Powers of Appointment Primer

Part 2: Taxation of Powers of Appointment

BY GRIFFIN BRIDGERS, SUSAN L. BOOTHBY, AND LISA C. WILLCOX

This is the second in a two-part series exploring the powerful benefits and complex issues confronting estate planning attorneys in using the power of appointment. Part 1 discussed Colorado law relating to powers of appointment. Part 2 addresses associated federal income and transfer tax issues.

Much of the uncertainty in drafting trusts in the first decade of this century centered on the changes made to the federal gift and estate tax laws. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) reduced transfer estate tax rates and increased the estate tax and generation-skipping tax exemption.[1] EGTRRA scheduled the repeal of the estate tax and generation-skipping tax for the year 2010, followed by a "sunset" of EGTRRA in 2011, in which the old regimes of the estate tax and generation-skipping tax would reappear.

The federal estate tax laws underwent yet another change in 2012 with the enactment of the American Taxpayer Relief Act of 2012.[2] That law increased the unified credit, now called the "applicable exclusion," to $5 million per person, indexed for inflation.[3] As a result of the indexing, the applicable exclusion for the year 2017 was $5.49 million.[4]

Now, under the Tax Cuts and Jobs Act, effective January 1, 2018, the estate tax and generation-skipping exemption has increased to $11.18 million in 2018.[5] The Tax Cuts and Jobs Act is due to sunset on December 31, 2025, returning the 2012 to 2017 exemption amounts, as indexed for inflation at that time.[6] Although only a small number of decedents' estates will be affected by this most recent legislative change, the estate and gift transfer tax structure has been the subject of frequent changes by Congress in the past and will likely change again in the future. With the transfer tax[7] exemption at $11.18 million, trust drafters will likely change their focus to making trusts more income tax efficient.

Much of the focus in tax planning is placed on the avoidance or deferral of transfer taxes by the donor of property, with little consideration given to the tax consequences to the estate plan beneficiaries. However, contrary to Colorado property law, the grant of a power of appointment can, in some cases, cause the powerholder to be treated as the owner of the assets over which the power can be exercised for income and transfer tax purposes. In such a case, an estate plan beneficiary may incur additional transfer tax liability. On the other hand, with today's generous estate tax applicable exclusion amount, such a result may be of no consequence to a beneficiary and, in some cases, may even create a tax benefit for beneficiaries as a group. This article looks at the specific powers of appointment that trigger such tax consequences.

Definition of General Power of Appointment

The definition of a *general* power of appointment is central to the analysis of transfer tax consequences surrounding powers of appointment.

For transfer tax purposes, a general power of appointment is defined in the Internal Revenue Code of 1986 (the Code) as a power that can be exercised in favor of any of the powerholder, the powerholder's creditors, the powerholder's estate, or the creditors of a powerholder's estate.[8] There are three restrictions that will prevent such power from being categorized as general for transfer tax purposes if they are added to a power of appointment.

First, if the powerholder's power to consume, invade, or appropriate property for his or her own benefit is limited by an ascertainable standard relating to the powerholder's health, education, support, and maintenance, this power to withdraw will not be treated as a general power of appointment.[9] The Colorado Uniform Act does not contain such a provision. The Uniform Power of Appointment Act (UPAA) contains a provision that treats a power subject to an ascertainable standard as nongeneral for purposes of creditor claims against the powerholder,[10] but as discussed in Part 1, Colorado has not yet enacted the creditor provisions of the UPAA.[11]

Second, if the power of appointment can only be exercised with the consent of the donor creating the power, such power will not be treated as a general power of appointment.[12]

Third, if the power of appointment can only be exercised with the consent of another person having a substantial adverse interest in the property over which the power can be exercised, such power will not be treated as a general power of appointment.[13] This final restriction is similar to one found in the Colorado Uniform Act, which states that if a powerholder may exercise a power of appointment only with the consent of an adverse party, the power is nongeneral.[14] An adverse party is defined as a person with a substantial beneficial interest in property, which interest would be adversely affected if the power were exercisable in favor of the powerholder, the powerholder's estate, a creditor of the powerholder, or a creditor of the powerholder's estate.[15]

The primary difference between the respective definitions of a general power of appointment between the Code and the Colorado Uniform Act is that the Code contains a plural reference to "creditors," while the Uniform Act uses the singular term "a creditor."[16] Presumably, this difference would be of no consequence in determining whether a power of appointment is general for transfer tax purposes.[17] Accordingly, a limitation of permissible appointees to a specific creditor or creditors of the powerholder, or the powerholder's estate, would then create a general power of appointment under both the Colorado Uniform Act and the Code. Such a limitation could be helpful, for example, in granting a general power of appointment to a powerholder who might be prone to creditor issues.

Taxable Powers of Appointment in General

Sections 2514 and 2041 of the Code each define the circumstances under which a power of appointment can subject the powerholder to gift or estate tax, respectively. For purposes of this analysis, this article focuses solely on powers of appointment created after October 21, 1942.[18]

In general, these Code sections treat the powerholder of a *general* power of appointment as the transferor, or owner, of the property over which the power can be, or could have been, exercised, in the following circumstances:

1. In general, the lapse or release of a general power of appointment, in full or in part, may cause the powerholder to be treated as having made a transfer, for gift tax purposes, of the assets over which the power could have been exercised.[19]
2. If the powerholder of a general power of appointment dies holding such power, or is treated as holding a previously exercised or released general power of appointment at the time of death under Code Sections 2035 to 2038, the assets over which such general power of appointment could have been exercised will be included, for estate tax purposes, in the gross estate of the powerholder.[20]
3. The application of the gift or estate tax to the exercise, release, or lapse of a general power of appointment by the powerholder may cause such powerholder to be treated as the transferor, for generation-skipping transfer tax purposes, of the assets over which such exercised, lapsed, or released power of appointment could have been exercised.[21]
4. If a powerholder has a general power of appointment that gives the powerholder the present right to withdraw the income or principal of the trust, such powerholder will be treated as the owner, for income tax purposes, of such assets.[22]
5. A powerholder of a general power of appointment who dies holding such power (for estate tax purposes), or who exercises such power effective at death, is treated as the transferor of the property subject to the power for purposes of Code Section 1014 (which allows the income tax basis of assets acquired from a decedent, by reason of his or her death, to be "stepped-up" to their fair market value at the date of the decedent's death).

In addition, the powerholder of a *nongeneral*[23] power of appointment may be treated as the transferor of the property, for gift and estate tax purposes, if the nongeneral power is exercised (during life or at death) in a manner that suspends or postpones, where permitted by the applicable state rule against perpetuities, "In addition, the powerholder of a nongeneral power of appointment may be treated as the transferor of the property, for gift and estate tax purposes, if the nongeneral power is exercised (during life or at death) in a manner that suspends or postpones, where permitted by the applicable state rule against perpetuities, the vesting of such property."

the vesting of such property.[24] This exception is commonly known as the Delaware tax trap.

It is helpful to examine the tax effects of a power of appointment highlighted through some examples of common situations that cause the powerholder of a power of appointment to be exposed to transfer tax and/or income tax liability.

For purposes of these examples, assume that Julie creates an irrevocable trust for her children and issue. In creating this trust, Julie gives each living trust beneficiary a *Crummey*[25] power to withdraw the lesser of (1) the beneficiary's equal share of any amount contributed to the trust by Julie in a given calendar year, or (2) the amount of the gift tax annual exclusion available for gifts by Julie to the beneficiary in question. This power expires 30 days after the date of Julie's contribution to the trust or, if sooner, on December 31 of the year of the contribution.

Gift Tax

For gift tax purposes, the exercise or release of a general power of appointment is treated as a transfer by the powerholder when such exercise or release occurs during the powerholder's life.[26] For this reason, it is important to consider the tax effects to the powerholder of the grant of a general power of appointment. For instance, if the powerholder exercised the general power of appointment in favor of a person other than himself or herself, this exercise would be treated as a gift by the powerholder to the recipient of such property.[27] In addition, if the powerholder anticipated adverse estate tax consequences (discussed below) due to his or her retention of a general power of appointment and, as a result, wished to release the power, such release would generally be treated as an indirect gift to the other trust beneficiaries. Especially in cases of a release of a general power of appointment, it is also often the case that the indirect gift will not be eligible for the gift tax annual exclusion under Code Section 2503(b), because the deemed transfer resulting from such release is a transfer of a future interest.[28]

In some scenarios, a general power of appointment may only be exercisable by a powerholder for a limited period of time. If this period of time expires, the power of appointment is treated as having lapsed. A lapsed power of appointment is treated as a release of such power that, as noted above, may cause adverse gift tax consequences to the powerholder if the power is a general power of appointment.[29] However, a lapse of a power of appointment during a calendar year is only treated as a release of such power to the extent that the value of the lapsed power exceeds the greater of $5,000 or 5% of the trust assets over which the power could have been exercised.

- If a beneficiary of Julie's inter vivos irrevocable trust fails or refuses to exercise his or her *Crummey* power, such beneficiary will be deemed to have made a gift to the other trust beneficiaries to the extent the beneficiary's withdrawal right exceeds $5,000. The 5% limitation would not be invoked because the beneficiary's withdrawal right was capped at the amount of the gift tax annual exclusion amount, which is currently $15,000, and 5% of this amount ($750) is less than $5,000.
- The results would be the same if the beneficiary expressly notified the trustee of the trust that the beneficiary wished to release his or her *Crummey* power.
- If, however, Julie had included a provision limiting the lapsed amount of each *Crummey* power to $5,000 or, if greater, 5% of the appointive property, a beneficiary's lapsed *Crummey* power would not have generated gift tax liability for the beneficiary.

For this reason, when creating *Crummey* powers[30] it is a common practice to limit the lapse of such powers to the greater of $5,000 or 5% of the powerholder's proportionate share of assets transferred to a trust. This prevents the lapse of this right of withdrawal from being treated as the release, for gift tax purposes, of a general power of appointment by the powerholder. The technique for avoiding gift tax is to give the beneficiary a "hanging *Crummey* power" whereby the excess of the current gift over the 5 and 5 limit remains subject to an ongoing demand power. The ongoing demand power lapses only to the extent of the greater of $5,000 or 5% of the trust assets of the following years. As noted below, such technique may also prevent the lapse of the *Crummey* power from having adverse estate tax consequences.

Estate Tax

Generally, if a powerholder dies holding a general power of appointment, the assets over which such power of appointment could have been exercised are included in the powerholder's gross estate for estate tax purposes.[31] In other words, the powerholder is treated as the owner of such assets by virtue of having held a general power of appointment at the time of his or her death. For estate tax purposes, the definition of a general power of appointment is substantially similar to the definition of a general power of appointment for gift tax purposes, including the applicable restrictions that prevent a power of appointment in favor of the powerholder from being treated as a general power of appointment.[32]

- If a beneficiary of Julie's trust dies while holding an unlapsed *Crummey* power, the appointive property would be included in the beneficiary's gross estate for estate tax purposes.

Intuitively, it would seem that the powerholder of a general power of appointment could avoid such a result either by exercising such power in full, or releasing such power in full, during life. However, this solution is not as simple as it appears on its face. In certain scenarios, the exercise or release of a general power of appointment during life can cause the assets that were subject to the general power of appointment to be brought back into the powerholder's gross estate for estate tax purposes, even if a gift tax was previously applied.[33] To understand such scenarios, it is important to first look at the general concept of retained interests or rights.

“In certain scenarios, the exercise or release of a general power of appointment during life can cause the assets that were subject to the general power of appointment to be brought back into the powerholder's gross estate for estate tax purposes, even if a gift tax was previously applied.”

Sometimes a transfer of property, with a retained right in that property (such as a right to income or use, a right of reversion, or a right to revoke or amend the transfer), can cause the transferred property to be included in the original owner's gross estate, even if the original owner does not actually own the property at the time of his or her death.[34] If such a retained right is released by the original owner, the previously transferred property may still be brought back into the owner's gross estate if the release happens within three years of the original owner's death.[35] The key to the application of these Code sections is that the decedent must have at one point owned property and transferred it during life while also retaining a right described above. These principles generally do not apply to beneficiaries of a trust who have, at no point, been an owner of the property in the trust.

The exercise or release of a general power of appointment during the powerholder's life can cause the powerholder to be treated as the "original owner" of the property subject to such power, even though the powerholder never held title to such property, for purposes of the application of these retained interest rules and the three-year rule described in the previous paragraph.[36] The inadvertent application of this result can easily be avoided by not allowing the beneficiary to have the right, during his or her lifetime, to exercise a general power of appointment. However, if a beneficiary wishes to release a general power of appointment during life to avoid the general inclusion in his or her gross estate of the assets subject to such power and associated adverse tax consequences, such release must be carried out in a manner that avoids the application of the retained interest rules. In such a case, the $5,000/5% limitation described above also applies to a lapse of the power, such that a lapse of a general power of appointment during a powerholder's life that does not exceed this threshold will not be treated as a release of the power.[37] However, a disclaimer or renunciation of the general power of appointment by the powerholder may be possible, so long as it meets the requirements generally applicable to qualified disclaimers for gift tax purposes.[38]

- Assume that a child of Julie's exercises each *Crummey* power to transfer his or her share of the appointive property to a new trust, in which the child retains the discretionary right to receive income of the trust. In such a case, the retained income right would have caused the assets of the new trust to be included in the child's gross estate if the child had funded the new trust with his or her own assets. Therefore, the exercise of the power of appointment would have the same effect.
- If the child were instead to release the power of appointment, or cause it to lapse, the appointive property in excess of $5,000 would be treated as if the child's own property for purposes of the application of Code Sections 2035 through 2038. Therefore, if the child had the right to receive income from the trust, such excess appointive property would also

be included in the child's gross estate.

A common estate tax planning technique involves the creation of a credit shelter trust at the death of the first spouse, which is generally funded with an amount equal to the deceased spouse's unused applicable exclusion amount. The assets of such a trust are typically not included in the surviving spouse's gross estate. Given the generous applicable exclusion amount now available, as well as the existence of the portability election, many estate plans now provide the surviving spouse with the flexibility to create a credit shelter trust through the use of a qualified disclaimer with respect to assets for which the spouse would otherwise have been treated as the owner for gift and estate tax purposes, either by virtue of an outright distribution or the application of Code Section 2044.

For gift tax purposes under Code Section 2518, a qualified disclaimer prevents the surviving spouse from being treated as the owner of the property. In other words, the disclaiming spouse would be treated as having predeceased the first spouse to die for gift tax purposes, as opposed to first receiving the property and then making a taxable gift of the property to the beneficiaries of the credit shelter trust. To preserve this gift tax treatment, the Code requires that the disclaiming spouse not accept the disclaimed interest or any of its benefits.[39] However, the disclaiming spouse is often a beneficiary of the credit shelter trust as well, meaning that such spouse will still be entitled to receive benefits from the disclaimed property.

Fortunately, the Treasury Regulations address this problem, permitting a disclaiming spouse to make a qualified disclaimer over property in which he or she retains a beneficial interest.[40] However, such a disclaimer is not qualified if the disclaiming spouse retains the right to direct the beneficial enjoyment of the disclaimed property beyond the limits of an ascertainable standard.[41] For this reason, it is generally recommended that spouses not be granted a general or nongeneral power of appointment over disclaimed property that passes into a credit shelter trust.[42]

As discussed below under "Basis Planning," many practitioners have begun to explore the inclusion of existing credit shelter trust assets in the surviving spouse's estate, through a trust decanting or modification, for purposes of achieving a step-up in income tax basis. This is often achieved by granting the surviving spouse a general power of appointment over some, or all, of the assets of the credit shelter trust, especially assets with significant built-in appreciation. Where applicable law permits the addition of such a power, it is unclear whether such a change would have a retroactive effect on the qualification of a previous disclaimer by the spouse. However, it is important to note that, for gift tax purposes, any deemed gift by the spouse by virtue of a retroactive disqualification of a disclaimer would likely not be treated as a completed gift so long as the spouse retains a power of appointment that is not exercised, released, or allowed to lapse during the spouse's life.[43]

Generation-Skipping Transfer Tax

Within multi-generational trusts, the general power of appointment can be a valuable tool. Generally, the funding of such a trust by the original settlor is subject to estate, gift, and/or generation-skipping transfer taxes. Upon the funding of the trust, the settlor's generation-skipping transfer tax exclusion is applied to the transfer.[44] If the settlor does not have a sufficient generation-skipping transfer tax exclusion to cause the trust to be exempt from such tax,[45] the generation-skipping transfer tax may subsequently apply, either in the case of a taxable termination or a taxable distribution.[46] However, this result can be avoided by assigning a general power of appointment over the trust assets to one or more beneficiaries who are nonskip persons.[47]

Generally, the transferor of the property subject to such tax applies the generation-skipping transfer tax exclusion.[48] The transferor of property, however, shifts each time that estate or gift tax is applied to previously transferred property to which a generation-skipping transfer tax exclusion has been previously applied.[49] Accordingly, if a beneficiary of a multi-generational trust dies holding a general power of appointment, releases a general power of appointment, or allows a general power of appointment to lapse such that the beneficiary becomes subject to estate and/or gift tax liability (as discussed above), that beneficiary will be treated as the owner and transferor of property in the trust over which the held or lapsed power could have been exercised for generation-skipping transfer tax purposes.[50] This allows such beneficiary to allocate his or her generation-skipping transfer tax exclusion to the trust, which can cause the inclusion ratio to be reduced to zero.[51]

- For each lapse of a *Crummey* power granted by Julie, the new beneficiary will become the transferor of the property subject to the power, for generation-skipping transfer tax purposes, to the extent that the beneficiary is deemed to make a taxable gift. In other words, the beneficiary will have to apply his or her generation-skipping transfer tax exclusion equal to the amount of the lapse to attain a zero inclusion ratio.

A common strategy in trust planning is to permit an independent trustee, or trust protector, to have the power to convert a nongeneral power of appointment held by a beneficiary to a general power of appointment, or to grant a general power of appointment to a beneficiary who did not previously hold any power of appointment.[52] By doing so, such trustee or trust protector can reduce or eliminate any generation-skipping transfer tax liability of the trust after the death of the original settlor(s).

- Assume that the trust does not have a zero inclusion ratio, after allocating all of Julie's available generation-skipping transfer tax exclusion. Assume further that each of Julie's children, who are nonskip persons, has a nongeneral power of appointment over his or her share of the trust's assets. If an independent trustee or trust protector has the power to convert the child's nongeneral power of appointment to a general power of appointment, with respect to some or all of the child's share, the appointive property subject to the converted power would be included in the child's gross estate. As a result, the child could apply his or her generation-skipping transfer tax exclusion to such appointive property at death to attain a zero inclusion ratio.

- However, during the child's life, it would be important to avoid making distributions to any skip person (with respect to Julie) from any trust property with an inclusion ratio of greater than zero; otherwise, this would result in a taxable distribution.

With respect to *Crummey* powers, it is also important to note that the application of the gift tax annual exclusion does not guarantee that the transfer will be granted a zero inclusion ratio for generation-skipping transfer tax purposes.[53] Only transfers in trust that are treated as direct skips to one beneficiary so qualify, and even then, the following requirements must also be met with respect to the sole skip person/beneficiary: (1) during the skip person's life, only that skip person can receive distributions of income or principal of the trust in question, and (2) the trust assets are included in the gross estate of the skip person upon death (if the trust does not terminate earlier).[54]

- Because there are multiple beneficiaries of the trust who are both skip persons and nonskip persons, any transfers thereto would be indirect skips. Therefore, Julie would not be able to take advantage of the deemed zero inclusion ratio for transfers that are nontaxable gifts and would need to allocate her generation-skipping transfer tax exclusion to each transfer subject to a *Crummey* power.
- If, however, the trust were split into equal shares for each beneficiary, such that each skip person was the sole beneficiary of his or her own separate share, and so long as each such skip person was granted a testamentary general power of appointment over his or her share, Julie would not need to allocate any of her generation-skipping transfer tax exclusion for lifetime transfers to the skip person's specific share.

Income Tax

For income tax purposes, the grantor trust rules generally treat the grantor (settlor) of a trust as the owner of the trust assets if such grantor retains certain powers.[55] However, if the grantor is not treated as the owner of trust assets for income tax purposes, one or more beneficiaries may be so treated if such beneficiaries retain certain powers over the trust assets.[56] Chief among such powers is a beneficiary's right to vest the corpus or income of the trust in himself or herself during life.[57] Such lifetime right of withdrawal, while not specifically defined as a general power of appointment, would be treated as a general power of appointment exercisable during life for gift and estate tax purposes.[58]

- If Julie is not treated as the grantor of the trust for income tax purposes, each beneficiary will be so treated with respect to any income generated by the appointive property subject to such beneficiary's *Crummey* power until such power lapses.

The effect of the lapse of the *Crummey* power on the grantor trust status should also be examined. Under Code Section 678(a)(2), the partial release or modification of a general power of appointment described in Code Section 678(a)(1) causes the releasing powerholder to be treated as the grantor to the extent that, following such release, the grantor retains such control as would cause the powerholder to be treated as the grantor under Code Sections 671 to 677. Therefore, for example, if the powerholder were entitled to continue to receive distributions of income from the trust following a partial release of the *Crummey* power, such beneficiary would be treated as a grantor under Code Sections 671 and 678(a)(2). With respect to lapses of powers described in Code Section 678(a)(1), the Internal Revenue Service (IRS) has ruled that the lapse would be treated as a partial release of such powers under Code Section 678(a)(2).[59]

The inadvertent application of this provision should be avoided. However, this tax rule can also have special application. For example, it can allow a beneficiary of a residence trust to take advantage of the exclusion on the gain on the sale of a principal residence, even if the beneficiary does not hold title to the residence for two of the five years prior to sale, so long as this grantor trust rule applied to the beneficiary during such time period.[60] Another potential application might be in the realm of retirement account planning, where a trust beneficiary holding a lifetime power of withdrawal over a trust might be treated as the owner of a retirement account to allow required minimum distributions to accumulate in a trust without taking into account the life expectancy of remainder or contingent beneficiaries.[61] However, practitioners should be very cautious in using general or nongeneral powers of appointment in conjunction with qualified retirement plan assets.[62]

Basis Planning

Where a trust is used to hold appreciated or appreciating assets for the benefit of future generations, in lieu of outright bequests, a major detriment is the loss of a step-up in income tax basis at each generation. However, assets within a trust can receive a step-up in income tax basis to the extent that they are required to be included in a beneficiary's gross estate for estate tax purposes.[63]

- Upon the death of a child of Julie, the appointive property subject to any unlapsed *Crummey* power will receive a step-up in income tax basis to its fair market value, as determined for estate tax purposes, at the child's death.

As discussed above, such estate inclusion can be triggered by allowing an independent trustee or trust protector to give a beneficiary a general power of appointment, at least over the portion of the trust for which a step-up in income tax basis is desired. However, if a trustee or trust protector does not have such a power, a modification or decanting of the trust may be required to give a beneficiary a general power of appointment. Depending on the law governing the construction or administration of the trust, such a result may not be possible.

Under the new Colorado Uniform Trust Code (effective January 1, 2019),[64] nonjudicial or judicial modifications of a trust may be possible, but will be subject to certain requirements including, but not limited to, analysis of whether the modification will violate a material purpose of the trust[65] and adequate virtual representation of minor beneficiaries and unborn beneficiaries.[66] Further, under the Colorado Uniform Trust Decanting Act, the grant of a general power of appointment to a beneficiary may not be possible unless the trustee has expanded distributive discretion,[67] or unless such a change would not cause a substantial change to any beneficial interest contained in the first trust.[68]

Delaware Tax Trap

Another way to achieve the effect of granting a general power of appointment to a beneficiary, such as the basis step-up and/or shift in transferor for generation-skipping transfer tax purposes, is the use of a planning technique known as the "Delaware Tax Trap."[69] There is a unique Code provision that treats the powerholder of a power of appointment as the owner, for estate tax purposes, of the assets over which such power is *actually* exercised if such exercise creates a new power of appointment that can be exercised under applicable local law so as to (1) delay the vesting of any interest in the property subject to the new power, or (2) suspend the absolute ownership of the property subject to the new power, in either case for a period ascertainable without regard to the date of creation of the first power.[70] While seemingly complicated on its face, this provision generally applies where the applicable state rule against perpetuities resets the perpetuities period as a result of the use of a power of appointment to grant a new power of appointment.[71]

This provision generally only applies in states whose rule against perpetuities permits such treatment. At present, Colorado is not such a state, as its statutory rule against perpetuities treats the creation of a new power of appointment as relating back to the date of creation of the original power of appointment.[72] Accordingly, for Colorado trusts, the Delaware Tax Trap generally cannot be used as a planning tool. However, a change in situs of the trust to a state permitting such treatment,[73] or the exercise of a power of appointment by a beneficiary in a state whose applicable law treats the law of the state of the powerholder as governing the exercise of such power, may permit the use of this strategy.[74]

- If Julie's trust is administered in Delaware, assume her child holds a testamentary nongeneral power of appointment over his or her share of the trust and that any unappointed assets would be distributed to the child's issue at his or her death. Further assume that the child exercises such power to cause the assets of the child's share to continue in trust for his or her issue, instead of being distributed outright. The child's exercise of the nongeneral power of appointment, in this case, would cause the appointive property to be included in the child's gross estate.

Special Cases

There are some situations, not expressly described in the Code or Treasury Regulations, in which the grant or exercise of a power of appointment (either general or nongeneral) can cause the powerholder to have adverse tax consequences. While this list is not intended to be all-inclusive, it is designed to alert practitioners to potential pitfalls.

In TAM 9419007, the IRS adopted the Tax Court's holding in *Estate of Regester v. Commissioner*.[75] In this case, a powerholder of a lifetime nongeneral power of appointment held the right to receive all net income of the trust, at least quarterly. The powerholder exercised the nongeneral power to appoint the trust assets. The IRS asserted, and the Tax Court concluded, that the powerholder's exercise of this nongeneral power of appointment resulted in a taxable gift of the powerholder's income interest in the trust. Given this result, it may be important to limit the grant of a lifetime nongeneral power of appointment to a beneficiary whose interest in a trust has an ascertainable value by virtue of mandatory distribution rights.

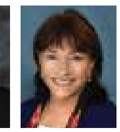
The IRS also concluded, in Revenue Ruling 95-58, that the right retained by a trust's settlor to remove or replace a trustee would not cause the assets of the trust to be included in the settlor's gross estate, so long as the settlor could not appoint himself or herself, or an individual who is not related or subordinate to the settlor under Code Section 672(c), as the trustee. However, this ruling is silent regarding the power of a beneficiary to remove or replace a trustee. The Treasury Regulations conclude that a beneficiary's power to remove and replace the trustee with any successor, including the beneficiary, would cause the beneficiary to have a general power of appointment by virtue of imputing the trustee's powers to such beneficiary.[76] Further, the beneficiary's release of the power to remove or replace a trustee, or resignation as trustee, could then be treated as a release of a general power of appointment.[77] To avoid such an outcome, it is likely that the safe harbor of Revenue Ruling 95-58 would also apply to a beneficiary with the right to name a successor trustee. In other words, limiting the pool of successor trustees to those who are not related or subordinate to the beneficiary would prevent the beneficiary's power to remove or replace the trustee from being treated as a general power of appointment.

Even in cases where the beneficiary has an unrestricted right to remove or replace the trustee with anybody, including the beneficiary, this power by itself may not be treated as a general power of appointment unless the trustee's distribution powers, in the hands of the beneficiary, would be treated as a general power of appointment.[78] In such a case, if the trustee's distribution power is limited to an ascertainable standard, this restriction would prevent the power from being treated as a general power of appointment with respect to the beneficiary if the beneficiary were to become a trustee.[79]

Even if the trustee's distribution power is not expressly limited to an ascertainable standard, certain state law savings provisions may prevent a beneficiary with the unrestricted right to remove or replace a trustee from having a deemed general power of appointment. For example, the Colorado Probate Code contains a provision that limits the distribution power of a beneficiary who is also a trustee to the ascertainable standard of health, education, maintenance, and support with respect to the beneficiary and those persons who have the power to remove or replace the beneficiary, and further restricts such beneficiary/trustee from making distributions to discharge legal support obligations of the beneficiary/trustee.[80] The end result is that this statute prevents the inadvertent grant of a general power of appointment to a beneficiary. However, it is important to note that the application of this statute can be expressly superseded in a trust, by reference to the statute itself, by a clear demonstration of the intent of the settlor to not apply the terms of the statute, or in cases where the assets would otherwise be included in the gross estate of the beneficiary notwithstanding the fiduciary power.[81]

Conclusion

In planning for radical changes to the federal estate and gift tax laws, as well as maintaining the important non-tax goal of creditor protection discussed in Part 1, the power of appointment should be considered when drafting any trust. If there is any certainty in this area, it is that there will be change in the future. A power of appointment can add flexibility to trusts that will affect the lives of our clients' descendants for decades to come.


Griffin Bridgers is an associate attorney with Hutchins & Associates LLC in Denver. He practices primarily in the areas of taxation, estate planning, and private wealth—(303) 893-6500, gbridgers@hutchinslaw.com. **Susan L. Boothby** is of counsel with Hutchinson, Black and Cook, LLC in Boulder. Her practice focuses primarily on estate planning and trust and probate administration—(303) 442-6514, boothby@hbcboulder.com. **Lisa C. Willcox** is an associate attorney with Hutchinson, Black and Cook, LLC in Boulder. Her practice focuses primarily on estate planning and probate administration—(303) 442-6514, willcox@hbcboulder.com.

Coordinating Editors: David W. Kirch, dkirch@dwkpc.net; Constance D. Smith, csmith@fwlaw.com

NOTES

1. Pub. L. No. 107-16, 115 Stat. 38 (2001).
2. Pub. L. No. 112-240, 126 Stat. 2313 (2013).
3. IRC § 2010(c)(3).
4. Rev. Proc. 2016-55, § 3.35.
5. IR-2018-94 (Apr. 13, 2018).
6. IRC § 2010(c)(3)(C).
7. For purposes of this article, the term "transfer tax" collectively refers to the gift, estate, and generation-skipping transfer taxes as described in Subtitle B of the Internal Revenue Code of 1986.
8. IRC § 2514(c).
9. IRC § 2514(c)(1).
10. UPAA § 502(b).
11. Boothby et al., "Powers of Appointment Primer Part 1: The Colorado Uniform Powers of Appointment Act," 47 *Colorado Lawyer* 54, 62 (June 2018).
12. IRC § 2514(c)(3)(A).
13. IRC § 2514(c)(3)(B).
14. CRS § 15-2.5-205(2).
15. CRS § 15-2.5-205(1).
16. *See* CRS § 15-2.5-102(6).
17. *See* Treas. Reg. § 20.2041-1(b)(1) (stating that, for purposes of determining whether a power is a power of appointment, the substance of the power controls over local property law connotations).
18. Code Sections 2514(a) and 2041(a)(1) each set forth similar provisions concerning the taxation of powers of appointment created on or before October 21, 1942. Given the infrequent application of these specific Code sections, we have omitted analysis of them from this article.
19. *See* IRC § 2514(b).
20. *See* IRC § 2041(a)(2).
21. *See* Treas. Reg. § 26.2652-1(a).
22. *See* IRC § 678(a).
23. This rule applies to any power of appointment; however, because the powerholder of a general power of appointment would already be treated as the transferor of the property described in this paragraph for estate tax purposes, its effect (notwithstanding the Internal Revenue Code

definition) is typically only applicable to limited powers of appointment. However, see the discussion below regarding exercise of a general power of appointment for gift tax purposes.

24. *See* IRC §§ 2514(d) and 2041(a)(3).

25. *See Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968). While a discussion of the technical details of *Crummey* powers is beyond the scope of this article, this case, along with subsequent IRS rulings and dicta that are not cited here, generally permit a transfer of assets to a trust to be treated as the transfer of a present interest in assets, such that the gift tax annual exclusion ($15,000 per donee for 2018) set forth in Code Section 2503(b) can be applied to the transfer. Without such an exception, any transfer in trust is generally treated as a gift of a future interest in property, which is not eligible for the gift tax annual exclusion under Code Section 2503(b)(1).

26. IRC § 2514(b).

27. Presumably, an exercise of the power in favor of the powerholder would not be subject to gift tax, because the gift tax is only applied to transfers to third parties.

28. *See* IRC § 2503(b)(1).

29. IRC § 2514(e).

30. *See Crummey.*

31. IRC § 2041(a)(2).

32. IRC § 2041(b)(1). *See also* IRC § 2514(c).

33. Such gifts would already be included in the estate tax calculation, to the extent treated as adjusted taxable gifts, under IRC §2001(b)(1)(B); however, adjusted taxable gifts are not included in such calculation if the previously gifted property is already included in the gross estate. *See* IRC § 2001(b)(2). The net effect of this treatment is that all transfers, including deemed transfers resulting from the exercise or release of a general power of appointment, are treated as having been made at the time of the powerholder's death, with the estate tax rate then applicable applying to all such transfers, but with credit being given for the excess (if any) of gift tax paid on lifetime transfers over the amount of estate tax allocable to such transfers.

34. *See generally* IRC §§ 2036 to 2038.

35. IRC § 2035.

36. IRC § 2041(a)(2). *See also* Treas. Reg. § 20.2041-2(c), Examples (1)–(4), for examples of how the exercise or release of a general power of appointment may cause estate inclusion for the powerholder. Even though these examples are contained in the Treasury Regulation governing powers of appointment created on or before October 21, 1942, the examples are also incorporated by reference into the Treasury Regulation governing powers of appointment created after October 21, 1942. *See also* Treas. Reg. § 20-2041-3(d)(1) for this reference.

37. IRC § 2041(b)(2).

38. Treas. Reg. § 20-2041-3(d)(6). *See also* IRC § 2518.

39. IRC § 2518(b)(3).

40. *See* Treas. Reg. § 25.2518-2(e)(2).

41. *Id.*

42. *See also Orange Book Forms: Colorado Estate Planning Forms*, (Marital Deduction Will), Note on Use 10 (CBA CLE 7th ed., vol. 3, tab 9), for a discussion of this topic.

43. *See* Treas. Reg. § 25.2511-2(b) and (c) (treating a gift as incomplete where the donor retains a testamentary power of appointment, retains the right to revest beneficial title to the property in himself or herself, or retains the right to name new beneficiaries).

44. *See* IRC § 2632 for a discussion of the application of the generation-skipping transfer tax exclusion to a trust.

45. *See* IRC §§ 2641 and 2642 for a discussion of the determination of the applicable rate and inclusion ratio. Generally, these code provisions provide that the applicable tax rate will be the highest maximum federal estate tax rate multiplied by a fraction subtracted from 1, called the inclusion ratio, the numerator of which was the generation-skipping transfer tax exclusion applied to the trust at the time of funding, and the denominator of which is the value of the property transferred to the trust (net of any estate tax actually paid from trust property and any charitable deduction). If the inclusion ratio is zero, no generation-skipping transfer tax is payable at any time.

46. *See* IRC §§ 2621 and 2622. IRC § 2612 generally defines a taxable termination as the point at which the interests of all non-skip persons (i.e., all persons who are not two or more generations removed from the settlor) terminate, and a taxable distribution as a distribution from the trust to a skip person (i.e., a person two or more generations removed from the settlor).

47. IRC § 2613 generally defines a nonskip person as any person who is not two or more generations removed from the transferor of the property (the settlor or, as discussed in the paragraph following this reference, each trust beneficiary holding a general power of appointment).

48. *See* IRC § 2632.

49. IRC § 2652(a)(1).

50. *See id.*

51. *See supra* n. 35 and 36.

52. For a discussion of these strategies, *see* Densen, "Trust Protectors: Powers, Capacity, and Selection," 41 *Colorado Lawyer* 63 (Sept. 2012).

53. IRC § 2642(c).

54. IRC § 2642(c)(2).

55. *See* IRC §§ 671 to 679.

56. *See* IRC § 678(b).

57. IRC § 678(a)(1).

58. *See* IRC §§ 2041(b)(1) and 2514(c).

59. *See* Blattmachr et al., "A Beneficiary as Trust Owner: Decoding Section 678," 35 *ACTEC J.* 106, 115 (2009) (citing PLR 200104005 for the Service's conclusion that the lapse of a *Crummey* power is treated as a partial release of a Code Section 678(a) power under Code Section 678(a)(2)).

60. *See* IRC § 121.

61. *See* Choate, *Life and Death Planning for Retirement Benefits* 319–321 (6th ed. Ataxplan Pub. 2006).

62. For a further discussion of this issue, *see* Bowman and Kirch, "Avoiding Pitfalls for Minor Beneficiaries of IRAs and Other Qualified Retirement Benefits," 46 *Colorado Lawyer* 47, 49 n. 23 (Oct. 2017).

63. *See* IRC § 1014(b)(9).

64. To be codified at CRS Ch. 15, Art. 5.

65. CRS § 15-5-111(3).

66. *See* CRS § 15-5-301.

67. *See* CRS § 15-16-911(4).

68. *See* CRS § 15-16-912(3).

69. This name is derived from a unique provision of Delaware's rule against perpetuities. *See* IRC § 2652(a)(1).

70. IRC § 2041(a)(3); IRC § 2514(d).

71. *See, e.g.*, Del. Code Ann. tit. 25, § 501(a).

72. *See* CRS § 15-11-1102.5(3)(b).

73. *See* Zaritsky, "The Rule Against Perpetuities: a Survey of State (And D.C.) Law" (ACTEC 2012), www.actec.org/resources/state-surveys, for a discussion of states that allow such treatment. As noted on page 8 of this survey, in states adopting the Uniform Statutory Rule Against Perpetuities or common law rule against perpetuities, the Delaware tax trap generally may only be triggered by the exercise of a nongeneral power of appointment to create a presently exercisable general power of appointment.

74. Under both the Colorado Uniform Act and the UPAA, the trust instrument can state the governing law of the exercise of the power of appointment. CRS § 15-2.5-103(1)(a); UPAA § 103.

75. *Estate of Regester v. Comm'r*, 83 T.C. 1 (1984).

76. *See* Treas. Reg. § 20.2041-1(b)(1). This regulation contains a number of similar examples.

77. *See* IRC §§ 2041(a)(2) and 2514(b) for the tax effects of a release of a general power of appointment.

78. *See id.*

79. *See* IRC § 2041(b)(1)(A).

80. CRS § 15-1-1401(1)(a).

81. CRS § 15-1-1401(2).

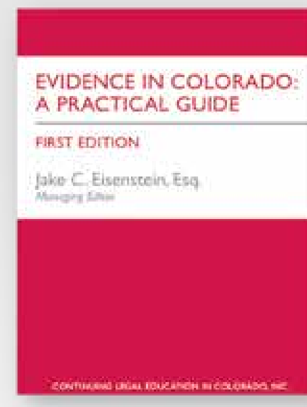
CBA CLE books

EVIDENCE IN COLORADO: A PRACTICAL GUIDE / 1st Edition

This 1st Edition is a practical guide to introducing evidence in Colorado. Chapters contain foundation requirements for each type of evidence, as well as sample examinations to illustrate how to get evidence admitted. Beyond a discussion of the rules of evidence, the book contains leading cases, as well as many practice pointers giving concrete advice.

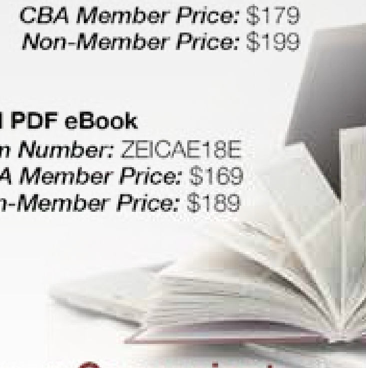
TABLE OF CONTENTS

An appendix contains both the Colorado and Federal Rules of Evidence for the reader's convenience.



Full Print Book
Item Number: ZEICAB18B
CBA Member Price: $179
Non-Member Price: $199

Full PDF eBook
Item Number: ZEICAE18E
CBA Member Price: $169
Non-Member Price: $189



Three Convenient Ways to Order:

ONLINE AT: www.cba-cle.org

CALL: In Denver 303.860.0608
Toll Free 888.860.2531

STOP BY: Our office and save on shipping!

CBA-CLE Books

$11.95 S&H plus sales tax are applied as follows: Denver 7.62%; RTD, 4%; rest of Colorado, 2.9%.

Colorado Bar Association CLE

The nonprofit educational arm of the Colorado Bar Association and the Denver Bar Association

1900 Grant Street, Suite 300, Denver, Colorado 80203-4303