taxable gift in certain situations. The most important of which is IRC §2514(d), which relates to the Delaware Tax Trap that is further discussed in IV., Planning Techniques, section below. IRC §2514(d) subjects to gift tax the property subject to the newly created power if that power "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 not ascertainable without regard to the creation of the first power."[51]

The release of a power of appointment is also subject to the gift tax under IRC §2514(b). It should first be noted that a release and a qualified disclaimer are not one in the same. A release is taxable under the Code but a "[qualified] disclaimer or renunciation of a general power of appointment created in a transfer made after December 31, 1976 is not considered a release of the power for gift tax purposes provided the requirements of §2518 have been satisfied."[52] IRC

[49] IRC §2514(b)
[50] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, B. Gift Tax
[51] IRC §2514(d)
[52] Id.

§2518(c)(2) treats powers with respect to property as interests in property and the same disclaimer rules apply.[53]

The affirmative release or passive lapse of powers should be viewed together for gift tax purposes as the passive lapse of a power of appointment is considered a release of that power under IRC §2514(e), with one important exception.[54] A lapse and a release are considered transfers of property and if a lapse occurs during any calendar year, it is considered a release and subject to gift tax, but only to the extent the property subject to the power exceeds the greater of $5,000 or 5% ("5 and 5 Rule") of the aggregate value at the time of the lapse.[55] This exception is discussed further in III, E., <u>Lapse and Release: Deemed Transfers</u> section below.

Things are less clear when the donee holds both a non-general inter-vivos power and a general testamentary power of appointment. In this situation, if the powerholder exercises their non-general inter-vivos power of appointment in a way that transfers the appointive property and terminates the general power or other rights in trust property, it "may constitute a release of the general testamentary power" causing a taxable gift under IRC §2514 or other Code provisions.[56] There appears to be some debate over whether this can be a taxable transfer during life, as some see the powerholder as not having an interest in the property until death so the release would not constitute a transfer of property. The Tax Court has held in *Estate of Robinson* that certain agreements between decedents and residuary legatees that extinguish a

[53] IRC §2518 (c)(2)
[54] IRC §2514(e)
[55] Id. (SEE §25.2514-3(c)(4) for examples)
[56] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, B. Gift Tax

testamentary general power did not result in a current taxable gift.[57] However, The Tax court in *Regester v. Commissioner* found that an independent taxable gift was made when an income beneficiary exercised a non-general power of appointment relinquishing her income interest.[58]

C. Generation- Skipping Tax (GST) and Allocation of Exemption

IRC §2601 imposes a tax on Generation-Skipping transfers.[59] The possessor of a general power of appointment who exercises the power during life or possesses the power at death is deemed a transferor of property for gift and estate tax purposes.[60] Such transfer may also be subject to GST tax if the trust is not already exempt and the transfer results in a direct skip, taxable termination, or taxable distribution. A trust can be exempt in three ways: 1) it is "grandfathered" meaning it became irrevocable on or before September 25th, 1985; 2) the transferor allocated GST exemption to the trust, often called "zero inclusion ratio trusts" or "non-

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[57] In *Estate of Robinson*, the tax court held that no taxable release of a general power of appointment occurred in a marital trust when decedent had agreement to terminate trust and obtain outright distribution of assets with residuary legatees. Husband gave wife marital trust in his will with testamentary general power. Half of the estate went to a marital trust and the other half to separate trust for legatees. Both trusts were terminated in accordance with agreement between decedent and legatees and the assets distributed. IRS claimed release of power and taxable under 2514. Tax Court rejected and held that agreement converted testamentary into inter-vivos power and since she exercised in favor of herself there was no gift. *Estate of Robinson v. Commissioner*, 101 T.C. 499 (1993)

[58] In *Regester v. Commissioner*, the donor was the income beneficiary of a trust. The donor also possessed a non-general power of appointment over the corpus. The donor exercised her non-general power of appointment. The service argued and the Tax Court agreed that the inter-vivos exercise of the non-general power of appointment over the corpus in turn effected an independent and taxable gift of the taxpayers income interest. The court reasoned that when a person has a life income interest and the ability to transfer or retain that right, the transfer of that property without consideration gives rise to a taxable gift. *Regester v. Commissioner* 83 T.C. 1 (1984)
See also: *Jewett V. Commissioner* where taxpayer held a contingent remainder interest that vested on his mother's death. If he failed to survive her his interest would pass to his two children. The taxpayer renounced his contingent remainder interest claiming a valid disclaimer. The taxpayer argued his disclaimer was equivalent to the exercise of a non-general power of appointment over the contingent remainder interest and therefore should not be subject to the gift tax. The Circuit Court held, and the Supreme Court agreed, that the power of appointment held by the taxpayer had the nature of being a general power as the taxpayer could wait and eventually receive his interest as long as he survived his mother. The Supreme Court reasoned that a disclaimant, unlike a non-general power holder can decide to accept the property in the same manner as the holder of a general power. *Jewett v. Commissioner*, 455 U.S. 305, aff'g, 638 F.2d 93 (9th Cir. 1990).

[59] IRC §2601

[60] IRC §2652(a) Transferor means the "decedent" for property subject to tax under chapter 11 and the "donor" for property subject to tax under chapter 12. .

grandfathered trusts,"[61] ; or 3) GST exemption was automatically allocated. This distinction is important when determining the GST tax consequences of a decanting which will be discussed further in the Decanting section below.

Allowing the property to be included in ones estate allows for the allocation of the decedent's (including decedent beneficiary holding a general power of appointment) GST exemption which results in no generation skipping transfer tax on the transfer of property. Meaning, the grantor or a general power holding beneficiary has included the assets within their estate and allocated a portion of their GST exemption under IRC §2631 to the trust to cause a zero inclusion ratio under IRC §2642. The exemption may be allocated by the transferor of property or deemed to be allocated under IRC §2632 automatic allocation rules. The ability to allocate this exemption is an integral part to modern day estate planning, and is increasingly important where tax reform proposes reduction in the estate and gift tax exemptions.

D. Exercise of Power

Although exercise is not essential for post 1942 powers to be taxable for estate tax purposes, it is relevant to determine inclusion under IRC §2035 and IRC §2514. Under IRC §2035 if the decedent made a transfer of his interest in property by exercises a general power or he relinquished a power "during the 3-year period ending on the date of the decedent's death,"[62] it will prevent inclusion in his estate but will be considered a taxable gift under IRC §2514.[63] Code

[61] Michael M. Gordon, Daniel F. Hayward, *The Tax Consequences of Decanting: A Summary of the Gift, Estate, Income And Generation-Skipping Transfer Tax Considerations When Utilizing Delaware's Decanting Statute*, at 7, April 13, 2012.
[62] IRC §2035(a)(1)
[63] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, B. Gift Tax

sec §2035 clearly omits exercises or releases of general powers from the 3-year rule. The reasoning behind this appears to be that possession of a general power is treated as ownership. If you exercise a general power it will be deemed a gift for gift tax purposes, just as it would for any other property transferred that was owned by an individual. By taxing it as a gift it removes the need to include the property within the power holders estate for estate tax purposes. Confusion exists, however, where that power is testamentary and the release is inter-vivos, particularly if greater than three years prior to the power holders death. The best view appears to be that a gift is made of the testamentary general power, which presents the issue of how that deemed transfer is to be valued.

The exercise or release of a general power of appointment created after October 21st, 1942, shall be deemed a transfer of property.[64] To determine whether one has in fact exercised a power of appointment it is important to look at local law first. However, regardless of whether local law deems the event an exercise, "for purposes of IRC §2041 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," it will still be deemed an exercise of the power.[65] Powers can be exercised presently, postponed, or exercised testamentary. A power "exercised by last unrevoked document is a presently exercisable power." [66] A postponed power is one that includes "power subject to an ascertainable standard that can become presently exercisable once

[64] IRC 2514(b). SEE ALSO *Estate of Gerson* "the exercise, release, or lapse of an appointment power incurs gift tax liability." *Estate of Gerson v. Commissioner*, 507 F.3d 435, 439, 2007 BL 148279, 4 (6th Cir. 2007).
[65] Treas. Reg. §20-2041-1(d)
[66] Restatement 3rd of Property- Wills and Other Donative Transfers §17:4

the standard is met.[67] Lastly, a testamentary power is one exercisable only by the decedent's will but has also come to include powers exercisable under the terms of a revocable trust as well.[68]

E. Lapse and Release: Deemed Transfers

Under IRC §2041(a)(2), a post 1942 power released by a powerholder during life is subject to estate tax upon their death if the release would have caused inclusion under §2035-§2038 if it were considered a transfer of property owned by the decedent.[69] The reasoning behind the taxation of such events is that "a release can have the same effect as a failure to exercise… a failure to act or release may lead to the same result and, therefore, should be accorded consistent treatment."[70] The release of a power of appointment is also considered a transfer of property by the powerholder for gift tax purposes and is thus subject to tax.[71]

IRC §2514(e) and IRC §2041(b)(2) state that a lapse of power created after October 21, 1942 during the life of the individual possessing the power shall be deemed a release of such power.[72] A lapse or release is deemed a "transfer of property" and is thus constitutionally subject to an indirect tax. Disclaimers or renunciations of a general power created after December 31, 1976

[67] Id. (Example: To C for life and C has the power to demand disbursements for support. If taking into account other resources other than the trust disbursements, C has no present need for the support the power is postponed).
[68] Bloom, I. and Brewer, J., 2012. *Powers of Appointment Under The Restatement (Third) of Property: Wills and Other Donative Transfers*. [online] Nycbar.org. Available at: <https://www.nycbar.org/images/stories/pdfs/lecture/hesspaperfinal.pdf>
[69] IRC §2041(a)(2); (See 20.2041-3(d)(2) which states §2041(a)(2) does not apply to the complete release of a general power of appointment created after 1942, exercisable during life or by will, if the release is not in contemplation of death within the meaning of §2035 and after the release the power holder retained no interest which would cause inclusion under §2036-§2038 if transferred by the power holder.
[70] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, A. Estate Tax Consequences
[71] IRC §2514(b)
[72] IRC §2514(e). IRC §2041(b)(2): See also *Fish v. US*- Where the court stated "The statute (2041(b)(2) provides, without equivocation, that a lapse of the power shall be considered a release, and does not purport to qualify the manner in which the lapse occurs. *Fish v. United States,* 432 F.2d 1278, 1280 (9th Cir. 1970)

are not considered to be a release of the power for gift tax purposes if it is deemed a "qualified disclaimer" under IRC §2518,[73] as mentioned in the Gift Tax section above. IRC §2514(e) and the regulations further provide that "a lapse (a passive non exercise) during any calendar year is considered a release so as to be subject to the gift tax only to the extent that the property which could have been appointed by exercise of the lapsed power of appointment exceeds the greater of (i) $5,000, or (ii) 5 percent of the aggregate value, at the time of the lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied."[74] This is commonly referred to as the "5 and 5 power." This commonly used exception is the basis for the so called "Crummey Notices" to satisfy the IRC §2503(b) present interest in property rule.[75]

Just by not exercising the power within a specified period will cause the power to lapse and will thus constitute a taxable release. Otherwise, if the lapse is within the "5 and 5 Power" it is not considered an exercise. However, if the power holder is not able to validly exercise or release the power, the failure to do so will not be considered a lapse. [76] As noted above in the Exercise section, the release of a general power within three years of death causes no Estate Tax inclusion as the "Technical Corrections Act of 1982 deleted §2041 from the list of sections to which IRC §2035 applies."[77] Nevertheless, since the power is released it would cause gift tax consequences under IRC §2514.

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[73] Treas. Reg. §25.2514-3(c)(5)
[74] Treas. Reg. §25.2514-3(c)(4).
[75] *Estate of Crummey*, 397 F.2d 82 (9th Cir. 1968) rev' in part T.C. Memo 1966-144)
[76] Id. (NOTE: Things that will cause the power holder not to be able to validly exercise or release: minority, mental and physical incapacity.)
[77] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, B. Gift Tax; See also: PLR- 201634015.

The "5 and 5 power" stated above is a great way for those wealthy individuals who would like to make a gift in trust but limit any tax consequences to the beneficiary subject to the "5 and 5 power."[78] It allows for the beneficiary of a trust to receive either $5,000 or 5% of the trust assets every year for a specified period. If the beneficiary "allows the power to lapse at the end of the specified period, he or she has in effect made a transfer of a future interest in the property."[79] There will be a deemed gift to the trust to the extent the power extends to property having a value that exceeds $5,000 or 5% of such property.[80] If a decedent beneficiary possesses a "5 and 5 power," the assets in excess of their power will not be included in their estate.

Another possibility is to give the beneficiary a "hanging power" which is a continuing power of appointment over the property attributable to the "5 and 5 power," to the extent the amount gifted by the donor exceeds $5,000 or 5% of the gifted property value. These powers allow the power to "hang" and only lapse at a rate of $5,000 or 5% a year even though contributions might be made in excess of such amount. For gift tax purposes there will be no completed gift until the beneficiary's death and no gift upon release would occur.[81] If the beneficiary survives the trust term their power may lapse with potentially no taxable gift if the property passes to them as they would be making a gift to themselves at that point which is not a taxable event.[82] If the property

[78] See *Cristofani* case where decedent created trust for children and grandchildren and each had all had a right to withdrawal from the trust within 15 days of contribution of assets to the trust. The court held that secondary grandchildren beneficiaries still met the present interest requirement because its not the likelihood of the subsequent withdrawal that matters but whether the beneficiaries had the power to make withdrawals. *Estate of Cristofani*, 97 T.C. 74 (1991). The IRS issued two AOD's following the Cristofani case stating they will continue to litigate situations where the annual withdrawal power is granted to someone who has no other interest other than the withdrawal power (1992-09) and they will challenge these powers if there is a lack of substance to the withdrawal right notwithstanding other interests in the trust. (1996-10)
[79] Robert B. Ellentuck, *Using a Crummey Trust to Preserve Gift Tax Exclusion*, The Tax Adviser (Nov. 1, 2014), https://www.thetaxadviser.com/issues/2014/nov/case-study-nov2014.html (last visited 2021).
[80] IRC §2514(e)
[81] James G. Pressley, Jr., John W. Randolph, Jr., *Florida Estate Planning, Edition 1, Chapter 15, Irrevocable Trusts -- Non-Charitable Beneficiaries*, James Publishing, Inc (Nov. 2009, updated Nov. 2012).
[82] Id.

subject to the power continues in trust or passes to another, the lapse would cause a taxable gift by the power holder to the extent of the remaining "hanging" right. There will, however, still be inclusion in the beneficiaries estate at date of death value under IRC §2041(a)(2) as the beneficiary is deemed to have transferred property with a retained interest.[83] A possible drawback to this solution is that the beneficiaries creditors would have access to the trust assets to the extent of the "hung" power in order to satisfy any outstanding claims.

IV. Planning Techniques

A. Example:

The following example will be used to illustrate planning techniques utilizing powers of appointment that are available to estate planners to achieve significant tax savings through a stepped-up basis under IRC §1014 in the hands of the beneficiary.

Consider the following:

J, a single father, dies in 2012 and leaves the remaining assets in his revocable living trust to A, his daughter, in trust for life remainder to A's two children in equal shares upon A's death. These are also to be held in separate trusts for the benefit of A's two children and administered in the same manner as A's. J also made his best friend M his trustee. For the purposes of illustration and simplicity the only assets of the trust were securities with a fair market value of $5 million at J's death. The trust document required M to administer the trust for A, subject to an ascertainable HEMS standard. J's estate also allocates J's remaining GST exemption to A's trust for a zero inclusion ratio causing no generation skipping tax under IRC §2601 when A's interest

[83] Id.

terminates, even though the assets won't be included in A's estate because presently she does not hold a general power of appointment.

A lived a blissful non-productive life traveling the world receiving her trust distributions from M. However, on a recent skiing trip to Canada, A died in an avalanche on January 10, 2021. At the time of A's death, the trust assets had appreciated in value to $10 million dollars. The basis in the assets was originally $5 million having gained the advantage of a basis step-up in J's estate, but the $5 million of appreciation since J's death will not gain the same advantage because they are not included in A's estate. Other than the trust assets A only had an additional $1.5 million in assets at the time of her death and, therefore, would only utilize $1.5 million of her 2021 $11.7 million lifetime exemption since the trust assets are not included in her estate.

A's two children would each receive $5 million worth of securities with a carry-over basis of $5 million or $2.5 million each in their separate trusts, since the assets of the trust were GST exempt and not taxed in A's estate. For purposes of illustration, consider that the children required income and principal distributions from M, as they were struggling during the corona virus pandemic to maintain their business. They each desired immediate distribution of $2.5 million (the amount equal to the $5 million of appreciation) or a loan in that amount to fund their expenses.(Assuming all would be covered under M's discretionary HEMS standard for simplification). Upon sale and liquidation of the securities to fund the distribution or loan the trust would recognize gain of $5 million between the two trusts, $2.5 million per child. This amount would be subject to federal and state capital gains tax rates, and assuming the total rate to be around 20% there would be a tax of $1.0 million or $500,000 per trust. This reduces the trust corpus of each to $4.5 million.

What if, however, there was a way to achieve a stepped-up basis in the hands of the beneficiary under IRC §1014, so their trusts would each receive a $5 million basis in assets, the fair market value of each of their shares, at A's death? There is and it's by utilizing powers of appointment! If A were able to include the trust assets from J into her estate for estate tax purposes ($10 million), she could utilize a portion of her remaining $11.7 million life time exemption to shelter them from estate tax while gaining the advantage of IRC §1014. The assets would pass tax free to the trusts for A's two children with a stepped-up basis of $5 million dollars under IRC §1014(b)(9).[84] There would be no estate tax consequences to A since her taxable estate would equal the $11.5 million with the inclusion of the assets of the trust, which is under the $11.7 million dollar exemption in 2021. A stepped-up basis in the hands of the beneficiary on appreciating assets coupled with no estate tax consequences to A sounds great but can it be done? In general, it can if the requisite power exists in the current trust instrument or can be provided by modification (including decanting) of a trust instrument where the power doesn't already exist.

B. <u>The Delaware Tax Trap</u>

Probably the most complex and least understood of the planning techniques that could be used to step-up the basis of the assets would be to spring the Delaware Tax Trap. The Delaware tax trap is a technique the daughter could utilize to achieve this result. The trap is essentially a technique to cause inclusion of assets in the daughters estate through the violation of certain IRC

[84] IRC §1014(b)(9) (property included in power holders estate by reason of the power of appointment is seen as acquired from the decedent and beneficiaries receive fair market value basis in that property)

provisions with the help of state law to erase gain through a stepped-up basis on the transfer of property in trust to a beneficiary. Its logic and application is very complicated and is easier explained through its history.

The common law rule against perpetuities provides that no non-vested property right is viable and valid unless it must vest no later than 21 years after the death of some life in being at the time of creation.[85] The uniform statutory rule provides that a non-vested property interest is initially valid if at creation it is certain to vest or terminate no later than 21 years after the death of an individual then alive.[86] Even if the non-vested interest is not initially valid it will still be valid if it vests or terminates within the permissible period. Delaware enacted a statute that made it permissible under their laws to measure an interest created by a non-general power of appointment at the time of the exercise of the power.[87] In essence, it allowed for indefinite successive exercises of non-general powers that were within the permissible perpetuities period. It intended to avoid violating the rule against perpetuities and also forego the imposition of estate tax for generations and generations.[88]

To prevent Delaware and other states from enacting such state statutes, Congress enacted IRC §2041(a)(3). It provides for inclusion in the gross estate of a power holder who creates another power to the extent of any property with which the powerholder by will, or disposition, which would be considered a transfer of property owned by the decedent and includable under

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[85] Henry M. Kittleson et al., *Uniform Statutory Rule Against Perpetuities (1986/1990)*, (July 13, 1990) https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=091fe65c-9d03-a83d-dd5f-a9c5b571b2bb
[86] Id.
[87] Graham D. Holding, Jr., Paul M. Hattenhauer, *Springing the Delaware Tax Trap under North Carolina Law to Obtain an Income Tax Basis Step-Up*. https://www.ceclaw.com/wp-content/uploads/2016/08/Springing-the-Delaware-Tax-Trap-Under-North-Carolina-Law-to-Obtain-an-Income-Tax-Basis-Step-Up.pdf
[88] Id.

IRC §2035, §2036, §2037, exercises such power by creating another which under local law can be validly exercised to postpone the vesting of any estate… for a period not ascertainable without regard to the date of creation of the first power.[89] In simpler terms, the rule means that a "an otherwise limited power of appointment can become a general power of appointment if the power holder exercises the limited power by appointing the property to a new donee, and giving that new donee a presently exercisable general power that is not subject to limited duration by reference to the start of the original period of limitation in the first trust."[90] IRC § 2514(d) is a parallel to code section §2041(a)(3) and treats a power exercised during life to create a new power in another as a gift and taxable.[91]

IRC §2041(a)(3) was originally implemented to preclude state jurisdictions from considering an exercise of a non-general power that created another non-general power as starting a new perpetuities period. However, with the life time exemption nearing $11.7 million (single)/ $23.4 million (married) violating this provision, in certain circumstances, is a clever estate planning technique.

Utilizing the Delaware Tax Trap is not available to all trusts and in all situations. Trusts that are candidates for springing the Delaware Tax Trap are:

1) Irrevocable trusts which (i) assets have value materially in excess of basis, or (ii) have a GST Inclusion Ratio of 1.0, or, in any event, significantly greater than

[89] IRC §2041(a)(3)(A-B)
[90] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, E. Converting a Limited Power to a General Power — The "Delaware Tax Trap".
[91] IRC §2514(d)

0.0 (sometimes called Non-GST Exempt Trusts) that may or will be distributed to skip persons,[92]

2) Trusts that are not includable in anyone's estate, and[93]
3) Trusts in which either: (i) a person has a non-general of appointment or (ii) the Trustee has discretion to make distributions (the broader the power to appoint to others, the better).[94]
4) Trusts that are either not grantor trusts for income tax purposes, or if they are grantor trusts: (i) the grantor cannot or will not exchange other assets for a low basis asset in the trust for which it is desired to step-up basis, (ii) the grantor is likely to live for quite some time and basis step in the near term is important, or (iii) if the problem is lack of GST Exemption allocation the grantor cannot or will not allocate sufficient GST Exemption.[95]

As previously mentioned the ability to utilize the trap is essentially given by state perpetuities statutes. The relevant part of Florida's perpetuities statute §689.225(2)(c) states in general that "A non-general power of appointment or a general testamentary power of appointment is invalid unless: 1. When the power is created, it is certain to be irrevocably exercised or otherwise to terminate no later than 21 years after the death of an individual then alive; or 2. The power is irrevocably exercised or otherwise terminates within 90 years after its creation."[96]

[92] Raatz, L. (2014). DELAWARE TAX TRAP OPENS DOOR TO HIGHER BASIS FOR TRUST ASSETS (AND AVOID GST TAX PROBLEMS WITH NONEXEMPT INDIRECT SKIP TRUSTS)., 6, https://www.dickinson-wright.com/-/media/documents/documents-linked-to-attorney-bios/delaware-tax-trap-opens-door
[93] Id. at 6
[94] Id.
[95] Id.
[96] Fla Sta. §689.225(2)(c)

Most states have, however, codified perpetuities statutes directly applicable to the Delaware Tax Trap. Florida statute §689.225(3)(e) is Florida's provision relating to the Delaware Tax Trap and provides that the exercise of a non-general or testamentary power to create another special or testamentary power, the nonvested property interests and the power of appointment so created is considered to have been created at the time of the creation of the first special or testamentary power.[97] Thus, Florida has codified a statute that in essence makes it impossible to utilize the "tax trap." It does not provide for the condition that "unless the trust provides otherwise" and thus sets an unconditional statutory rule which prevents the Delaware Tax Trap from being sprung. However, In states such as Kentucky or Wisconsin, the creation of a general power of appointment at death will start a new perpetuities period.[98] If that new power and instrument does not reference the prior's perpetuities period and the vesting of interests is able to be postponed by doing so, the trap will be "sprung."

In our example, consider everything the same except that father also granted daughter the power to appoint the remainder outright or in trust to grandchildren, A's two children. Daughter would also be able to grant her two children inter-vivos general powers of appointment.[99] If the trust in question is subject to the laws of a jurisdiction which consider the grandchildren's exercise of the general power as starting a new perpetuities period, the trap can be utilized.[100] If the daughter A exercises the power by creating separate trusts for her children and grants them

[97] Fla Stat. §689.225(3)(e)
[98] Raatz, L. (2014). DELAWARE TAX TRAP OPENS DOOR TO HIGHER BASIS FOR TRUST ASSETS (AND AVOID GST TAX PROBLEMS WITH NONEXEMPT INDIRECT SKIP TRUSTS). https://www.dickinson-wright.com/-/media/documents/documents-linked-to-attorney-bios/delaware-tax-trap-opens-door
[99] BNA Portfolio 825-4th: Powers of Appointment — Estate, Gift, and Income Tax Considerations, Detailed Analysis, E. Converting a Limited Power to a General Power — The "Delaware Tax Trap"
[100] Id.

a general power of appointment, the property of grandchildren's trusts will be included in A's estate under IRC §2041(a)(3).[101] A had exercised her non-general power by creating another power that could be exercised to suspend the absolute ownership of the trust property as it did not reference or make the power subject to the date the trust was created by A's father which gave A her non-general power.

C. <u>Trustee/ Trust Protector Power to Grant General Power of Appointment</u>

A trustee or trust protector may be able to grant a general power of appointment to a trust beneficiary, such as A in our example, to achieve a stepped-up basis in A's estate. Alternatively, it may be more advantageous to have a trust protector hold and grant such a power. Some have argued that within a trustees power to convey property to beneficiaries, the power to grant powers over that property also exists. Florida has codified statutes that expressly permit the trustee to grant, modify, or omit a power of appointment during a decanting.[102] Where a power does not exist in a trustee to grant powers, it may potentially be granted by modification. A trust protector is one who "provide[s] oversight of certain decisions and allow[s] for a degree of flexibility not easily accommodated by the traditional parties to a trust."[103] The "trust protector is a function that carries out enumerated administrative and strategic purposes generally not reserved to the trustee, settlor, or beneficiaries."[104] In essence, the trust protector is someone

101 Id.
102 FL. Stat. §736.04117
103 Andrew T. Huber, *Trust protectors: The Role Continues to Evolve*, (March 14, 2018) https://www.americanbar.org/groups/real_property_trust_estate/publications/probate-property-magazine/2017/january_february_2017/2017_aba_rpte_pp_v31_1_article_huber_trust_protectors/
104 Id.

in which you give broad authority to oversee the trusts administration, including oversight of the trustee. The trust instrument is able to direct when the protectors duties arise.

It is important to review state law as many states have codified statutes that provide for the use of trustees and trust protectors. Florida, for instance, has provided in their Florida Trust Code (FTC) that "The terms of a trust may confer on a trustee or other person a power to direct the modification or termination of the trust."[105] If the trust terms allow a person other than the settlor "the power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power"[106] unless the exercise by such person is "manifestly contrary to the terms of the trust"[107] or the trustee knows it would constitute a serious breach of fiduciary duty.[108] As a result, the difference between duties owed by a trustee or trust protector may determine who should hold the power.

An issue that arises is whether the trust protector owes his duties to the beneficiaries or whether a duty is owed to the settlor. The vast majority of states, including Florida, have codified statutes to provide that fiduciary duties are owed to the beneficiaries. The FTC provides that "A person, other than a beneficiary, who holds a power to direct is *presumptively* a *fiduciary* who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries."[109] Labelled as a fiduciary under Florida law means that the trust protector owes "at least the basic duties of undivided loyalty and confidentiality."[110] However, if the powers of a trust protector expressly remove the trust protectors duty to act as a fiduciary, a

[105] Florida Trust Code §736.0808(3)
[106] Fla Sta. §736.0808(2)
[107] Id.
[108] Id.
[109] Florida Trust Code §736.0808(4)
[110] BNA Portfolio 857-2nd: Managing Fiduciary Liability, Detailed Analysis, F. Trust Protectors

trust protectors discretion to grant a general power to a beneficiary may be accomplished without fear of liability for a breach of duty if the power holder were to ultimately exercise the power in a wayward manner. For example, to a new spouse 30 years younger.

Although the modern trend is to consider fiduciary duties as being owed to the beneficiaries, few cases have held that the trust protector owes a duty to the settlor to carry out his intent while performing the duties or exercising the powers granted to them by the settlor.[111] Therefore, granting a general power to a beneficiary like A could jeopardize the trust and beneficial interest in A's children, causing a trust protector to breach his or her duties incurring liability for any loss. Therefore, it is commonly suggested that the trust instrument declare that the trust protector does not owe a fiduciary duty to the trust beneficiaries and potentially requires consultation with the family and other beneficiaries where notices and permissible agreements covering exculpation can be provided.

The existence of a trust protector or trustee who is able to make the decision in the future to grant or not grant the power to cause inclusion in the beneficiaries estate provides versatility. It would appear it would be preferred to use a trust protector as opposed to a trustee when doing so, as a trustee may not be exculpated from liability. Furthermore, the power conveyed can be granted subject to formula or condition, which will be discussed further below.[112] The ability to

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[111] https://www.floridabar.org/the-florida-bar-journal/trust-protectors-under-current-florida-law-a-passing-trend-or-valuable-planning-tool/(See also – *Minassian v. Rachins* where Husband (decedent) established a trust for benefit of wife upon his death with estate planning attorney as trust protector. Child beneficiaries filed suit alleging improperly administered estate. Trial court ruled against her focusing on the trust instruments language of the word "shares" for each of the children. However, instrument allowed wife to appoint trust director and instrument had very detailed authority for protector. The trust protector amended the trust to provide that the remaining property would be distributed to new trust with separate share for each beneficiary. Trial court ruled against mother and trust director but 4th DCA reversed. Held that Florida law permits trust protector, powers granted to modify the trust were valid under Florida law and the settlor intended use of director instead of court to resolve conflicts and ambiguities. *Minassian v. Rachins* 152 so. 3d 719 (Fla. 4th DCA 2014)

[112] See Treas. Reg. §20.2041-3 ex:4 for contingent power.

choose when and if to grant a general power to the beneficiary is very beneficial as "General powers [are] usually subject to creditor claims so having third party give power later on reduces risk of assets being claimed by creditors."[113] With the increased perpetuities period under F.S. §689.225, permitting trusts to last as long as 360 years under Florida law, uncertainty about future tax law developments, and the need to address changes in the lives of the trust beneficiaries over a long period of time, trust protectors can be used to build flexibility into the trust.[114]

D. Providing Limitations on General Powers

In order to protect against too broad of a power, which covers a wayward exercise or adverse estate taxes , powers can be restricted and made subject to formula. For example, estate tax inclusion will not be denied if the power can only be exercised with the approval of a person who has no interest in the property.[115] Therefore, for example, the appointment of a non-adverse trust protector or other person can build in safeguards without jeopardizing estate inclusion and a Code §1014 basis increase. Furthermore, formula testamentary general powers of appointment can limit the amount of inclusion and achieve a stepped-up basis in some of the trust assets while specifically limiting inclusion for estate tax purposes. A formula testamentary general power gives the holder a general power of appointment, usually exercisable testamentary, to appoint a

[113] Juan C. Antúnez, *Can "trust protectors" be used to privatize Florida trust-construction disputes?* Florida Probate & Trust Litigation Blog (2020), https://www.flprobatelitigation.com/2014/12/articles/mediating-arbitrating-inheritance-disputes/4th-dca-says-yes-to-trust-protector-no-to-trial-court/ (last visited 2021).
[114] Jeffrey S. Goethe, *Trust Protectors Under Current Florida Law: A Passing Trend or Valuable Planning Tool?* The Florida Bar (2017), https://www.floridabar.org/the-florida-bar-journal/trust-protectors-under-current-florida-law-a-passing-trend-or-valuable-planning-tool/.
[115] IRC §2041(b)(1)(C)(ii)

fractional share of the trust over which they have a power. The fractional share of the trust covered by the general power will be limited to "only include the largest amount which will not result in or increase the federal estate tax payable by the power holder."[116] "Once the amount of the power is determined, the formula could then distinguish between the trust's assets that would benefit most from a basis step-up."[117] This is very beneficial if you have a highly appreciated asset or assets in which you believe will continue to appreciate over time as you can "specifically subjec[t] only "appreciated" assets to the power and inclusion in the beneficiaries estate."[118]

There are a few different types of formula powers of appointment that can be utilized to achieve a basis step-up and still escape federal estate taxes. Some are known as: 1) formula automatic general power of appointment; 2) general formula power over the appreciated trust assets; and 3) tiered formula general powers.[119] Although they're named differently, all of these formulas essentially do the same thing, they grant of power over a specific amount of the trust assets which is limited in the trust document to cause no estate inclusion, to specified assets or those that will cause the most capital gains tax if sold, etc. The formula automatic general power of appointment allows the grantor to convey a general power of appointment over the trust assets but only so much as to cause no federal estate tax consequences.[120] This is achieved through limiting language in the trust instrument. Going back to our fact pattern, father ("J")

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[116] Lester B. Law, Howard M Zaritsky, Heckerling Institute on Estate Planning, *Basis After the 2017 Tax Act-Important Before, Crucial Now*, Univeristy of Miami School of Law, 1-91, 2019
[117] Keith K. Grissom, *Use Powers of Appointment as Basis Planning Tools*, Thompson Reuters, (Apr. 2018)
[118] Id.
[119] Lester B. Law, Howard M Zaritsky, Heckerling Institute on Estate Planning, *Basis After the 2017 Tax Act-Important Before, Crucial Now*, Univeristy of Miami School of Law, 1-91, 2019
[120] Id.

could have given daughter ("A") a testamentary general power of appointment over the trust property to cause that property to be taxed in her estate for estate tax purposes under IRC §2041, but the father made it a generation skipping trust not necessarily considering the capital gains implications. Since the combined total of the assets of the trust and her separate estate property is still below the life time exclusion amount, no estate tax would be paid. If he gave her a formula testamentary power, the adverse results and loss of GST exemption could have been avoided, with the formula seeking an optimal result after considering all taxes including not only A's estate and gift tax exemptions but also her GST exemption.

However, if the trust assets had appreciated to $12 million instead of $10 million, and daughter possessed a testamentary general power to appoint the assets by her will, the $12 million trust assets would increase her estate to $13.5 million. This amounts to a taxable estate of close to $2 million over the exclusion amount of $11.7 million causing a roughly $800,000 estate tax liability for A.

If the assets were to exceed A's $11.7 million 2021 exemption, and father gave daughter a formula general testamentary power to appoint the property, a tax could be avoided. The father could specify in the trust document that A's power is only over the assets which will cause her no federal or estate tax liability or only some if the capital gains tax savings exceeds the estate tax detriment. It can further consider A's GST exemption. For example, the father could have stated "I give to my daughter A a testamentary general power of appointment, exercisable alone to appoint a fractional share of the trust property. . . the fractional share covered by the power of appointment conferred upon A shall be the largest amount, which if added to A's estate will not result in or increase A's estate tax liability by reason of her death. . . this power shall be exercisable by appointing the described fractional share free of trust to my daughter A's estate or creditors, to/for the benefit of other persons or entities, in trust or otherwise, as my daughter A shall choose."[121] By having this language in the trust instrument it prevents all of the trust assets from being included in A's estate under IRC §2041 and will include only as much of the trust assets so as to prevent any federal or estate tax. Since she will be considered a transferor of property to the extent of estate inclusion, her GST exemption can be allocated to the trust created by J. This language can be included in the original trust instrument; the trust may be modified; or the trustee, M, may be able to modify the trust through a decanting discussed below, in order to give her such a power to the extended provided by law and the instrument itself.

E. <u>Decanting</u>

Where a trust does not possess the requisite language or provide for a trustee or trust protector to grant powers, it may be permissible to modify the trust to include desired provision. Florida has a number of methods available to modify trusts but a preferred option is through trustee decanting. Decanting offers a method to achieve a stepped-up basis as the creation of a second trust apart from the original trust can be structured to give the trustee the ability to grant certain powers to beneficiary's causing estate inclusion and a resulting stepped-up cost basis. A decanting can essentially be labeled as a trust modification by an agreement of non -judicial settlement within the trust document or by court order. In order to utilize this approach there

[121] Lester B. Law, Howard M Zaritsky, Heckerling Institute on Estate Planning, *Basis After the 2017 Tax Act-Important Before, Crucial Now*, Univeristy of Miami School of Law, 1-93, 2019

needs to be an already existing trust. The trustee of the existing trust "exercises [their] discretionary power to distribute the assets of the first trust to a second trust with more favorable terms."[122] As decanting is a form of modification, review of state trust modification statutes is essential. Many states , including Florida, have codified their own decanting statutes which can vary drastically from state to state.

Florida's decanting statute is codified under Fla. Stat. §736.04117. Fla. Stat. §736.04117(2) The statute is broken down to specify the trustee's ability to decant when they have absolute discretion[123] and the trustee's ability to decant when they do not have absolute discretion.[124] The statute provides that unless a trust instrument expressly states otherwise, an authorized trustee who has absolute power to invade its principle, to make current distributions, may instead exercise such power by appointing all or some of the principle of the trust subject to the power in favor of a trustee of one or more other trusts, for the current benefit of one or more beneficiaries.[125] However, this can only be done if the "beneficiaries of the second trust include only beneficiaries of the first trust"[126] and if the "second trust does not reduce any vested interest."[127] Alternatively, some believe the trustee with such powers may grant a beneficiary a general power of appointment in an existing trust to achieve the desired result, since if they can convey property they can convey powers over that property.[128]

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[122] Keith K. Grissom, *Use Powers of Appointment as Basis Planning Tools*, Thompson Reuters, (Apr. 2018)
[123] Fla. Stat. §736.04117(2)
[124] Fla. Stat. §736.04117(3)
[125] Fla. Stat. §736.04117(2)(a)
[126] Fla. Stat. §736.04117(2)(a)(1)
[127] Fla. Stat. §736.04117(2)(a)(2)
[128] Conner R. Kempe, *Trustee Grant of Power: A Simpler Way to Modify GST Exempt Trusts*, (2017), an unpublished paper

Although many state decanting statutes provide that a decanting cannot eliminate a beneficiary's right to income, a decanting provision drafted in a trust instrument may eliminate such a restriction.[129] The Florida decanting statute gives the trustee the ability to create, retain, or modify an existing power granted under the first trust instrument, but this power is not absolute. If the trustee chooses to create or modify an existing power, the power is only valid if the holder of the newly created or modified power is a current beneficiary of the first trust.[130] If they are not a current beneficiary the power is valid but the exercise of the power is not effective until the power holder becomes or would have become if living a current beneficiary of the first.[131] The foregoing is consistent with the notion that a trustee who holds the power to distribute property to a beneficiary, should also be considered to hold the power to grant powers over that property.

One of the most important subsections to the Florida decanting statute is (c), which allows for the "class of permissible appointees in favor of which a created or modified power of appointment may be exercised may differ from the class identified in the first trust."[132] Not only does Florida statute directly allow this, commentators on the Florida *Phipps* case believe the court's recognition of the trustee's ability to "include non-beneficiaries as permissible appointees under a special power created through decanting may exist under common law."[133] The

[129] BNA Portfolio 871-2nd: Trust Decanting, Working Papers, Worksheet 8 Summary of Tax Implications of Decanting
[130] Fla. Stat. §736.04117(2)(b)(3)
[131] Fla. Stat. §736.04117(2)(b)(4)
[132] Fla Stat. §736.04117(2)(c) (SEE: *Phipps v. Palm Beach Trust Co*., 196 So. 299 (1940) The FL. S. CT. held that under common law a decanting was valid to a second trust that solely benefitted the beneficiaries of the first trust, but the second trust also gave one trust beneficiary the power to direct income payments to his wife through his will. Court reasoned the trustees decanting of property was a valid exercise of the trustees non-general of appointment).
[133]BNA Portfolio 871-2nd: Trust Decanting — State Law and Federal Tax Considerations, Detailed Analysis, C. Gift Tax Issues (See *Phipps v. Palm Beach Trust Co.* The Florida Supreme Court upheld a decanting under common law where the second trust solely benefited the beneficiaries of the first trust but also provided one beneficiary of the

restatement third of property states that "the donee of a non-general power has the authority to exercise the power by creating a new general power in a permissible appointee."[134] Furthermore, "the donee of a non-general power has the authority to exercise the power by creating a general power in a permissible appointee."[135] The restatement also provides that in the case of a newly created general power of appointment the power is able to be exercised in favor of non-beneficiaries as the general power is equivalent to ownership and thus the holder should be able to appoint in favor of anyone.[136] The restatement does not afford a newly created non-general powers the same flexibility as "the holder can only be authorized to appoint to beneficiaries of the original trust."[137]

Decanting presents unique estate, gift, and generation-skipping tax issues. Some of which are if the trustee exercises his power to decant and grants a general power of appointment and also if a non-general power of appointment in the second trust is exercised and triggers the Delaware Tax Trap there will be estate inclusion under IRC §2041(a)(3).[138] In regard to the later referencing the Delaware Tax Trap, there should be no issue if there is no beneficiary participation or consent in the decanting.[139] However, exercising a power so as to violate the Delaware Tax Trap may be beneficial in certain situations so as to "facilitate income tax basis step-up planning for irrevocable trusts."[140]

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trust with the power to make income payments to his spouse in his will. *Phipps v. Palm Beach Tr. Co., 196 So. 299, 300. (1940)*

[134] Restate (third) of Property: Donative Transfers 19:14 cmt. G(3)

[135] Restate (third) of Property: Donative Transfers 19:14 cmt. G(1)

[136] BNA Portfolio 871-2nd: Trust Decanting — State Law and Federal Tax Considerations, Detailed Analysis, C. Gift Tax Issues

[137] Id.

[138] BNA Portfolio 871-2nd: Trust Decanting, Working Papers, Worksheet 8 Summary of Tax Implications of Decanting

[139] Id.

[140] Id.

(1) Income Tax Consequences

Decanting can raise questions in regard to gain and loss recognition under IRC §1001 for the distributing trust and the trust beneficiaries of the distributing trust as assets from one trust are being distributed to a receiving trust. If the distribution of appreciated assets is made from a distributing trust, the distributing trust will recognize no gain so long as the distribution is not made in satisfaction of an obligation to distribute a fixed amount.[141] However, the trustee of the distributing trust has the ability to elect to recognize gain under IRC §643(e)(3). Usually, a beneficiary may realize income on a trust distribution to the extent of DNI,[142] but a change in the beneficial interest of a beneficiary may also cause income realization.[143] However, if the trust instrument or state law expressly provides the trustee with the ability to change the beneficial interest of the beneficiary from an income to unitrust interest, the beneficiary will recognize no gain because their interest has always been subject to such conversion.[144] Therefore, the trustee's exercise of a decanting power, whether pursuant to the trust instrument or state law, will not result in gain or loss recognition to the trust beneficiary. Beneficiary consent and court approval are not required prior to the exercise of the trustee's decanting power.[145] Code

[141] The American College of Trust and Estate Counsel, *ACTEC comments on transfers by a Trustee from an Irrevocable Trust to Another Trust*, Notice 2011-101, 5/16 (Dec. 21, 2011).
[142] IRC §662(a). See *Cottage Savings Assn. v. United States* where the Supreme Court held that a company realized a loss when it exchanged mortgage notes for other mortgage notes that were deemed "materially different." The IRS has provided that a beneficiary will be treated as realizing gain under *Cottage Savings* where the beneficiaries income interest is converted to a unitrust interest unless the conversion is pursuant to state law.
[143] The American College of Trust and Estate Counsel, *ACTEC comments on transfers by a Trustee from an Irrevocable Trust to Another Trust*, Notice 2011-101, at 6.
[144] See also Treas. Reg. §1.643(b)-1 which provides that a "conversion" from an income interest to a unitrust interest may constitute a realization event to the trust or its beneficiaries for purposes of §1001 if the switch or conversion is not specifically authorized by state statute but valid under state law.
[145] The American College of Trust and Estate Counsel, *ACTEC comments on transfers by a Trustee from an Irrevocable Trust to Another Trust*, Notice 2011-101, at 6.

§1001(e) can also cause various tax consequences to beneficiaries whose involvement is deemed to result in their exchange of property rights that are materially different as part of a decanting or other form of modification.[146]

(2) Gift Tax Consequences

If a beneficiary is required to consent or the trustee-beneficiary plays a part in the decanting it may also result in a taxable gift.[147] A beneficiary's failure to object to a decanting is usually not a taxable event. However, it can become taxable in certain situations such as when the beneficiaries consent is required or the beneficiary will lose enforceable rights to receive trust property.[148] The same can be said for the beneficiary releasing the trustee from liability since the IRS might argue that by releasing the trustee from liability the beneficiary in essence "consented" to the decanting and a taxable gift therefore results.[149] If no beneficial interests shift and the decanting is valid under state law, the release will most likely be harmless.[150] Furthermore, if a consenting beneficiary who permits a shifting of their beneficial interest reserves a non-general power of appointment over the shifted interest, an incomplete gift would occur as the consenting beneficiary has not released dominion and control over the property subject to the power.

[146] Treas. Reg. §1.643(b)-1; See also §1001(e)
[147] Alan Halperin, Michelle R. Wandler, *Decanting Discretionary Trusts: State law and tax considerations*, Tax Management Estates, Gifts, and Trusts Journal, Vol. 29 No. 05 (Sept. 9, 2004)
[148] Id.
[149] Id.
[150] See PLR 200401009 Where it was held if the distributing and receiving trust have identical beneficiaries and dispositive provisions there is no shift in a beneficial interest and no gift tax should result.

(3) Generation- Skipping Transfer Tax Consequences

Decanting can also trigger generation-skipping transfer taxes in certain situation. Certain trusts are exempt from the GST tax imposed by Chapter 13 of the Internal Revenue Code. The Tax Reform Act (TRA) exempts transfers from a trust that was made irrevocable by September 25th, 1985.[151] The Act also provides that GST tax is inapplicable to any generation-skipping transfer under a will or revocable trust executed before October 22, 1986 if the decedent died before January 1, 1987.[152] These are both referred to in the GST regulations as "exempt trusts." Therefore, the GST tax is only applicable to trusts created after enactment of the TRA on October 22, 1986 in which the grantor survived past January 1, 1987.

Treas. Reg. §26.2601-1(b)(1) and the Tax Reform Act of 1986 (TRA) provide a trust can lose GST exempt status if there is an actual or constructive addition made after the effective date.[153] However, the GST regulations under §26.2602-1(b)(4)(i)(A)/(D) provide two safe harbors relevant to decanting "grandfathered trusts" but there are currently no regulations regarding "non-grandfathered" trusts. Although there is little guidance on the modification of "non-grandfathered trusts" it has been widely presumed that "at a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust."[154] Therefore, it seems the modification safe harbors found in the regulation also can be applied to "non-grandfathered" trusts.

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[151] Alan Halperin, Michelle R. Wandler, *Decanting Discretionary Trusts: State law and tax considerations*, Tax Management Estates, Gifts, and Trusts Journal, Vol. 29 No. 05 (Sept. 9, 2004)
[152] Id.
[153] Michael M. Gordon, Daniel F. Hayward, *The Tax Consequences of Decanting: A Summary of the Gift, Estate, Income And Generation-Skipping Transfer Tax Considerations When Utilizing Delaware's Decanting Statute*, at 7, April 13, 2012.
[154] IRS PLR 201814005 at 7

The modification safe harbor's for grandfathered trusts are the "discretionary distribution" safe harbor and the "trust modification" safe harbor.[155] Under the §26.2602-1(b)(4)(i)(A) "discretionary distribution" safe harbor, the decanting of a GST exempt trust's principal to a new trust will not lose exempt status if two requirements are met. First, the terms of the governing GST exempt trust instrument authorize distributions to a new trust without beneficiary consent or court order, or state law authorizes distributions to a new trust when the trust becomes irrevocable without consent or approval by the beneficiaries or court.[156] Second, the terms of the trust do not extend the vesting period of any interest in the trust beyond the federal perpetuities period.[157]

The "trust modification" safe harbor under §26.2601-1(b)(4)(i)(D) also provides for two requirements. First, a modification of the exempt trust's governing instrument by judicial or non-judicial reform that is valid under state law will not cause Chapter 13 tax consequences "if the modification does not shift a beneficial interest in the trust to a beneficiary at a lower generational level than the person who held the interest before the modification and the modification." Second, the modification "does not extend the vesting of any beneficial interest in the trust beyond the period provided in the first trust." [158]

If either of these safe harbors are satisfied, at this point and without further guidance, both "grandfathered" and "non-grandfathered" trusts are able to be decanted without loss of GST exempt status.

[155] Treas Reg. §26.2602-1(b)(4)(i)(A) and (D). See: Loretta A. Ippolito, *Expert Q&A on Decanting a Trust,* 01 December, 2018.
[156] Treas. Reg. §26.2602-1(b)(4)(i)(A)
[157] Loretta A. Ippolito, *Expert Q&A on Decanting a Trust*, 01 December, 2018.
[158] Treas. Reg. §26.2601-1(b)(4)(i)(D)(See examples under (E))

Going back to our example, father could include a decanting clause in the trust instrument granting trustee the power to decant. Certain state jurisdictions, such as Florida, have codified statutes allowing the trustee to exercise his absolute or non-absolute power to decant even without such being included in the trust instrument.[159] If Trustee, M, were able to decant the trust and grant daughter a general power of appointment under state law, this would permit inclusion in the daughters estate upon her death under IRC §2041(a)(2) and a stepped-up basis in the hands of her children. However, depending on how the power is drafted, it could pose some risk to A's children, since A may exercise her power to transfer property to others. If she chooses to exercise the power in favor of her children inter-vivos, it could also be considered a taxable gift under IRC §2514. By causing inclusion in A's estate she becomes the transferor of property for GST tax purposes under IRC §2652(a) and this will permit A to allocate her GST exemption.

V. <u>Conclusion</u>

Powers of appointment provide a unique way for estate planners to achieve significant tax savings in certain situations. Although they might not be the best option for every client and every situation, they are a versatile tool that should not be dismissed. The Democratic led Congress might soon overhaul the Internal Revenue Code, which could reduce the estate tax exemption while increasing rates and thus make tax basis planning less prevalent or desirable. However, they remain applicable as of the date of this paper and offer valuable ways to utilize these powers in an estate plan. Furthermore, President Biden has not yet proposed a reduction

[159] Fla. Stat. §736.04117(2)-(3)

of the estate tax exemption, but Senator Sanders has proposed reduction in his "For the 99.5% Act." Careful drafting is required so as to not cause any unintended income, estate, gift, or generation skipping tax consequences to beneficiaries. However, if done correctly, utilizing these powerful devices in the strategies outlined in this paper will allow for a stepped-up basis in the hands of the power holding beneficiaries. Furthermore, the future is unknown and tax laws will continue to evolve. Powers of appointment have continued to provide holders with flexibility in confronting inevitable change.

PROPOSED TAX BILL AMENDMENTS AFFECTING THE STRATEGIES IN THIS PAPER

GAI21423 NYM, 117th Congress 1st session, "For the 99.5 Percent Act" A BILL to amend the Internal Revenue Code of 1986 to reinstate estate and generation-skipping taxes, and for other purposes.
https://www.sanders.senate.gov/wp-content/uploads/For-the-99.5-Act-Text.pdf

SEC. 9. ELIMINATION OF GENERATION-SKIPPING TRANS-FER TAX EXEMPTION FOR CERTAIN TRUSTS.

''(h) ELIMINATION OF GST EXEMPTION FOR CER-TAIN TRUSTS.—

''(1) IN GENERAL.—

''(A) TRANSFERS FROM NON-QUALIFYING TRUSTS.—In the case of any generation-skip- ping transfer made from a trust that is not a qualifying trust, the inclusion ratio with respect to any property transferred in such transfer shall be 1.

''(B) QUALIFYING TRUST.—For purposes of this subsection, the term 'qualifying trust's means a trust for which the date of termination of such trust is not greater than 50 years after the date on which such trust is created.

''(2) TRUSTS CREATED BEFORE DATE OF EN-ACTMENT.—In the case of any trust created before the date of the enactment of this subsection, such trust shall be deemed to be a qualifying trust for a period of 50 years after the date of the enactment of this subsection.

SEC. 2. MODIFICATIONS TO ESTATE, GIFT, AND GENERA- TION-SKIPPING TRANSFER TAXES.

(b) EXCLUSION AMOUNT.—

Over $750,000 but not over $3,500,000 .... $248,300 plus 39 per- cent of the excess of such amount over $750,000.

Over $3,500,000 but not over $10,000,000 .... $1,320,800 plus 45 percent of the excess of such amount over $3,500,000.

Over $10,000,000 but not over $50,000,000 ...... $4,245,800 plus 50 percent of the excess of such amount over $10,000,000.

Over $50,000,000 but not over $1,000,000,000….. $24,245,800 plus 55 percent of the excess of such amount over $50,000,000.

Over $1,000,000,000 .... $546,745,800 plus 65 percent of the excess of such amount over $1,000,000,000.''.

ESTATE TAX.—Paragraph (3) of section 2010(c) of the Internal Revenue Code of 1986 is amended to read as follows:

''(3) BASIC EXCLUSION AMOUNT.—For purposes of this section, the basic exclusion amount is $3,500,000.''.

(2) MODIFICATION TO GIFT TAX EXCLUSION AMOUNT.—Paragraph (1) of section 2505(a) of the Internal Revenue Code of 1986 is amended to read as follows:

''(1) the applicable credit amount in effect under section 2010(c) for such calendar year (determined as if the basic exclusion amount in section 2010(c)(2)(A) were $1,000,000), reduced by''.