Florida Law Review

Volume 9 | Issue 4 Article 8

December 1956

Affirmative Use of Powers of Appointment

Frank D. Newman

Sidney C. Ward

NOTE

AFFIRMATIVE USE OF POWERS OF APPOINTMENT

> "The power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out."[1]

Since Professor Leach wrote these frequently quoted words in 1928 the federal estate and gift tax provisions relating to powers of appointment have been completely revised. The justification for his statement has been materially strengthened by these changes, and today liberal tax savings are added to the characteristic flexibility of the power of appointment in the estate that has made it one of the most effective tools in estate planning. Unfortunately it is too often overlooked.

In this note the versatility of powers of appointment in estate planning will be demonstrated. Because there are numerous references to tax advantages it should not be implied that the use of powers is restricted to estates that are large enough to incur estate tax liability. The wide variety of objectives that may be accomplished by its use makes the power of appointment adaptable to small as well as large estates.

DEFINITIONS

When an owner of property gives authority to another person to direct the disposition of that property, a power of appointment has been created. This authority may be unlimited or it may be subject to certain restrictions placed upon it by the creator. An accurate definition of the term is "a power created or reserved by a person (the donor) having property subject to his disposition enabling the donee of the power to designate, within such limits as the donor may prescribe, the transferees of the property or the shares in which it shall be received."[2]

---

[1]Leach, *Powers of Appointment*, 24 A.B.A.J. 807 (1938).

[2]RESTATEMENT, PROPERTY §318 (1) (1940). Sec. 319 provides further definitions: "(1) The donor is the person who creates or reserves the power. (2) The donee is the person in whom the power is created or reserved. (3) The objects of a power are those persons among whom the donee is given power to appoint. (4) The ap-

Under this definition powers are classified with reference to the degree of discretion that the donee may exercise in the actual appointment of the property. If the donee may exercise the power for his own benefit, he will usually have a "general" power of appointment. A power to appoint only in favor of a specific group of persons not including the possessor is a "special" power. The special power of appointment is either exclusive or nonexclusive. If exclusive, the donee of the power can exclude any of the possible appointees; if nonexclusive, the power must be exercised, at least in part, in favor of each of the appointees.

The creator of the power, whether general or special, may require that it be exercisable by the donee in his will only. In this situation the donee has a "testamentary" power. When there is no restriction as to the time of exercise, the donee has a power exercisable by deed during his lifetime or by will at his death.

Under the present provisions of the Internal Revenue Code,[3] estate and gift tax consequences may arise only in connection with general powers of appointment.[4] The code defines this class of powers as those that may be exercised by the donee, or "possessor" as he is referred to in the statute, in favor of himself, his creditors, his estate, or the creditors of his estate. Regardless of the local property law connotations of the term "general power of appointment," tax liability may be incurred if the particular device has the characteristics enumerated in the statute. For tax purposes all powers are either general or nongeneral. Further, the code specifically excepts from the definition of general powers certain arrangements that provide the estate planner with extremely valuable methods of eliminating tax consequences without sacrificing complete control over the property.

ADVANTAGES OTHER THAN TAX SAVINGS

Probably the most notable use of the power of appointment is that of postponing the decision of distribution of the property subject

---

pointees are the persons to whom interests are appointed by the donee. (5) The takers in default of appointment are the persons who will receive property not effectively appointed."

[3]INT. REV. CODE OF 1954, §§2041, 2514.

[4]There is a minor exception, inapplicable in Florida and most jurisdictions, that of creation of successive powers. See INT. REV. CODE OF 1954, §§2041 (a) (3), 2514 (d).

to the power. In this respect flexibility is introduced into the estate to meet the changing conditions that occur after the death of the owner of the property. An arrangement that is appropriate at the death of the owner may become vastly inappropriate at a future time. For example, when the ultimate beneficiaries of the property are minors the owner may create a power of appointment that will defer the division of his estate until the capabilities and fortunes of the minors are more developed — until their needs are more readily ascertainable. Thus the possessor of the power may make special provisions for a child who becomes disabled, or for the spouse and children of a child who predeceases the possessor. Again, it might develop that the distributive share of one child should be postponed because of his instability. These decisions may be made years after the death of the estate owner.

If the possessor of a general power exercises it in favor of himself or his estate, the property will be subject to administration costs as part of his probate estate; but, if he exercises it in favor of someone other than himself or allows the property to pass to the takers in default by failing to exercise the power, the property will not be included in his probate estate. Fees, costs, and expenses are determined without including the property subject to the power; the delays of probate and administration that often cause undue hardship to the survivors are completely eliminated when the property passes outside the probate estate. Likewise, an estate owner may decrease his own probate estate by transferring property into a trust and retaining a general power of appointment over the corpus. No tax advantage is gained, but the costs and delays may be substantially reduced. If the possessor has a special power, exercise in favor of himself is impossible and the property will always be outside his probate estate.

In most jurisdictions property subject to a power cannot be reached by creditors of the possessor unless the power is general and is exercised.[5] In the usual case the creator names the probable appointees as the takers in default of exercise of the power. Therefore, should the possessor continue to prefer the named takers in default as eventual recipients of the property, the exercise of the power may be unnecessary and perhaps dangerous.[6]

The distinction between testamentary powers and those exercis-

[5]5 AMERICAN LAW OF PROPERTY §23.17 (1952).

[6]In Keating v. Mayer, 136 F. Supp. 286 (E.D. Pa. 1955), the inadvertent exercise of a power brought the property into the possessor's estate for tax purposes even though the appointees were also the takers in default.

able by deed provides the creator of the power with a variety of methods by which to accomplish his specific objectives. By giving the possessor a life interest in the property and a testamentary power to appoint, the owner can be assured that the possessor cannot dissipate the property during his lifetime. A testamentary power prohibits the irrevocable exercise of the possessor's discretion as to disposition of the property until the last moments of his life. This assures that flexibility of disposition will be retained until the possessor is in the best possible position to make an appropriate appointment. On the other hand, when exercise of the power by deed is authorized the possessor is in a position to meet any emergencies during his lifetime that might necessitate exercise of the power over all or any portion of the property.

As an example, assume that *H* and *W* retire in Florida and buy a home. With an eye toward avoiding the inclusion of the home's value in *H's* taxable estate, *W* purchases the home in her name. In her will she provides a life estate for her husband and remainder to their three children, each of whom is married and living in another state. The provision in her will effectively excludes the value of the property from *H's* estate upon his death. Consider, however, the value of introducing into *W's* will a nongeneral exclusive power of appointment that *H* may exercise by deed or will. Without sacrificing any tax advantage, he is authorized to appoint the home at any time during his lifetime and for any reason to one or more of the children. If he wishes to move into another residence the power may be exercised in favor of the children and the property may be sold by them; or, should one of the children move to Florida, the power could be exercised in favor of that child. The entire arrangement is made more flexible by the introduction of the power of appointment; and the primary objective, that of tax advantage, is not affected in any way.

THE FEDERAL TAX

The Revenue Act of 1916[7] contained no provision for the treatment of powers of appointment. The Supreme Court held that under this act property appointed under a general power could not be included in the estate of a decedent who had exercised the power.[8] The Revenue Act of 1918[9] filled the gap by taxing the appointed property but only

[7]39 STAT. 777.
[8]United States v. Field, 255 U.S. 257 (1921).
[9]§402 (e), 40 STAT. 1097.

if the property "passed" by an "exercise" of a general power of appointment.

Treatment of powers was substantially the same until 1942, when the tax was extended to all property over which a decedent had a general power of appointment subsequently created, whether exercised or not.[10] The 1942 provisions were subjected to a sweeping change by the Powers of Appointment Act of 1951.[11] The latter act was incorporated into the Internal Revenue Code of 1954.

The code treats separately powers created on or before October 21, 1942, and those created after that date. The emphasis of this discussion will be on post-1942 powers, with which the estate planner is primarily concerned today.

Tax liability may arise only in connection with the general power,[12] which, with some important exceptions, is defined in the code as one exercisable in favor of the decedent, his creditors, his estate, or the creditors of his estate. The provisions apply whether the power is held, exercised, released, or allowed to lapse; it may, however, be disclaimed or renounced without tax consequences. As would be expected, the Treasury takes the position that disclaimer or renunciation, to be treated as such, must occur within a reasonable time after the existence of the power is known to the would-be possessor.[13]

The General Power

There is one important tax advantage of the general power of appointment: it may be used to overcome the terminable interest rule, which would otherwise disqualify the property for the marital deduction allowed by the estate tax provisions of the 1954 code.[14] In order to comply with the terminable interest provision, the wife must receive the life income from the property and a general power of appointment over the remainder. This arrangement will qualify even though the surviving spouse has only the testamentary power to appoint.[15] In some instances this may be particularly advantageous.

---

[10]Revenue Act of 1942, §403, 56 STAT. 942.

[11]65 STAT. 91. For a discussion of the treatment of powers created before and after 1942 and the changes wrought by the Powers of Appointment Act of 1951 see Daves and Downey, *Dispositive Methods, supra* p. 491.

[12]INT. REV. CODE OF 1954, §§2041, 2514; see note 4 *supra.*

[13]U.S. Treas. Reg. 105, §81.24 (b) (2) (iii) (*c*) (1954).

[14]INT. REV. CODE OF 1954, §2056 (b) (5).

[15]*Ibid.* The section requires that "such power in the surviving spouse to appoint

For example, if the husband allows the wife to direct the disposition of the property by will only, he qualifies the property for the marital deduction while at the same time he protects it from the possibility of dissipation or inept investment by her and avoids the possibility of enriching a successor husband, at least until the wife dies.

On the other hand, the testator may find it more advantageous to give the surviving spouse a lifetime power to appoint the property. For instance, the husband may desire to take advantage of the marital deduction; but his wife, having a substantial estate of her own, finds it disadvantageous to have the property added to her estate. With a general power of appointment in the wife exercisable by deed, the husband qualifies the property for the marital deduction in his estate, and the widow can dispose of the property by inter vivos gifts, thereby decreasing her estate at the lower gift tax rates.

A third possibility combines all of the above objectives. The husband could give his wife a general power to appoint by will and a special power to appoint by deed to any or all of their children. Such an arrangement qualifies the trust property for the marital deduction because of the general power in the surviving spouse. The wife may dispose of the property by giving it to her children, yet she may not exercise it in favor of herself or anyone other than the children during her life. In this situation the exercise of the special power by deed is considered a release of the general testamentary power and a gift that may give rise to gift tax liability.[16]

The Nongeneral Power

The federal government has limited its estate and gift tax provisions essentially to general powers of appointment. It is therefore important that the estate planner become familiar with the many ways in which the nongeneral power may be used. Two types of nongeneral powers are contemplated. First are those powers that under no circumstances may be exercised in favor of the possessor, his estate, or the creditors of either. This is comparable to the property law "special" power. Second are those powers that are nongeneral even though, with certain limitations, exercise may be made in favor of the possessor. The code specifically allows invasion of the property under two sub-

the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events."

[16]U.S. Treas. Reg. 108, §86.2 (b) (2) (iii) (1943).

sections[17] without classifying the power as general. Special treatment is also given to powers that may be exercised by the possessor only in conjunction with another person.

The Special Power. The use of the special power is best illustrated by a recent case before the Court of Claims.[18] The taxpayer was receiving the life income from a trust, and in addition he had a special power of appointment over the corpus exercisable by deed or will in favor of his lineal descendants. The prohibition of exercise in favor of the taxpayer, his estate, or his creditors, made this a nongeneral power for tax purposes. Under the provisions of the Internal Revenue Code it is clear that the corpus would not have been included in his estate had he retained it until his death, whether his will provided for exercise of the power or not. This case arose, however, not on the event of his exercise by will but because he exercised the power during his lifetime. The Government contended that when he exercised the power over the corpus he had divested himself of the right to the income for the remainder of his life and had transferred something of value that constituted a taxable gift. The court held that the transfer was tax free, since none of the gift tax provisions of the code extend to the special power of appointment.

The special power can be limited by the creator to a testamentary exercise. He can name a class of persons or specific individuals in whose favor the property may be appointed, or he can exclude persons or classes altogether or direct what their interest shall be. All these limitations are accomplished in the instrument creating the power of appointment by appropriate directions as to the manner in which the power may be exercised by the possessor. It is not necessary that the possessor have any interest in the property other than the power. From the tax standpoint the principal thing to avoid is the "general" power.

Nontaxable Powers of Invasion by the Possessor. The Powers of Appointment Act of 1951, as incorporated into the present law, provides the estate owner with two additional tools. Because these provisions are new and because they add great flexibility to the estate plan, they should be given careful consideration from the standpoint of affirmative use in the formulation of new plans as well as in the revision of existing ones.

---

[17]INT. REV. CODE OF 1954, §§2041 (b) (1) (A), (b) (2), 2514 (c) (1), (e).

[18]Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956).

The first of these new provisions allows an individual, in any one year, to withdraw principal for his support, maintenance, education, or medical care.[19] This right cannot be available for the individual's every whim or pleasure but must be limited to an ascertainable standard, such as "to enable him to maintain his accustomed standard of living."[20] The code regards such a power as nongeneral, and the property from which these withdrawals may be made is not a part of the estate of the possessor nor do the withdrawals constitute a taxable gift to the possessor.

By the use of this provision the estate owner may accomplish two objectives that together were not attainable before the 1951 act. Prior to this time he could qualify for the marital deduction one half of his adjusted gross estate by outright bequest or survivorship or by creating a life interest with a general power of appointment.[21] Although the tax saving was very attractive, many estate owners wished to provide better for their wives and consequently they exceeded the amount that qualified for the maximum marital deduction. This arrangement resulted in inclusion of the excess in both estates for tax purposes. Under these new provisions of the code, however, the estate owner may qualify property for the maximum marital deduction and in addition give his wife a power of invasion into the nonqualifying half of the adjusted gross estate to insure her continued standard of living in the event that the qualifying half becomes inadequate. As long as the withdrawals are based on an ascertainable standard relating to support, maintenance, education, and medical expenses, the property over which the power exists will not be includible in her estate for tax purposes and a second tax is avoided.

The power of invasion is of course not limited to use in the marital deduction situation. It can be given to the possessor of a special power to supplement a life income or even in lieu of a life interest in the corpus. The vital fact is that the power in the possessor assures the continuance of his standard of living without adding to his taxable estate the property over which the power exists.

The second tool added by the 1951 act is in regard to the lapse of a

---

[19]INT. REV. CODE OF 1954, §§2041 (b) (1) (A), 2514 (c) (1).

[20]Ithaca Trust Co. v. United States, 279 U.S. 151 (1929). The regulations specifically state that "a power to consume, invade, or appropriate property for comfort, pleasure, desire, or happiness, is not a power limited by an ascertainable standard." U.S. Treas. Regs. 105, 81.24 (a) (3) (ii) (1954); 108, §86.2 (b) (3) (ii) (1943).

[21]INT. REV. CODE OF 1954, §2056, effective since 1948.

power of appointment during the life of the possessor.[22] He may be given a power by the creator to withdraw each year from the principal $5,000 or five per cent of the amount subject to the power, whichever is greater. This right can be exercised at his pleasure and without regard to need. The right, however, must be noncumulative; that is, if the possessor fails to make a withdrawal in any one year his right is gone and he will be limited to $5,000 or five per cent of the corpus in the next year. The possessor is treated as having a nongeneral power to that limited extent. Gift tax will not result if the power lapses. As a deterrent to the formation of multiple trusts, each containing this provision for invasion, the statute does include in the possessor's estate the amount that could have been withdrawn on the date of his death.

These nontaxable powers of invasion may be used in combination. The creator can keep the property out of the possessor's estate, thus avoiding estate taxes and probate and administration costs. At the same time the possessor may be given the right to the income from the property, the right to direct further disposition either by deed or will to any or all of the designated appointees, the noncumulative right to withdraw up to five per cent or $5,000 of the principal each year, and the right to withdraw any amount to meet living, educational, or medical expenses.

The Joint Power. A third provision in both the estate and gift tax sections[23] treats separately powers that are exercisable only in conjunction with another person. If the power may be exercised by the possessor only with the consent and joinder of the creator, it is deemed to be a nongeneral power. The same rule applies if the joinder must be obtained from a person who has a substantial interest adverse to an exercise of the power in favor of the possessor. The regulations indicate that a taker in default has the requisite substantial adverse interest, but a person who is merely a permissible appointee does not.[24] If the person whose consent is required will receive a general power over the property at the death of the possessor, that interest is sufficient to meet the requirements. No other hint as to the meaning of "substantial adverse interest" is given. If the joint power fails to fit in either category the possessor may be taxed on a fractional part of the

[22]INT. REV. CODE OF 1954, §§2041 (b) (2), 2514 (e).
[23]INT. REV. CODE OF 1954, §§2041 (b) (1) (C), 2514 (c) (3).
[24]U.S. Treas. Regs. 105, §81.24 (b) (2) (ii) (1954); 108 §86.2 (b) (5) (ii) (1943).

property affected by the exercise. The intricacies of the computation are explained in the regulations.[25]

Scope of the Nongeneral Power. Nongeneral powers can best be illustrated by considering an estate plan, including the application of both general and nongeneral powers, for a hypothetical family consisting of *H,* an estate owner, *W,* his wife, and their three children. The first step is to ascertain *H's* objectives: he desires that his children be the ultimate recipients of his wealth, yet he wishes *W* to have a substantial income for the rest of her life. Of course he wants to accomplish these objectives with the least possible tax and other cost to his wife, himself, and their estates.

Briefly, the estate may be planned along these lines.[26] *H* provides in his will for the payment of claims against his estate and for funeral and administration expenses incurred after his death. In general, the remainder of his estate constitutes the adjusted gross estate.[27] Provision is made for the division of this amount into two equal trusts, called Trust *A* and Trust *B*.[28] *W* is given the income from Trust *A* and a general power to appoint the trust property during her life by deed or upon her death by will. Trust *A* will therefore qualify for the marital deduction and will not be taxed in his estate; however, it will be taxed in *W's* estate if it is retained until her death.

Trust *B* will contain the following provisions for *W's* benefit: the income from the trust for life, the special power to appoint the trust property to any one or all of her children or their heirs, the noncumulative right to invade up to $5,000 or five per cent of the corpus each year, and the right to invade the corpus for the purpose of maintaining her present standard of living and for educational and medical expenses. Trust *B* cannot qualify for the marital deduction, but this is not important, because the maximum deduction is achieved by Trust *A*. Trust *B* will be includible for estate tax purposes in *H's* estate but will not be includible in *W's* estate at her death, except to the extent of her power to invade — $5,000 or five per cent.

The illustration shows the flexibility that can be added to a plan,

---

[25]*Ibid.*

[26]This illustration will be varied slightly in community property states; see INT. REV. CODE OF 1954, §2056 (c) (2) (C).

[27]INT. REV. CODE OF 1954, §2056 (c) (2).

[28]This presupposes that no property has passed to the wife outside the probate estate. If in fact some property has already qualified for the marital deduction the amount placed in Trust *A* will be proportionately reduced.

as well as the tax advantages made available, by the use of powers of appointment in estate planning. At the same time the plan can be modified or altered to meet the needs of each individual estate. The illustration does not include an extremely valuable variation discussed below in connection with the income tax.

Rather than pass the income of Trust *A* and Trust *B* to *W, H* could give her all of the income from Trust *A* and in addition a portion of the principal of that trust, which together would equal a specified amount.[29] Income from Trust *A* will be taxed to *W* as such, but the amount received from principal will not be taxed as income.[30] The income from Trust *B* will merely be "plowed back" into the corpus of that trust. *W* will be given the right to invade Trust *B*, based on an ascertainable standard relating to health, education, support, and maintenance. This provision makes Trust *B* available to her in case of some unforeseen difficulty. In addition she will be given the unrestricted power to invade Trust *B* each year to the extent of five per cent of the corpus or $5,000, whichever is greater. The latter power can be restricted by stipulating that the right does not accrue until the principal amount of Trust *A* is reduced to a stated amount.

Such a revision of the plan offers both income and estate tax advantages. First, the income from Trust *A* is the only amount upon which *W* will have to pay income tax. To illustrate, *H* wants *W* to receive $12,000 a year; Trust *A* and Trust *B* each contain $200,000, and an income of three per cent is realized on each trust. Rather than give *W* the $6,000 income from each trust, he gives her the income from Trust *A* plus $6,000 of the principal from that trust. In the first year of the trust *W* pays a tax only on the $6,000 income instead of on $12,000, which would be required if she received income from both trusts. Trust *B*, as a separate tax entity, will pay a tax on its $6,000 income. Therefore, two taxes are levied at lower rates on each $6,000 income instead of one tax at a higher rate on $12,000. In each succeeding year the income from Trust *A* will decrease and the amount withdrawn from principal will increase. The estate tax advantage to *W* lies in the fact that Trust *A* is continuously being used up; the more it is reduced during her lifetime the less will be the amount in existence for inclusion in her estate at her death. While Trust *A* is being

---

[29]The marital deduction provision requires that all income from the qualifying property be paid to the wife. It is possible that the income alone may exceed the specified amount, in which case it is essential that the wife receive all of the income.

[30]INT. REV. CODE OF 1954, §662.

reduced Trust *B* is continuously increasing in value because of the addition of its income to the corpus. When the principal of Trust *A* is expended, or reduced to the designated amount, *W* may then withdraw $5,000 or five per cent each year from the corpus of Trust *B*.

The great value and versatility of the power of appointment have been briefly demonstrated in an attempt to indicate its potentialities in estate planning. To be effective an estate plan must accomplish the objectives and solve the problems of the individual client; the plan must be tailor-made to fit those problems and objectives. Powers of appointment are readily adaptable to particular circumstances. In addition to flexibility, appreciable savings in taxes and costs of administration may be achieved by their appropriate use. In short, the power of appointment is made to order for the estate planner.

FRANK D. NEWMAN
SIDNEY C. WARD