ESTATE PLANNING'S MOST POWERFUL TOOL: POWERS OF APPOINTMENT REFRESHED, REDEFINED, AND REEXAMINED

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Editors' Synopsis: One of the most versatile tools estate planners have at their disposal is the power of appointment. Despite its wide use, the benefits and limitations of the power of appointment are not widely understood. This Article discusses those benefits and limitations, and instructs how to use the power of appointment to achieve the intended disposition of the donor or testator, including drafting techniques for both general and special powers of appointment either exercisable presently or in the future. Finally, this Article discusses how to use powers of appointment to "decant" trust assets from one trust to another, reducing the tax consequences of trust dispositions.

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I. INTRODUCTION

Perhaps no tool in estate planning is more ubiquitous, yet less understood, than the power of appointment. This Article outlines the history, functions, and limitations of powers of appointment and discusses the application of powers of appointment to the distribution of corpus from one trust instrument to another, commonly referred to as decanting.

At its most fundamental, a power of appointment is a right given to a person under a legal instrument that enables the person to further designate the recipients of property or interests in property. The party who initially creates the power is the "donor," the holder of the power is the "donee" or, less commonly, the "powerholder" or "appointer," and the ultimate recipients are the "appointees." The possible recipients under the instrument governing the power are collectively the "permissible appointees," while those who will receive the property to the extent the power is not exercised are the "takers-in-default." The property over which the donor grants the power of appointment nearly always is held in trust and the trust instrument governing that property creates the power. But no reason exists why this must be so. For example, a donor may grant a power by will over property passing in the decedent's estate, or even by deed over a parcel of real estate.

Powers of appointment, like so many of the foundational concepts of modern estate planning, originated as part of the English common law. In the fifteenth and sixteenth centuries, they came into widespread use by grantors wishing to make testamentary transfers that otherwise would be ineffectual by will due to the early English prohibition on bequests of land.[1] In the centuries since, their use has broadened from these somewhat con-

[1] Specifically, a landowner who wished to leave property to persons other than his legal heirs and not subject to the rules of primogeniture could make an *inter vivos* transfer with a retained power of appointment, exercisable by will. Because the grantor's subsequent exercise of this power was technically not a bequest of a fee simple interest in the property, it was not subject to the forced inheritance rules.

strained beginnings, and powers of appointment are now a powerful tool to balance respect for a grantor's intentions with long-term administrative and substantive flexibility. In the early twentieth century, Professor W. Barton Leach of Harvard Law memorably called a power of appointment "the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out."[2]

A power of appointment generally relates to the property interest, and in many respects principles of property law govern the power. The specific intent to grant the donee the power creates the power. No special words are necessary, although using the phrase "power to appoint" or "power of appointment" makes the donor's intent to create a power much more clear. The types of powers, rules governing whether they are presently exercisable or not, the manner in which they may be exercised, the persons to or for whom they may be exercised, and similar matters are controlled by principles under state law (primarily as set forth under common law, though often supplemented or modified by modern statutes).

Although a power of appointment is analogous in some respects to an interest in property, a power of appointment is not a true interest. For example, a power of appointment is not automatically transferable.[3] Section 2523(b)(2) of the Internal Revenue Code (Code)[4] provides a rule governing the transfer tax consequences of a power, distinct from that which would logically accompany a direct interest in the underlying property.[5] Nevertheless, the granting, existence, release, lapse, exercise of, and contract to exercise a power of appointment may have tax effects, including gift, estate,

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

[3] *See, e.g.*, RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.1 cmt. b (2011) (stating that a power of appointment is not transferable).

[4] All section references in this Article shall be to the Internal Revenue Code of 1986, as amended.

[5] *See* I.R.C. § 2523 (providing that a gift of a life estate or other terminable property interest to the donor's spouse is treated as a taxable gift in circumstances where the QTIP election is not available). While section 2523(b)(1) governs when the donor-spouse retains "an interest" in the property after the gift, section 2523(b)(2) applies an equivalent rule when the donor-spouse, either alone or in conjunction with another person, holds a power of appointment over the property. When this section of the Code was originally enacted in 1948, contemporary practitioners understood that a separate rule was needed for powers of appointment. *See also* Stanley S. Surrey, *Federal Taxation of the Family—The Revenue Act of 1948*, 61 HARV. L. REV. 1097, 1142 (1948) ("To insure disqualification where the donor retains a power of appointment (*since such a power is not regarded as an interest in property*), there is an express provision covering such a case.") (emphasis added).

generation-skipping transfer (GST), and income taxes, similar or identical to the tax effects on property interests themselves.

II. TYPES OF POWERS OF APPOINTMENT

Powers of appointment come in a variety of forms. Analyzing the type of power granted usually is a process of interpreting the power, although if the language used is unclear, presumptions and maxims may help to determine the type and scope of power.

A. Imperative versus Non-Imperative Powers

Powers of appointment may be imperative or non-imperative. As the name suggests, imperative powers must be exercised. If the donee of the power fails to exercise it, a court having jurisdiction over the trust (or the property) will exercise it. Non-imperative powers, by contrast, need not be exercised. Where takers-in-default are identified, the power almost certainly will not be imperative.

While non-imperative powers are much more common, imperative powers may have utility in certain planning scenarios. A relatively common imperative power occurs when the trust agreement instructs the trustees to transfer property to one or more charities at the termination of a trust that has made no alternative disposition of the property. For example, a trust agreement might state:

> Upon termination of the trust, if no descendant of mine is then living, the trust corpus and income shall be distributed to such one or more charitable organizations, transfers to which are deductible for federal income tax purposes, as my trustees then acting shall select and in such amount or proportions as my trustees shall determine, in the exercise of their sole and absolute discretion.

B. Exclusive versus Non-Exclusive Powers

Powers of appointment also may be exclusive or non-exclusive. An exclusive power allows the donee, by exercising the power, to exclude certain eligible appointees from receiving any of the property subject to the power. A non-exclusive power requires, at least to some degree, that all eligible appointees receive some of the appointed property. Whether a power is exclusive or non-exclusive is a question of construction of the instrument granting the power. It often turns on the precise terms, such as whether the power is exercisable in favor of "*each and every one* of my grandchildren," as opposed, for example, to "*among* my grandchildren" or "to *such* of my

grandchildren as the donee shall select."[6] To ensure that a power is exclusive, drafters should consider phrases such as "in such amount or shares as my donee shall determine including all to one to the exclusion of all others."

Under the doctrine of illusive appointees, the donee of a non-exclusive power must appoint a minimum share to each appointee of a non-exclusive power.[7] The doctrine requires each appointee to receive a reasonable share, though what constitutes a reasonable share may, of course, be uncertain in practice. One half of an equal share or ten percent of an equal share may or may not be reasonable depending upon the circumstances. In addition, the exact consequence of a failure to provide each eligible recipient with a reasonable share is unclear: such a failure by the powerholder may result in each appointee receiving the minimum permissible share, an equal share, or no share if the property passes to the default takers because the power is deemed unexercised.[8]

C. General versus Nongeneral Powers

A general power of appointment is one that the donee may exercise in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.[9] As discussed in more detail below, holding a general power is, in many respects, the equivalent of owning property directly. For example, the donee of a presently exercisable general power is treated as the owner of the property for purposes of debtor-creditor law, as well as for estate, gift, GST, and income tax purposes.[10] Hence, although the holder of the power can benefit from the property directly, much greater risk exists of losing the property and of its adverse taxation. Note that, at common law, a general power for purposes of state debtor-creditor law may include one exercisable by the donee for his or her health, education, maintenance, and support; however, many states have altered this presumption by statute or

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[6] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.5 cmts. d–f (2011).

[7] *See id.* § 17.5 cmt. j.

[8] If the exclusivity of the power and the potential minimum share each appointee must receive are uncertain, the donee might commence a proceeding in court seeking guidance on that issue.

[9] Thus, a general power for state law purposes is essentially the same as one for federal tax purposes. *Compare* I.R.C. § 2041(b), *with* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.3 (2011).

[10] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 22.3 cmt. a (2011).

otherwise, and, of course, such a power is not a general one for federal estate and gift tax purposes.[11]

A nongeneral power commonly is called as a "special" or "limited" power of appointment. As long as the power is not exercisable in favor of the donee, the donee's estate or creditors, or the creditors of the donee's estate, the power is by definition a nongeneral power, whether it is exercisable among a broad universe of potential appointees or only to a narrow or limited group, such as the descendants of the powerholder or certain named charities. Drafters should specifically refer to the nongeneral power as a "nongeneral," "special," or "limited" power of appointment in documents to reinforce that it is not a general power.

In the majority of jurisdictions, a power will be general unless the operative language in the creating instrument suggests otherwise. Some states, however, use a different rule, construing a power as nongeneral unless it may expressly be appointed in favor of the donee, the donee's estate, the donee's creditors, or the creditors of the donee's estate.[12]

In the past, general powers were commonly used as part of a strategy for giving a spouse property, in trust, that would qualify for the federal estate or gift tax marital deductions. In more recent years, however, general powers of appointment have declined in frequency and importance as part of trust drafting, particularly since the allowance in 1982 of qualified terminable interest property (QTIP) trusts.[13] QTIP trusts, which may qualify for the federal estate and gift tax marital deduction by election, need not grant the beneficiary spouse any power of appointment as is necessary for a trust described in section 2056(b)(5) or 2523(e).[14] General powers still appear in

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[11] *See* N.Y. EST. POWERS & TRUSTS LAW 10-7.2 (McKinney Supp. 2012).

[12] For the majority rule—that a power of appointment is deemed to be general unless specifically restricted—see RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.3 (2011); *see also* Powers v. United States, 37 Fed. Cl. 709 (1997) (claimants argued unsuccessfully that a decedent's power should be construed as nongeneral to avoid incurring adverse federal tax consequences). For cases applying the minority rule, see Frank v. Frank, 253 A.2d 377 (Md. 1969); Hillman v. Hillman, 744 N.E.2d 1078 (Mass. 2001).

[13] *See* I.R.C. §§ 2055(b)(7), 2523(f) (describing QTIP trusts).

[14] *See* I.R.C. §§ 2056(b)(5), 2523(e). A trust will not qualify for the estate or gift tax marital deduction under either section 2056(b)(5) or 2523(e) unless the general power is exercisable in favor of the spouse who holds the power or the spouse's estate. Hence, a power to appoint to the spouse's creditors, the creditors of the spouse's estate, or both will not permit the trust to qualify for the marital deduction under one of those sections even though such a power is a general power for property and for estate and gift tax inclusion purposes.

trusts for children or other descendants that do not qualify for the GST tax exemption; as discussed in more detail later, a general power will trigger inclusion of the property in the powerholder's taxable estate, which may be beneficial in some circumstances. Alternatively, rather than provide a general power in the trust instrument, a grantor may permit a non-adverse party to grant the descendant a general power or to convert a nongeneral power into a general one if necessary for GST tax planning. Interestingly, a donee does not hold a general power simply on the grounds that the trustee (or someone else) may confer a general power or may convert a nongeneral power into a general one. A donee's power is a general one, however, even if exercisable only with the consent of someone other than the donor or a party holding an adverse interest. Hence, the distinction between holding a general power exercisable only with the consent of a non-adverse trustee and holding a special power that may become general when a non-adverse trustee confers the power may be surprisingly narrow.[15]

Interpretive issues may arise if a donee who is the donor's descendant is authorized at death to appoint the property to "any descendant" of the donor. The donee is likely not a potential appointee—and, therefore, does not hold a general power of appointment—because, at death, the donee is not living and able to accept the appointment of property.[16] Nevertheless, the preferred practice is expressly to exclude the donee and the donee's creditors from the class of permissible appointees (for example, "to such one or more of my descendants then living other than the donee, the donee's estate, or creditors of either").

A final issue to note is that even if a donee holds both a life estate interest in property and a general power of appointment (which taken together are essentially equivalent to outright ownership), the interests remain separate and will not result in fee simple ownership simply by operation of law.[17] Conversely, a power of appointment may limit what might otherwise be a fee simple disposition to a life estate in the donee with language such as "my farm to my son A with a power to bequeath the same to his children as he may decide."

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[15] *See* Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. TAX'N 242 (1988), *updated and reprinted* in 24 REAL PROP. PROB. & TR. J. 75 (1989) (presenting a way to achieve the tax effects of a general power by the manner in which the donee of a non-general power exercises it).

[16] *See, e.g.*, Priv. Ltr. Rul. 02-10-038 (Mar. 8, 2002).

[17] *But see* Wolfe v. Shelley, (1581) 76 Eng. Rep. 206 (K.B.); 1 Co. Rep. 936 (providing that under the common law rule in Shelley's Case, a life estate with a remainder in the life estate holder's heirs would automatically convert to a fee simple estate).

D. Presently Exercisable versus Postponed Powers

If a power (whether general or special) is exercisable at the time in question, this power of appointment is "presently exercisable." A power is considered presently exercisable even if it is exercisable in the future as well (for example, by the donee's will).[18] However, sometimes a donee of a power presently exercisable and a power exercisable in the future (for example, by will) may qualify as holding two different powers of appointment. Lifetime powers may be exercisable immediately or may be postponed until the occurrence of a certain event (for example, when the donee has reached a particular age).

If a power (whether general or special) is not exercisable at the time in question, this power of appointment is "postponed." A power exercisable by will (that is, a "testamentary" power) is always a postponed power—in this case, by definition, until the donee dies.[19]

Different tax, debtor-creditor, and property law implications may exist depending upon when and how the power is exercisable. For example, section 674(b)(3), which creates an exception to the grantor trust rule of section 674(a), provides that a trust is not a grantor trust if the grantor or a non-adverse party retains a power, "exercisable only by will," to control the beneficial enjoyment of trust property, so long as the power does not apply to trust income.[20] A lifetime power of appointment does not qualify for this exception, and, at least arguably, a power that takes effect upon the donee's death but is exercisable by deed (that is, by an instrument other than by will) would not be within the scope of section 674(b)(3) either.

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[18] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.4 cmt. a (2011).

[19] *See id.* § 17.4 cmt. d. Whether a power is presently exercisable or postponed, an instrument exercising the power should be drafted to give appropriate notice and direction to the trustee, for example:

> Under paragraph X of Article XX of a trust instrument executed by my spouse and known as the Jane Doe Trust, I am given a testamentary power of appointment as to all property constituting the trust at the time of my death. If I survive my spouse, I hereby exercise that power by appointing all property over which I have power of appointment under that paragraph, *per stirpes*, to my descendants living at my death.

[20] I.R.C. § 674(b)(3).

E. Relation Back Doctrine

The "relation back" doctrine treats the exercise of a power of appointment by the donee as a delayed transfer by the donor.[21] The power relates back to the act of the donor in establishing it, as if the donee were acting as the agent of the donor to transfer the property to the appointee (or, as it is sometimes put, as if the donee is filling in a blank in the donor's original instrument).[22] This doctrine can have important administrative and jurisdictional consequences. For example, in most states the doctrine means that any applicable Rule Against Perpetuities period begins the date of the donor's original transfer, regardless of the donee's subsequent appointment. The doctrine may mean that when the donee exercises the power by will and appoints it to a testamentary trust, the court where the donor's will is probated will have primary jurisdiction over the trust created by the exercise of the power. Additionally, the doctrine has supported an appointee's right of action against a trustee for breach of fiduciary duties, even for acts that predate the appointment.[23]

The relation back doctrine may also have tax effects, at least for nongeneral powers.[24] For example, in *Self v. United States*,[25] the Court of Claims held that the exercise of a nongeneral power of appointment during the donee's lifetime was not a taxable gift by the donee, even though it resulted in the loss of a present income interest by the donee, because the court treated the donor and not the donee as transferor of the property.[26]

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[21] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 17.4 cmt. f (2011).

[22] *See, e.g.*, Dant v. Fid. & Columbia Trust Co., 193 S.W.2d 399 (Ky. 1946); *In re* Harbeck's Will, 55 N.E. 850 (N.Y. 1900). The doctrine dates back at least to the early nineteenth century, as described in the *Commentaries on American Law* by Chancellor James Kent: "The party who takes under the execution of the power, takes under the authority, and under the grantor of the power, whether it applies to real or personal property, in like manner as if the power, and the instrument executing the power, had been incorporated in one instrument." 4 JAMES KENT, COMMENTARIES ON AMERICAN LAW 331 (4th ed. 1830).

[23] *See* Smith v. Bank of Clearwater, 479 So. 2d 755 (Fla. Dist. Ct. App. 1985).

[24] The donee of a general power is the owner of the property for tax purposes, which eliminates any complications arising from the relation back doctrine. *See* I.R.C. §§ 2041(a)(2), 2514(b).

[25] 142 F. Supp. 939 (Ct. Cl. 1956).

[26] *See id.* at 942. The Court of Claims noted specifically that "[a]t common law, the transfer of property under a power of appointment was considered to have been made directly from the donor to the appointee. The donor's instrument effected the transfer and the property did not belong to the donee." *Id.* at 940. *But see* Estate of Regester v. Comm'r, 83 T.C.M. (CCH) 1, 8 (1984). This subsequent Tax Court case reaches a contrary result, so *Self*

III. EXERCISING POWERS OF APPOINTMENT

A. Class of Appointees

A power of appointment is exercisable only in favor of the "proper" potential appointees. This "class" of appointees is a question of construction. It may be quite narrow (for example, "my descendants living when the donee dies") or broad (for example, "anyone," which likely will be a general power because the donee is not excluded as an appointee). If the class of appointees is indefinite or indeterminate, the power may be invalid on grounds of impossibility (for example, "to such lawyers who are smarter than Richard B. Covey" or "for the benefit of any and all men and women among my employees and acquaintances known to my said trustees to have been loyal to me").

In some situations, questions of construction of the class will occur. A common example is if the class of potential appointees is or includes "my nieces and nephews" because many clients consider the nieces and nephews of their spouse as their own nieces and nephews. Perhaps surprisingly, the term "children" has sometimes been construed to mean "descendant" and, therefore, could include grandchildren or more remote descendants.

B. Manner of Exercise

As a general rule, a donee may exercise a power in any manner in which a direct owner could dispose of the property over which the power applies. This power generally includes transfers in further trust unless the power indicates otherwise.

An attempted exercise may be found invalid if it violates an applicable property rule such as the Rule Against Perpetuities. For example, the donee exercises the power in further trust granted to the donee under the will of the donee's predeceased parent with the "new" trust to end upon the death of the survivor of the donee's descendants living when the donee dies (rather than those living when the donor died).[27]

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may no longer be good law. In Priv. Ltr. Rul. 02-43-026 (Oct. 25, 2002), the Internal Revenue Service (Service) cited Rev. Rul. 79-327, 1979-2 C.B. 342, and noted that it had held that an individual's exercise of a special power of appointment resulted in a gift of income interest under section 2511. In particular, the Service explained that "To the extent it is contrary to the regulations, the Service will not follow *Self*, where the court reached a contrary conclusion regarding the gift of a life interest upon the exercise of a special power of appointment."

[27] This particular problem may be avoided, however, through the use of an appropriate savings clause, for example: "With respect to a trust or fund created with property received

C. Methods of Exercise

Whether the donee has exercised a power of appointment hinges upon a finding of whether the donee (1) intended to exercise it, and (2) complied with any rules specified by applicable state law or conditions specified by the donor (such as requiring that the power may be exercised only by specific reference to the power). While clear intent to exercise the power must exist, such intent may be implied. Implied intent may occur, for example, by a disposition in a will of the property subject to the power—such as stock in a closely held business or specified land—or by the amount of the disposition. A general residuary clause in the donee's will typically does not manifest an intent to exercise any power held by the donee "unless the power in question is a general power and the donor did not provide for takers in default or the gift-in-default clause is ineffective."[28] Moreover, in some cases, substantial compliance with the requirement of exercise will suffice to constitute a valid and effective exercise.

A donee may exercise a power either through a specific, blending, or blanket exercise clause. A specific exercise clause appoints and disposes of property subject to the power of appointment by itself (for example, "I hereby exercise the power of appointment I hold under Article Six of the Will of my father, George, who died on January 8, 1972, which was duly admitted to probate by the Surrogate's Court of Nassau County, New York, on January 28, 1972, as follows:"). A blending exercise clause appoints the property subject to the power of appointment is appointed with other property transferred (for example, "I leave my residuary estate and the property under my late mother's will over which I hold a power of appointment to my spouse"). This blending exercise of the power may be a general exercise of any power of appointment or a specific exercise (to one or more powers specifically identified). Finally, a blanket exercise clause appoints the property without specific reference to the specific power (for example, "including any property over which I have a power of appointment").

The donor commonly requires the donee to make specific reference to the power for the donee to be able to exercise it. If the donor does so, then an attempt to exercise the power without meeting the specific reference requirement will not successfully exercise the power. Thus, by including a specific reference requirement, a donor effectively provides that the donee's intent to exercise will not be implied.

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as a result of this exercise of my power of appointment, such trust or fund shall terminate no later than . . . [reference the perpetuities period from the original trust instrument]."

[28] RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 19.4 (2011).

On the donee's side, specific and blanket non-exercise statements may ensure that the donee does not exercise a power without an express statement. Because a power is sometimes exercisable by a residuary disposition in a will and because the donee may acquire a power after having executed the will, a blanket non-exercise provision is usually appropriate (for example, "I give my residuary estate, *which shall not include any property over which I have power of appointment*, as follows . . .").

An exercise of a power of appointment may be conditional (for example, "if my spouse survives me, then I hereby exercise the special power of appointment granted to me under the XYZ Trust in favor of my spouse"). Although a situation in which the power would not be otherwise exercised—such as if the donee's spouse does not survive the donee—seems unlikely, the practice of either conditioning the exercise on more "complete" language (for example, "if *but only if* my spouse survives me") or adding language (for example, "if the condition is not present, the power should be deemed not exercised") may be preferable.

As a general rule, a donee cannot revoke or amend the exercise of a power unless the donee retains such a right in the instrument exercising the power. A donee retains such a right if the exercise is by the donee's will, as the will is of no legal effect until the donee's death.

An exercise in favor of a deceased appointee usually will not be an effective exercise. However, an antilapse law may deem the power exercised in favor of the descendant of an appointee. A power of appointment may be exercisable in favor of the descendants of a deceased appointee, even if such descendants are not within the class of permissible appointees, unless the donor has manifested a contrary intent.

D. Capacity to Exercise

A donee has the capacity to exercise a power of appointment only if the donee has sufficient capacity such that the donee could dispose of the property if the donee directly owned it. For example, if the power is exercisable by will, then the donee will have the capacity to exercise it only if the donee has the capacity to execute a will. If the power is exercisable during life, the donee must have the legal capacity to make a binding gratuitous transfer. The law of the donee's domicile, rather than that of the domicile of the donor, normally determines whether the donee has sufficient capacity and whether the exercise is effective.

As a general rule, a legal representative of a donee may exercise a power of appointment unless the donor has specified otherwise, but only if the representative could dispose of the property if directly owned. For example,

the donee's legal representative (such as a guardian), cannot execute a testamentary power of an incapacitated donee unless under state law a legal representative can execute a will for the represented person.

In some cases, specifying in the instrument granting the power whether a legal representative may exercise a power of appointment conferred upon the donee may be appropriate. Furthermore, the use of an express provision in any power of attorney indicating whether the agent may or may not exercise any power of appointment the donee holds may be appropriate.

A donee need not, however, submit a will exercising a testamentary power to probate or a legal probate estate opened for the donee solely to effectively exercise the power (though independent reasons for seeking to open a probate estate may exist). If the donee submits the will under which the power of appointment is exercised for probate, however, denied admission of the will deems the power not effectively exercised.

E. Releases and Disclaimers of Powers of Appointment

Unless the donor has manifested intent to the contrary, a donee may release a power of appointment in whole or in part. A donee, for example, can release a portion of a general power to make it nongeneral for transfer-tax planning or other reasons. Note, however, that such a release may be a taxable event and may not prevent the donee's continued treatment as holder of a general power of appointment. A donee may disclaim a power as a matter of common law, although almost all jurisdictions have statutes expressly dealing with disclaimers including disclaimers of powers of appointment.[29]

F. Contracts to Exercise a Power of Appointment

A contract to exercise or not exercise a general power of appointment is enforceable as long as such contract is otherwise valid and enforceable under applicable law. A contract otherwise valid and enforceable under applicable law to exercise or not exercise a nongeneral power of appointment is enforceable unless the exercise would be in favor of an impermissible appointee. These rules apply whether the power is presently exercisable or not.

G. Failure to Exercise

If a purported exercise of a power of appointment is ineffective for any reason, property over which the appointment was exercised usually will instead pass to the takers-in-default. However, partially ineffective exercises

[29] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 2-1.11 (McKinney 2012).

receive other treatment because the effective portion of the appointment may be followed while the ineffective portion is disregarded. For example, in an exercise in favor of the donee's spouse for life with remainder over to the donee's then-living descendants where only the descendants (and not the spouse) are permissible appointees, the remainder over to the descendants usually will be effective but the vesting of the remainder will be postponed until the death of the spouse even though the takers-in-default, and not the spouse, receive the property interest during the spouse's life.[30]

If the exercise of a general power is not effective, the power will pass as part of the donee's estate absent an effective taker-in-default. If a nongeneral power is not effectively exercised and no taker-in-default exists, the property will pass to the potential appointees if they constitute a defined, narrow class, or the property will revert to the donor. For these reasons, identifying the takers-in-default and not simply relying on the assumption they will be the residuary takers under the donee's own estate plan is important. If the donor wants the donee's residuary takers to be the takers-in-default, the donor should expressly state this intention, but this express statement may cause the appointive property to be subject to claims of the donee's creditors.

IV. TAX FACTS AND TRAPS FOR THE UNWARY

A. Basic Code Structure: Sections 2514 and 2041

1. Estate Tax

Property over which a decedent holds a general power of appointment is included in the gross estate of the donee unless it was a general power created on or before October 21, 1942 and is not exercised (or was partially released or otherwise converted to a nongeneral power before November 1, 1951).[31] A power to consume, invade, or appropriate the property pursuant to an ascertainable standard relating to health, education, maintenance, and support is not a general power.[32] A power exercisable only with the consent of the donor or an adverse party is not a general power of appointment.[33]

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[30] *See* RESTATEMENT (THIRD) OF PROP.: WILLS AND DONATIVE TRANSFERS § 19.20 (2011). In addition to attempted appointments to impermissible recipients, partially ineffective appointments may include, for example, those that would violate the applicable Rule Against Perpetuities, in which case the present interest may be effective while the remainder, to the extent it exceeds the perpetuities period, fails.

[31] *See* I.R.C. §§ 2041(a)(1)(A)–(B).

[32] *See* I.R.C. § 2041(b)(1)(A).

[33] *See* I.R.C. § 2041(b)(1)(C).

Property over which a decedent-donee holds a nongeneral power is not included in his or her gross estate unless it meets the following criteria: (1) the power was created after October 21, 1942; (2) the power is exercised by will or by a disposition such that if the donee owned the property outright it would be included in the donee's estate under section 2035, 2036, or 2037; and (3) the power is exercised to create "another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."[34] This is known as the "Delaware Tax Trap."

"Springing the Delaware Tax Trap"—for example, by exercising the power in further trust and giving the beneficiary of that trust a presently exercisable general power of appointment—will commence a new perpetuities period, at least in any jurisdiction that still has a version of the Rule Against Perpetuities in force. This allows the donee to shift property into the donee's gross estate to secure a "step up" in basis under section 1014 or to avoid the application of GST tax.[35]

2. Gift Tax

The exercise or release of a general power of appointment by the donee is a gift by the donee if the appointed property passes to someone other than the donee.[36] As with the estate tax rule, a power to consume, invade, or appropriate the property pursuant to an ascertainable standard relating to health, education, maintenance, and support is not a general power.[37] A power exercisable only with the consent of the donor or an adverse party is not a general power of appointment.[38]

This gift, however, may be incomplete under Treasury Regulation section 25.2511-2.[39] Nonetheless, the property subject to the power will be included in the donee's gross estate. In fact, exercising or releasing a general power will cause estate tax inclusion in the estate of the donee if the exercise or release occurs in a manner so that property transferred by the donee

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[34] I.R.C. § 2041(a)(3).

[35] *See* Blattmachr & Pennell, *supra* note 15.

[36] *See* Treas. Reg. § 25.2514-1(a).

[37] *See* Treas. Reg. § 25.2514-1(c)(2).

[38] *See* Treas. Reg. § 25.2514-3(b)(1)–(2).

[39] *See* Treas. Reg. § 25.2511-2; Diana S.C. Zeydel, *When is a Gift to a Trust Complete—Did CCA 201208026 Get it Right?*, 117 J. TAX'N 142 (2012).

would be included in his or her estate under section 2035, 2036, 2037, or 2038.[40]

Granting a beneficiary a unilateral power to withdraw property transferred to a trust—a type of general power of appointment—may allow the transfer to qualify as a completed gift for the gift tax annual exclusion under section 2503(b) and as a non-taxable transfer for GST tax purposes under section 2642(c).[41] A lapse of such a power to withdraw or any other general power is treated as a release and therefore may be a taxable gift by the appointee who let the withdrawal power lapse, but only to the extent for the calendar year that it exceeds the greater of $5,000 or 5% of the property over which the power is exercisable.[42]

The exercise of a nongeneral power can constitute a gift in at least two circumstances: (1) the springing of the Delaware Tax Trap as described above[43] and (2) the donee gives up an interest in the property, such as an income interest.[44]

B. Disclaimers and Releases

A donee may disclaim a power of appointment pursuant to section 2518 without the disclaimant being treated as making a gift.[45] Among other conditions, the donee must effect the disclaimer upon the earlier of nine months after the creation of the power of appointment (and completion for gift tax purposes) or nine months after the donee's reaching of the age of twenty-one years.[46]

Any permissible appointee (or taker-in-default) under a nongeneral power also may disclaim an interest in the appointed property, but only if the appointee makes the disclaimer within the earlier of nine months after the power of appointment's creation (and completion for gift tax purposes) or nine months after the purported donee reaches the age of twenty-one

[40] *See* I.R.C. §§ 2041(a)(1)(B), 2041(a)(3)(b); *see also* de Oliveira v. United States, 767 F.2d 1344 (9th Cir. 1985).

[41] *See* Diana S.C. Zeydel, *How to Create and Administer a Successful Irrevocable Life Insurance Trust*, EST. PLAN., June 2007, at 3. *See generally* Georgiana J. Slade, 807-2d Tax Mgmt. Portfolio (BNA), *Personal Life Insurance Trusts* (2009).

[42] *See* I.R.C. §§ 2041(b)(2), 2514(e).

[43] *See* I.R.C. § 2514(c)(3).

[44] *See, e.g.*, Estate of Regester v. Comm'r, 83 T.C.M. (CCH) 1 (1984). *But see* Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956).

[45] *See* Treas. Reg. § 25.2518-3(a)(1)(iii).

[46] *See* Treas. Reg. § 25.2518-2(c)(1)(i)–(ii).

years.[47] This requirement can be surprising in many cases because a potential appointee who otherwise holds no current or future interest in the property must still disclaim the right within the specified period or any later disclaimer will be treated as a gift.[48] For broad nongeneral powers (for example, "to any person or organization other than the donee, the donee's estate, or the creditors of either"), it would be impossible for administrative reasons alone, for all permissible appointees to effectively disclaim within the required period. For general powers of appointment, however, this rule does not apply and only the donee of the power need disclaim.[49]

As discussed above, a release, as indicated above, as opposed to a qualified disclaimer, may have gift or estate tax consequences. In addition, special rules may apply to releases or disclaimers of powers under any power of appointment created before 1942.[50]

C. Powers of Appointment and the Marital Deduction

A property transfer whereby a property owner provides a spouse with an income interest for life coupled with a general power of appointment exercisable in favor of the property owner's spouse or the spouse's estate may qualify the property for the estate or gift tax marital deduction.[51] A property transfer under which a property owner provides a spouse with an income interest for life may qualify the property for the estate or gift tax marital deduction by election as QTIP, but only if, among other conditions, the spouse has no lifetime power of appointment other than one exercisable exclusively to the spouse.[52]

Under section 2523(b)(2), a transfer will not qualify for the gift tax marital deduction "if the donor immediately after the transfer to the donee spouse has a power to appoint an interest in such property which he can exercise (either alone or in conjunction with any person) in such manner that

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[47] *See* Treas. Reg. § 25.2518-2(c)(3)(i).

[48] *See* Treas. Reg. § 25.2518-2(c)(5) ex. 1.

[49] *See* Treas. Reg. § 25.2518-2(c)(5) ex. 2.

[50] *See* Treas. Reg. §25.2514-2. When the transfer tax consequences of general powers of appointment were significantly broadened in 1942, the predecessor to section 2514(a) was added as a grandfathering rule for many existing instruments. Specifically, the release or nonexercise of a general power granted on or before October 21, 1942, is not considered an exercise of a general power for federal gift tax purposes. A partial release of such a power to convert it into a nongeneral power before November 1, 1951, followed by subsequent exercise, also is protected from characterization as a general power.

[51] *See* I.R.C. §§ 2056(b)(5), 2523(e).

[52] *See* I.R.C. §§ 2056(b)(7), 2523(f).

the appointee may possess or enjoy any part of such property after such termination or failure of the interest transferred to the donee spouse."[53] For purposes of this provision, the donor is considered to retain such a power after the transfer to the donee spouse, "even though such power cannot be exercised until after the lapse of time, upon the occurrence of an event or contingency, or on the failure of an event or contingency to occur."[54]

This odd provision has been in the Code since the enactment of the marital deduction in 1948.[55] It appears, on its face, that if a wife creates a QTIP trust for her husband and retains a power of appointment—even a nongeneral power—exercisable after her husband's death, the transfer fails to qualify for the marital deduction even though the terms otherwise required under section 2523(f) are present, and no one else can enjoy the property until after the husband has died.[56] However, two statements in the legislative history to the Economic Recovery Tax Act of 1981,[57] under which QTIPs could first qualify for the marital deduction, provide that the spouse who creates a QTIP trust may retain a power to control disposition of the property after the spouse for whom the trust was created dies.[58] Private Letter Rulings from the Internal Revenue Service (Service) provide analysis to the same effect.[59]

To reconcile this conflict, remember that a power of appointment the grantor creates for himself or herself is not a power of appointment for federal gift tax purposes (although it is such a power for property law purposes). Rather, this power allows the grantor to control the beneficial enjoyment of the property, usually triggering estate tax inclusion under section 2036(a)(2).[60] Hence, section 2523(b)(2) would apply only if the spouse making the transfer to a QTIP trust holds a power of appointment granted by someone else, such as a parent.[61] Apparently, the drafters of the 1948 Act felt a special rule was necessary to cover such powers of appointment

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[53] I.R.C. § 2523(b)(2).

[54] *Id.*

[55] *See* Revenue Act of 1948, ch. 168, § 361, 62 Stat. 110 (codified as amended in scattered sections of I.R.C.).

[56] *See* I.R.C. § 2523(f).

[57] *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (codified as amended in scattered sections of I.R.C.).

[58] *See* H.R. REP. NO. 97-201, tit. IV, at 160–63 (1981), 1981-2 C.B. 352, 378.

[59] *See* Priv. Ltr. Rul. 04-06-004 (Oct. 31, 2003); Priv. Ltr. Rul. 94-37-032 (June 20, 1994).

[60] *See* I.R.C. § 2036(a)(2).

[61] *See* I.R.C. § 2523(b)(2).

because of the understanding, mentioned above, that a power of appointment is something other than an interest in property.[62]

D. Section 678: Presently Exercisable General Power and Income Tax

Under section 678 (part of the so-called "grantor trust" rules), to the extent a taxpayer who did not create a trust has the unilateral right to withdraw the income or corpus of the trust, the income, deductions, and credits of the trust are attributable to the taxpayer unless such income, deductions, and credits would otherwise be attributable to the grantor.[63]An identical rule applies when a taxpayer has partially released or otherwise modified such a power to withdraw, but retained sufficient interest in the trust such that the income would be attributed to the taxpayer if the taxpayer were the grantor. Hence, a unilaterally exercisable general power of appointment will trigger grantor trust status under section 678.[64] However, many issues relating to section 678 remain unresolved.[65] For example, whether a trust beneficiary who "partially releases" a power for purposes of section 678 should ever be treated as making a gift is not clear. Section 678 refers to a release "within a reasonable time," not to a qualified disclaimer, and it seems likely that a section 678 release that does not conform to the qualified disclaimer rules, even if made within a "reasonable time," could have gift tax consequences.[66]

E. An Attempt at "Portability" Before Portability Through General Powers

In 2011 and 2012, Congress gave a surviving spouse the ability to "inherit" the predeceasing spouse's unused exemption equivalent under portability.[67] In 2013, Congress made portability permanent.[68] Previous attempts

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[62] See Jonathan G. Blattmachr, Diana S.C. Zeydel & Mitchell M. Gans, *The World's Greatest Gift Tax Mystery Solved*, 115 TAX NOTES 243 (2007), for further explanation of section 2523(b)(2). *See also IRC Sec 2523(f)—Lifetime Qualified Terminable Interest (QTIP) Trusts and Permissible Principal Interests of Donor Spouse*, PRAC. DRAFTING 8881 (Richard B. Covey ed., 2007).

[63] *See* I.R.C. § 678(a)–(b).

[64] *See id.*

[65] *See generally* Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009). Additionally, whether section 678 has a "springing" effect and is operative as to a beneficiary as soon as grantor trust status ceases as to the actual grantor (for example, at the grantor's death) is unresolved. The Service has issued conflicting guidance on this question in the past. *See* Priv. Ltr. Rul. 90-26-036 (June 29, 1990); Priv. Ltr. Rul. 93-21-050 (May 28, 1993).

[66] *See* I.R.C. 678.

[67] *See* I.R.C. § 2010(c).

to use or preserve the unused estate tax exemption of a spouse include having the surviving spouse's revocable trust grant a general power of appointment to the first spouse to die upon his or her death. Whether such an arrangement effectively achieves its goal is uncertain.[69]

V. PLANNING OPPORTUNITIES WITH POWERS OF APPOINTMENT

A. Flexibility

Few powers relating to the flexibility in disposing of property are greater than a power of appointment. As described previously, the exercise of a power of appointment can change the substantive and administrative provisions of a trust, including the beneficiaries, the method of receiving property (for example, outright or in trust), the trustees, the fiduciary powers, the governing law, fiduciary compensation, and the length of time a trust will last.

B. Different Needs and Benefits

Arming a beneficiary with a power of appointment may allow the beneficiary to choose to address different needs and to provide different benefits or rewards to potential appointees. The donee can custom tailor what each appointee should or should not receive and how it will be received (for example, outright or in trust with different trust provisions for different appointees). Placing property in trust may be critically important for some because of mental or physical disability, eligibility to governmental benefits, creditor claims (including those that may arise in a divorce), substance abuse, or the beneficiary's imprudence in managing property. Or, if appropriate, the donee may condition the exercise in favor of an appointee (such as a descendant) on the appointee entering into a prenuptial or postnuptial agreement. Moreover, the donor may condition any exercise in favor of the donee's spouse on the donee and his or her spouse entering into a prenuptial or postnuptial agreement that an independent trustee determines is adequate to protect the donee from spousal claims.

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[68] *See* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 101(c)(3)(a), 126 Stat. 2313, 2318 (2013).

[69] *See generally* Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP. PROB. & TR. J. 413 (2007).

C. King Lear Effect

Perhaps the next best thing to owning a lot of wealth is controlling it. A power of appointment provides that benefit to the donee. To ensure that the donee does not exercise the power in an inappropriate manner, the donor can make the power exercisable only with the consent of a non-adverse party. If the power is exercisable with the consent of an adverse party, the granting of such consent may be a gift by that party. The non-adverse party could be a trustee. However, some lawyers think having the trustee consent (or refuse to consent) to the exercise could cause potential fiduciary liability for the trustee. Therefore, to obviate that risk, the power to consent can instead be given to a trust protector or other party who acts only in a non-fiduciary capacity. In any event, whether the non-adverse party is or is not acting in a fiduciary capacity should be explicit, bearing in mind that if the non-adverse party is a fiduciary, fiduciary duties may apply in all cases, even if the instrument attempts to provide otherwise.

Requiring the donee to obtain the consent of a non-adverse party may prevent what might otherwise be viewed as an improper exercise. In some cases, permission from a non-adverse party may be required only with respect to certain situations, such as an attempt to appoint the property outright or to give an appointee a further power to appoint, or where the exercise would trigger the imposition of GST tax or forfeit the grandfathering of a tax benefit.

D. How Broad the Power of Appointment

The class of appointees under a nongeneral power may be very narrow or broad. Often, the class includes, and may be limited to, the donor's descendants. Other times, the class includes anyone other than an appointee who would make it a general power (that is, the donee, the donee's creditors or estate, or the creditors of the donee's estate), unless a compelling reason exists to make it a general power to trigger the property's inclusion in the donee's estate for Federal estate tax purposes—to garner a "step up" in basis or to avoid a GST tax.

It is surprising that many property owners who initially intended to gift or bequeath wealth outright to descendants or to give those descendants withdrawal rights at particular ages choose to limit the class to whom a descendant may appoint property once subsequently deciding to place the gift or bequest in trust.

Often, the donor will limit the class of appointees to his or her descendants. On occasion, the donor will also permit appointment to a spouse of a descendant but will often restrict the benefit conferrable to a spouse to an

income interest or to distributions for an ascertainable standard only such as support, maintenance, or health. Not infrequently, the class of appointees may include one or more charities. In some circumstances, the authority to exercise the power (in some cases alone and in others only with the consent of a non-adverse party) will be granted or broadened depending upon matters such as whether the donee or the donor has any descendant in being or not.

E. Restrictions on Exercise

Traditionally, an exercise of a power of appointment intended to take effect at the donee's death became exercisable only by a probated will. Requiring a will's admission to probate to effectuate power, however, may significantly complicate the exercise by introducing unnecessary cost and delay—particularly if the probate process triggers a will contest—and by making the disposition public when it could have been accomplished through a private instrument. Therefore, allowing the exercise of the power also by deed or other instrument, including the decedent's will may be preferable, leaving the decision to probate such document to a fiduciary's discretion.[70]

F. Some Blending Issues; Multiple Powers

If the appointive property is blended with the donee's own property, local law might require special language to comply with any relevant restrictions. For example, if either the donee's own property or the appointive property, or both, is subject to a Rule Against Perpetuities limitation, the disposition may need additional language instructing the trustee receiving the appointive property and the donee's own property to hold appointive and owned properties separately and to utilize a separate Rule Against Perpetuities limitation for each, although authorizing the trustee to manage the assets jointly. In such a case, directing that the property distributed by the trustees to a beneficiary qualify as initially coming from the source that has the shortest Rule Against Perpetuities limitation may be appropriate. Similar issues arise for a donee exercising more than one power such as one granted by the donee's mother and another by the donee's father.

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[70] For example: "In determining whether a testamentary power of appointment has been exercised, the trustee, without liability (unless there is proof of bad faith), may rely on a will believed by the trustee to be the will of the holder of the power of appointment, assume that the holder left no will in the absence of actual knowledge of one within three months after the holder's death, or require that any will purporting to exercise a power be admitted to probate."

G. Extending a Trust Term

One of the most common uses of a power of appointment is to extend the term of the trust, such as when property otherwise would pass outright to grandchildren upon reaching a certain age. In addition, by exercising a special power of appointment in further trust (assuming the beneficiary does not hold a general power and the exercise does not spring the Delaware Tax Trap), the donee may be able to postpone the time when the property will be subject to estate or gift tax. Even if the appointed trust is subject to the Rule Against Perpetuities, extending the term for a significant period may be possible by using as the "measuring lives" a reasonable number of individuals born just after the perpetuities period of the original instrument began, even if those individuals are not beneficiaries of the trust or otherwise related to the donor or donee.

At common law, no restriction existed on the class of persons that could be measuring lives for purposes of complying with the Rule Against Perpetuities, so long as the lives used in the instrument of transfer were identifiable in order to obtain proof of the deaths of the individuals taken as measuring lives.[71] English law permitted a class consisting of all the lineal descendants of Her Late Majesty Queen Victoria, which at the time people thought to include approximately 120 known descendants.[72] Accordingly, at common law, no requirement existed that the measuring lives be related to the beneficiaries of the trust, and use of a class of unrelated measuring lives to determine the duration of a trust was permissible.

As discussed later in this Article, extending the term of a grandfathered trust in some circumstances can cause the loss of a GST exemption, but exercising a special power of appointment not held as a fiduciary (as opposed, perhaps, to a decanting power) and using the lives of unrelated persons born before the perpetuities period with respect to the commenced grandfathered trust should not cause a loss of GST grandfathering.

H. Granting Successive Powers

If property would otherwise continue in trust without the successor beneficiaries having a power of appointment, the donee may find it prudent to exercise the donee's power of appointment to give the successors their own powers of appointment. Under the law of some jurisdictions, the donee may

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[71] *See* Thellusson v. Woodford, (1805) 32 Eng. Rep. 1030; (Ch.) 11 Ves. Jr. 112; RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 1.3 note 3 (1983); JOHN CHIPMAN GRAY, THE RULE AGAINST PERPETUITIES § 217 (4th ed. 1942).

[72] *See In re* Villar, [1929] 1 Ch. 243 (C.A.).

make the power granted exercisable in favor of appointees who were not within the class of potential appointees of the original power. Similarly, a trustee exercising a decanting power may grant a power of appointment to a beneficiary who otherwise did not have such a power, or the trustee may expand any power the beneficiary does hold.

I. Effecting "Generation Jumping"

If a transferor gives or bequeaths property to a grandchild, a more remote descendant of the transferor, or a person or a trust assigned to the generation of a grandchild or more remote descendant, the law might impose both a gift or estate and a GST tax. Moreover, each time property in a trust that is not otherwise exempt from GST tax moves to benefit one younger generation (that is, someone in the generation of grandchildren of the donor or a more remote descendant), the law imposes a new GST tax. Unlike estate tax, no prior transfer credit exists for GST tax purposes.[73]

However, the law will only impose one GST tax regardless of the number of younger generations over which the taxpayer transfers property at a single time. For example, when a child dies, rather than having the property benefit grandchildren initially, a taxpayer can avoid a GST tax when the grandchildren die by having the property, after the child dies, initially benefit only great-grandchildren. This effect is called "generation jumping."[74] If a child whose death would cause a GST tax holds a special power of appointment, the child may exercise the power of appointment to effectuate generation jumping by providing for the property to be held for the exclusive benefit of the child's most remote descendants for a period of time.

J. Reciprocal Trust Doctrine and Special Powers of Appointment

When two taxpayers create "reciprocal" trusts for each other, those trusts will be "uncrossed" for tax purposes. The law treats each taxpayer as creating the trust for his or her own benefit for certain federal tax purposes. Among other things, this doctrine can cause the property in the trusts to be included in the gross estate of the beneficiary even though, in fact, the beneficiary did not create it.[75] However, in *Estate of Levy v. Commissioner*,[76] the United States Tax Court found the reciprocal trust doctrine did not apply to the assets in the trust Mr. Levy's wife created for him because he had grant-

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[73] *See* I.R.C. § 2013(a) (providing a credit for estate tax on prior transfers).

[74] *See generally* Jonathan G. Blattmachr, *Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation*, CHASE REV. (Spring 1996).

[75] *See, e.g.*, Grace v. United States, 395 U.S. 316 (1969).

[76] 46 T.C.M. (CCH) 910 (1983).

ed her a broad lifetime nongeneral power of appointment over the trust he created for her and she did not grant him such a power in the trust she created for him.[77]

If the trusts might otherwise be reciprocal, granting a lifetime special power to the beneficiary of one trust but not the other may prevent the doctrine from applying. However, taxpayers should also consider adding other differences in the trusts.[78]

VI. SPECIAL ISSUES FOR FIDUCIARIES AND CREDITORS

A. Rights of Creditors of the Donor or Donee

Property subject to a nongeneral power of appointment is not subject to the claims of creditors of the donee, or for the expenses of administering the estate of the donee, whether the power is presently exercisable or not. For general powers, whether the property is subject to creditors may depend on whether the donor created the power in himself or herself (that is, the donor retained a general power), or granted the power to someone else. In the former case, property subject to the power is subject to the claims of creditors of the donor or donee to the same extent it would be subject to such claims if the property were still directly owned by the donor. In the latter case, however, property subject to a general power is no longer subject to the claims of the donor's creditors and may or may not be subject to the claims of creditors of the donee, depending upon applicable state law and in some jurisdictions, only if the power is exercised.[79] To avoid attachment, it may be appropriate to form the trust over which the general power is granted under the law of a state that does not make the property subject to the claims of the donee's creditors.

Under the law of some states, a power exercisable by the donee only for his or her health, education, maintenance, and support is not subject to attachment by the donee's creditors, although property otherwise subject to a general power is subject to the donee's creditors' claims.[80]

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[77] *See id.* at 912.

[78] *See generally* Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust,[sm]* PROB. & PROP., July-Aug. 2007, at 52.

[79] For the modern rule that property subject to a general power is exposed to the donee's creditors, see RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 22.3 (2011). The approach of the Third Restatement deliberately diverges from the Second Restatement and prior common law, under which property subject to a general power was unavailable to the donee's creditors as long as the power went unexercised.

[80] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-7.2 (McKinney 2002).

In some states, the "estate" against which a surviving spouse may be entitled to a minimum share, often called an "elective share," includes property over which the deceased spouse held a general power of appointment.[81]

B. Fiduciary Powers of Appointment

Historically, the line has not always been clear between a power of appointment and fiduciary or trustee powers as ordinarily conceived. Can a power of appointment be granted to, and held by, a trustee or other fiduciary under one instrument? If so, is the power then held in a fiduciary capacity (that is, is the powerholder subject to potential fiduciary liability for the decision to exercise, or not to exercise, the power)? The Second Restatement of Property took the position that a power of appointment could be held in a fiduciary capacity.[82] Nevertheless, the Second Restatement made a distinction between personal and fiduciary powers, which may explain why the Third Restatement provides that "[a] fiduciary distributive power is a power of appointment . . . but it is not a discretionary power of appointment."[83] The Third Restatement further explains this distinction by noting that,

> [i]n the case of a discretionary power of appointment . . . the donee may exercise the power arbitrarily as long as the exercise is within the scope of the power. In the case of a fiduciary distributive power, the fiduciary's exercise is

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[81] *See* UNIF. PROBATE CODE § 2-205(1) (amended 2010), 8 pt. 1 U.L.A. 94–95 (Supp. 2012).

[82] *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 (1986). Section 19.3 further provided that a power of appointment may be exercised by a trustee to appoint property in further trust. *See id.* § 19.3

[83] RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011), defines fiduciary distributive powers as including

> a trustee's power to distribute principal to or for the benefit of an income beneficiary, or for some other person, or to pay income or principal to a designated beneficiary, or to distribute income or principal among a defined group of beneficiaries. Unlike [the exercise of a] power of appointment, a fiduciary distributive power does not lapse upon the [death] of the fiduciary . . . but survives in a successor fiduciary. Nevertheless, a fiduciary distributive power, like a discretionary power of appointment, cannot be validly exercised in favor of or for the benefit of someone who is not a permissible appointee . . . and is subject to [a common-law or statutory rule relating to perpetuities] under the same rules applicable to a . . . nongeneral power of appointment.

> subject to fiduciary obligations as provided in the Restatement Third of Trusts.[84]

As suggested by the phrasing of the Third Restatement, powers held by a fiduciary to determine the discretionary payments to one or more beneficiaries historically have been considered akin to powers of appointment. It seems that the distinction is simply between a fiduciary, who holds the power and must act in a fiduciary capacity—in good faith, reasonably, and not arbitrarily or capaciously—and a nonfiduciary, who is not subject to these constraints and may exercise discretion bound only by the donor's intent as expressed in the trust instrument. The comments to the Third Restatement of Trusts draw an equivalent distinction between powers held in a fiduciary capacity, and those that are held for the powerholder's own benefit.[85] Even in light of these different standards governing application or exercise of the power, however, a fiduciary power to determine distributions is, for most purposes, still akin to a power of appointment.

When, as is often the case, the donee of the power of appointment also acts as trustee, there is a crucial question as to whether the donee may exercise the power in an individual, nonfiduciary capacity. If so, then the donee has the ability to exercise discretion bound only by the terms of the power and may, for example, completely disinherit the default takers or other beneficiaries or appoint property to himself or herself—acts that ordinarily would clearly violate the fiduciary duty if taken as a trustee.

The answer to this question remains unclear. On the one hand, it would seem that the donor should be able to provide any donee with a power of appointment as the donor decides; naming one individual as both donee and trustee—or a permissible trustee—creates a conflict of interest, which the donor can foresee and waive. On the other hand, a trustee who happens to act in other capacities—for example, as a creditor of the trust—typically is not permitted to pick and choose the fiduciary standards that apply to any certain action. What little law exists on this issue generally appears to favor the former, more flexible but also more ambiguous approach, permitting the donee of a power to exercise it in the donee's discretion, barring some indi-

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[84] *Id.* (citations omitted).

[85] *See* RESTATEMENT (THIRD) OF TRUSTS § 75 cmt. b–f (2007). The discussion echoes the Reporter's Notes to the Third Restatement of Trusts, which draws a distinction between (i) a personal power that may be exercised for the personal benefit of the donee of the power and (ii) a fiduciary power that must be exercised for the purpose for which the settlor created it. *See id.* § 64 cmt. b–d. The Reporter's Notes indicate that if the powerholder's power is personal, then the trustee's only duty is to ascertain whether the attempted exercise is or is not within the scope of the trust terms. *See id.*

cation of contrary intent by the donor.[86] The ambiguity surrounding this issue seems likely to continue, as more recent thinking on powers of appointment typically analogizes the ability to "decant" to a fiduciary power to invade the property in further trust.

VII. POWERS OF APPOINTMENT AND DECANTING

A. Introduction

In addition to the traditional usages discussed above, powers of appointment have a newly discovered—or rediscovered—aspect, as applied to the increasingly popular tool known as trust decanting. Decanting generally refers to the transfer of assets from an existing trust to a different trust instrument, and has gained heightened prominence as a means of accomplishing tax planning, making administrative updates to old trusts, and, where appropriate, modifying the substantive terms of previously drafted trust documents to respond to changing conditions.[87] Although experience indicates that most such trust decantings are effectuated for nontax reasons, there may be substantial income and transfer tax effects, as discussed later.

While often discussed as a single, unified phenomenon, decanting can be seen as a bundle of several similar planning techniques, which together may be said to aim at the same end. First, decanting may be accomplished via a distribution of assets from one trust to another, either under a fiduciary or a nonfiduciary power.[88] Alternatively, a trust may be decanted pursuant to the provisions of a statute that specifically authorizes such a distribution. As discussed in more detail below, seventeen states have adopted such statutes expressly permitting changes to trust instruments, pursuant to a trustee's power to invade the corpus of the trust.[89] Third, decanting may be

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[86] *See, e.g.*, *Ferrell-French v. Ferrell*, 691 So. 2d 500 (Fla. Dist. Ct. App. 1997); *Rubinson v. Rubinson*, 620 N.E.2d 1271 (Ill. App. Ct. 1993); *Norwest Bank Minnesota North, N.A. v. Beckler*, 663 N.W.2d 571 (Minn. Ct. App. 2003).

[87] The term "decanting" derives from the analogy to pouring a liquid, such as wine, from one container to another. *See* Joseph T. La Ferlita, *New York's Newly Amended Decanting Statute Typifies Trend Towards Greater Flexibility*, PROB. & PROP., July-Aug. 2012, at 34.

[88] *See id.*

[89] *See* ALASKA STAT. § 13.36.157 (2012); ARIZ. REV. STAT. ANN. § 14-10819 (2012); DEL. CODE ANN. tit. 12, § 3528 (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West 2010); 760 ILL. COMP. STAT. 5/16.4 (eff. Jan. 1, 2013); IND. CODE ANN. § 30-4-3-36 (LexisNexis 2011); KY. REV. STAT. ANN. § 386.175 (2012); MO. REV. STAT. § 456.4-419 (2012); NEV. REV. STAT. ANN. § 163.556 (West 2011); N.H. REV. STAT. ANN. § 564-B:4-418 (LexisNexis 2008); N.Y. EST. POWERS & TRUSTS LAW 10-6.6 (McKinney 2002); N.C. GEN. STAT. § 36C-8-816.1 (2011); OHIO REV. CODE ANN. § 5808.18 (West 2012); R.I. GEN. LAWS § 18-4-31

accomplished as a trust "merger," under a rule—that may apply under the relevant trust instruments, a statute, or both—permitting the assets of two or more trusts to be combined if the respective trust terms are sufficiently parallel.[90] Finally, the laws of most, if not all, states permit a change in the terms of a trust by court order or with court approval, including by reformation, amendment, and construction.[91]

While decantings pursuant to statutory authority are distinguishable from those under a distribution power alone, and both of the former from the exercise of a power of appointment to appoint property in further trust, all three of these techniques appear to rest on the same conceptual foundation. As discussed in Part VI.B above, a power to invade the corpus of a trust for distribution to beneficiaries is, in substance, a power of appointment for property law purposes.[92] Generally, the holder of such a power may appoint the property in further trust, subject to any rules or restrictions in the original instrument.[93] This further suggests that a trustee who may invade the corpus of a trust, unless the instrument provides otherwise, may pay it to a different trust for the benefit of the beneficiary or beneficiaries for whom it may be invaded.[94] In other words, as will be discussed below, a

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(West 2012); S.D. CODIFIED LAWS § 55-2-15 (2012); TENN. CODE ANN. § 35-15-816(27) (2007); VA. CODE ANN. § 64.2-778.1 (West 2012).

[90] Most statutes that address trust merger require that the merging trusts be "substantially similar" or "substantially identical." *See, e.g.*, 760 ILL. COMP. STAT. ANN. 5/425 (West 2012). Perhaps surprisingly, there appears to be no developed case law on the proper scope of trust merger or the meaning of this statutory terminology.

[91] *See, e.g.*, FLA. STAT. ANN. § 736.04115(2)(a) (West 2010) ("The court shall exercise discretion in a manner that conforms to the extent possible with the intent of the settlor, taking into account the current circumstances and best interests of the beneficiaries."). *Cf.* I.R.C. § 2055(e)(3).

[92] If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under sections 2514(c) and 2041(b). The power to invade for one's own benefit—that is, to withdraw property from the trust—may cause the powerholder to be the owner of the trust for purposes of section 671 so that the income, deductions, and credits against tax of the trust are attributed to the powerholder. *See* I.R.C. § 678(a). If the power is held in a fiduciary capacity, however, section 678 may not apply. *See* Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009).

[93] *See generally* AUSTIN WAKEMAN SCOTT ET AL., SCOTT AND ASCHER ON TRUSTS § 3.1.2, at 144–45 (5th ed. 2008) (stating that the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised).

[94] *See, e.g.*, RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 19.14 (2011) (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including one in trust and one

trustee with a decanting power, whether based on statute or the trustee's common law distribution authority, may exercise the same authority as the holder of a power of appointment. The difference is not in the scope of the power, but in the fiduciary requirements that apply to its exercise. If approached as a power of appointment, decanting may be subject only to the minimal rules that apply to the exercise of a power: adherence to the donor's intent under the instrument, and, perhaps, compliance with any relevant state public policy.[95] By contrast, when effectuated as a trustee's decision, decanting would properly be subject to all of the ordinary duties which attend distributions of trust assets. The various statutes addressing decanting can be seen simply as a legislative acknowledgement of a set of powers which already existed under state common law. Indeed, many of the statutes make this clear in their respective legislative histories.[96]

B. Decanting History and Statutes

The first discussion of decanting by an American court is contained in *Phipps v. Palm Beach Trust Co.*[97] In that case, the Supreme Court of Florida—the highest court of the state—held that a trustee could invade trust property by paying it over to another trust for the beneficiary.[98] That decision seems consistent with the common law throughout the United States and, as a result, a decanting power likely is held by trustees under the common law of all states.[99] No court has held that there is no such fiduciary power under common law.

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that creates a power of appointment in another, that solely benefits permissible appointees of the power).

[95] In most states, such public policy-based limitations, apply only to the exercise of a power in a manner which encourages illegal behavior, divorce, or attempts to restrict an appointee's ability to freely marry.

[96] *See, e.g.*, Memo. in Support of Legis., N.Y. Governor's B. Jacket, 1992 ch. 591, at 4.

[97] 196 So. 299 (Fla. 1940).

[98] *See id.*

[99] *See* Wiedenmayer v. Johnson, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969). *Wiedenmayer* concerned an indirect decanting, however, in that the trustees exercised their power of invasion in favor of the beneficiary contingent on the beneficiary's agreeing to transfer the property in further trust. The court concluded the transfer was in the beneficiary's best interests, describing "best interests" as follows:

> The expression is not limited to a finding that distribution must be to the son's best 'pecuniary' interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce and the consequences thereof, which the new trust, rather than the old contingencies provided for in his father's trust indenture, will engender. Of what avail is it to rest one's 'best

New York was the first state to enact decanting legislation.[100] Although amended since its original enactment in 1992, it essentially allows a trustee who has "absolute" authority to invade the trust corpus for a beneficiary (under a broad standard as opposed, for example, to one limited to health, education, maintenance, and support) to pay the corpus over to another trust for the beneficiary. The legislative history to the New York act provides that it is consistent with and declaratory of existing common law.[101]

Nevertheless, when New York adopted its statute, there was no developed case law about decanting in New York, or in any other state other than Florida. Even though the Florida Supreme Court ruled that a trustee could transfer the property from the original trust to another pursuant to an absolute power of invasion, Florida eventually adopted a decanting statute to clarify issues surrounding decanting authority and its exercise.[102] For clarity and predictability, it may be preferable for the legislature of a state to adopt a decanting statute, rather than for practitioners to rely on general principles of property law. Legislation similar to that in New York now has been enacted in Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Missouri, Nevada, New Hampshire, North Carolina, Ohio, Rhode Island, South Dakota, Tennessee, and Virginia,[103] which appears to reflect an acknowledgment of such a statute's utility. Also, with heightened appreciation

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> interests' on a purely financial basis, and without regard to the effect upon a man's mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?

Id. at 536.

[100] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (2002) (the original decanting statute was enacted in 1992, but has since been amended); *see also* Alan S. Halperin & Lindsay N. O'Donnell, *Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting*, 42 HECKERLING INST. ON EST. PLAN. ¶ 1301 (2008).

[101] *See* Memo. in Support of Legis., N.Y. Governor's B. Jacket, 1992 ch. 591, at 4.

[102] *See* FLA. STAT. ANN. § 736.04117(1)(a) (West 2010).

[103] *Compare* ALASKA STAT. § 13.36.157 (2012); ARIZ. REV. STAT. ANN. § 14-10819 (2012); DEL. CODE ANN. tit. 12, § 3528 (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West 2010); 760 ILL. COMP. STAT. 5/16.4 (eff. Jan. 1, 2013); IND. CODE ANN. § 30-4-3-36 (LexisNexis 2011); KY. REV. STAT. ANN. § 386.175 (2012); MO. REV. STAT. § 456.4-419 (2012); NEV. REV. STAT. ANN. § 163.556-8 (West 2011); N.H. REV. STAT. ANN. § 564-B:4-418 (LexisNexis 2008); N.C. GEN. STAT. § 36C-8-816.1 (2011); OHIO REV. CODE ANN. § 5808.18 (West 2012); R.I. GEN. LAWS § 18-4-31 (West 2012); S.D. CODIFIED LAWS § 55-2-15 (2012); TENN. CODE ANN. § 35-15-816(27) (2007); *and* VA. CODE ANN. § 64.2-778.1 (West 2012), *with* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002).

for the authority to distribute to new trusts, many practitioners now include decanting provisions in their trust forms.[104]

The Alaska, Arizona, Delaware, Florida, Nevada, New York, North Carolina, and South Dakota statutes all expressly state that the power to invade in further trust is a special power of appointment.[105] Delaware, Florida, Nevada, North Carolina, and South Dakota also expressly state that the power is not exercisable in favor of the trustee, the trustee's estate, the trustee's creditors, or the creditors of the trustee's estate.[106] The restriction is intended to avoid having the power to decant treated as a general power of appointment under section 2041.

In *Phipps*, the Florida court cited section 17 of the Restatement of Trusts for the proposition that "if a trustee has a [nongeneral] power of appointment, that is, a power to appoint among the members of a specified class, [then] whether [the trustee] can effectively appoint a trustee for members of the class depends on the terms of the power vested in him."[107] Accordingly, the court concluded as follows: "The general rule gleaned from the foregoing and other cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."[108] As suggested in Section VI above, as long as the power to decant is deemed to be held by the trustee, it is, by definition, a fiduciary power.

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[104] *See, e.g.*, provisions in Wealth Transfer Planning, a document assembly system published by Interactive Legal, LLP, which inserts a broad "decanting" provision if the drafter checks the question "trustee may create trusts." (an overview of the Wealth Transfer Planning System is available at https://interactivelegal.com/products/wealth-transfer-planning-overview).

[105] *See* ALASKA STAT. § 13.36.157 (2012); ARIZ. REV. STAT. ANN. § 14-10819 (2012); DEL. CODE ANN. tit. 12, § 3528 (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West 2010); NEV. REV. STAT. ANN. § 163.556-8 (West 2011); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002); N.C. Gen. Stat. § 36C-8-8161 (2011); S.D. Codified Laws § 55-2-15 (2012).

[106] *See* DEL. CODE ANN. tit. 12, § 3528(c) (2007); FLA. STAT. ANN. § 736.04117(3) (West 2010); NEV. REV. STAT. ANN. § 163.556-8 (West 2011); N.C. GEN. STAT. § 36C-8-816.1(e)(1) (2011); S.D. CODIFIED LAWS § 55-2-15(2) (2012).

[107] Phipps v. Palm Beach Trust Co., 196 So. 299, 301 (Fla. 1940).

[108] *Id.* In addition, the ruling in *Phipps* appears to have authorized granting a beneficiary a power of appointment, consistent with a trustee's decanting power. Because the trustee could pay the principal of the trust directly to the beneficiary who could then give or bequeath the property to anyone in the world or expend it for his or her own benefit, granting the beneficiary a special or general power of appointment gives the beneficiary the same type of disposition or expenditure authority.

Initially, the New York statute allowed decanting only if the trustee received the consent of either the beneficiaries or a court having jurisdiction over the trust.[109] That requirement, however, was subsequently removed.[110] While the provision was in effect, New York courts approved decanting for a number of reasons, including:

- Protecting the tax treatment of a trust;[111]
- Reducing administrative costs;[112]
- Altering trusteeship provisions such as the identity or manner of appointing fiduciaries;[113]
- Extending the termination date of a trust;[114]
- Converting a nongrantor trust to a grantor trust or the reverse;[115]
- Changing a trust's governing law;[116]
- Dividing trust property to create separate trusts;

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[109] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 1966).

[110] *See* 1992 N.Y. Sess. Laws ch. 591 (McKinney).

[111] See Matter of Ould, N.Y.L.J., Nov. 28, 2001 at 26, col. 5 (Sur. Ct., N.Y. Cnty 2001), in which the trustees were permitted to appoint the trust estate consisting of a second-to-die insurance policy to a new trust, thereby eliminating the Crummey power of withdrawal of one of the insureds.

[112] See Matter of Vetlesen, N.Y.L.J., June 29, 1999 at 25, col. 3 (Sur. Ct., N.Y. Cnty 1999), in which a sole trustee appointed principal of an inter vivos trust to himself and another as trustees of a testamentary trust and the trustees agreed to share one commission.

[113] See Matter of Klingenstein, N.Y.L.J., Apr. 20, 2000 at 35, col. 6 (Sur. Ct., Westchester Cnty 2000), in which limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee, designation of successor trustees, and ability of corporate trustee to appoint a successor were changed.

[114] See *In re* Alfred Hazan, N.Y.L.J., Apr. 11, 2000 at 30, col. 7 (Sur. Ct., Nassau Cnty 2000), in which a trustee was permitted to extend a trust for a beneficiary's lifetime. See also Matter of Dornbush, 627 N.Y.S.2d 232 (Sur. Ct., N.Y. Cnty 1995), in which the corpus of an irrevocable trust subject to New York law, which was to end at the death of the first to die of the grantor and the beneficiary, was paid to a new Florida trust for the beneficiary's lifetime in order to protect the trust assets from the beneficiary's potential creditors.

[115] *See* I.R.S. Chief Couns. Adv. Mem. 2009-23-024 (June 5, 2009) (holding that the mere conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes requiring the recognition of gain).

[116] See Dornbush 627 N.Y.S.2d at 232 in which the trustees of two irrevocable trusts subject to New York law were allowed to pay over assets to substantially identical Florida trusts in order to protect the trusts' assets from New York real property transfer gains taxes.

- Reducing potential liability;[117]
- Converting a trust into a supplemental needs trust to permit a beneficiary to qualify for certain governmental benefits; and[118]
- Making trust interests spendthrift or the reverse.[119]

Nevertheless, in *Estate of Mayer*,[120] relief was denied in the case of a testamentary trust that authorized the independent trustee to distribute principal "in [his] sole and absolute discretion, [as he] may deem necessary . . . for the *health, support, maintenance and education of any person or persons who may at such time be a person or persons eligible to receive income from the trust* . . . ."[121] The court concluded that absolute discretion connotes a standard that is unconstrained except by the implicit requirements of reasonableness and good faith.[122] The court held that the proposed invasion was in essence a request to invade for estate planning purposes (the petitioners alleged that it would permit the reduction of taxes) and outside the parameters established by the testator, "even when reviewed with the greatest possible leniency."[123]

Other common uses of decanting include: (1) addressing changed circumstances, such as changes in applicable fiduciary law or changes in family circumstances or dynamics; (2) modifying administrative provisions, such as restrictions on investment powers or to create a "directed trust"; and (3) correcting a drafting error without the necessity of going to court.

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[117] See Matter of Kaskel, 620 N.Y.S. 2d 217 (Sur. Ct., N.Y. Cnty 1994), in which the trustees of several family trusts, which included spendthrift provisions, were allowed to terminate the existing trusts and pay over assets to new trusts without spendthrift provisions so that the beneficiaries could assign their interests in distressed real estate properties from the trusts to corporations, followed by an invasion of the principal of the trusts in favor of the corporations.

[118] *See* Estate of Grosjean, N.Y.L.J., Dec. 10, 1997 at 29, col. 6 (Sur. Ct., Nassau Cnty 1999). See also *In re* Alfred Hazan, N.Y.L.J., Apr. 11, 2000 at 30, col. 7; Estate of Barkman, N.Y.L.J., May 20, 2003 at 24, col. 3 (Sur. Ct., Nassau Cnty 1993), in which the court permitted the conversion even though the beneficiary had a fixed income interest.

[119] See Matter of Rockefeller, N.Y.L.J., Aug. 24, 1999 at 26, col. 2 (Sur. Ct., Nassau Cnty 1999), in which a committee of individuals with discretionary distribution authority over a trust was permitted to pay trust assets to a new trust to protect the trust principal by providing a spendthrift restraint.

[120] 672 N.Y.S. 2d 998 (Sur. Ct., N.Y. Cnty 1998).

[121] *Id.* at 999 (emphasis in original).

[122] *Id.* at 1000.

[123] *Id.* at 1001.

Not all state decanting statutes are alike. However, there are common or parallel provisions. Some follow the New York approach and allow decanting only if the trustee's power to invade the trust is absolute.[124] Others permit invasions even if there is a fixed, that is, ascertainable, standard for invasion,[125] and at least one of the statutes requires that the invasion standard be the same in the trust to which the trust assets are distributed as it was in the invaded trust.[126] Most expressly state that an income interest cannot be eliminated,[127] but must be preserved in decanting, though the South Dakota statute appears to permit a fixed income interest to be eliminated through decanting. Some, but not all, of the statutes provide that a decanting power cannot be used to extend the term of the trust beyond the applicable Rule Against Perpetuities.[128]

VIII. SOME TAX ISSUES OF DECANTING

Prior to 2012, the Department of the Treasury and the Service informally requested suggestions for the appropriate treatment for income and transfer tax purposes of the distribution of trust assets from one trust to another trust. In February 2012, the Service issued Notice 2011-101, requesting public comment on the income, gift, estate, and GST tax consequences of decanting transactions, or, in the Service's words, "arising from transfers by a trustee of all or a portion of the principal of a Distributing Trust to a Receiving Trust that change beneficial interests."[129] The Notice provides that the Service is considering the issue for possible published guidance, and will no longer issue private letter rulings with respect to any decanting transactions that result in a change of beneficial interests while the study is underway.

The possibility of tax consequences nearly always arises when property is transferred. There may be:

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[124] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (only version prior to 2010 amendments is applicable); FLA. STAT. ANN. § 736.04117(1)(a) (West 2010).

[125] *See, e.g.*, DEL. CODE ANN. tit. 12, § 7528 (2007).

[126] *See, e.g.*, ALASKA STAT. § 13.36.157 (2012).

[127] *See, e.g.*, ALASKA STAT. §13.36.157; N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002); FLA. STAT. ANN. § 736.04117(1)(a) (West 2010).

[128] *Compare, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (West 2002), *and* FLA. STAT. ANN. § 736.04117(1)(a) (2012), *with* ALASKA STAT. §13.36.157 (West 2010).

[129] Notice 2011-101, 2011-52 I.R.B. 932.

- Income tax where, among other situations, the property is being sold or exchanged for another asset;[130]
- Gift tax where the property is transferred, or deemed transferred, during lifetime for less than full and adequate consideration in money or money's worth;[131]
- Estate tax where such a transfer is made, or deemed made, at death;[132]
- GST tax where the property is being transferred to a "skip person";[133] and
- Other taxes, such as state or local transfer taxes, and property taxes affected by changes in the value of the property transferred.

There is little developed law about the tax consequences of decanting, and detailed guidance to taxpayers would be helpful because the use of decanting is widespread and growing. In attempting to discern what the tax effects of decanting are, it is appropriate to analogize it to other transfers where there is more developed law.

The act of decanting may be most closely analogized, as indicated above, to the exercise of a special power of appointment over trust property, or to the discretionary distribution of property from a trust by the trustee to a beneficiary. Indeed, the decanting statutes are premised on the idea that decanting is a method of making a discretionary distribution from the trust for—rather than to—one or more of the trust beneficiaries.

It is somewhat surprising that, in many respects, federal tax law does not distinguish, for gift or estate tax purposes, between a power held in a fiduciary capacity and one held in a nonfiduciary capacity. For example, a power to withdraw property from a trust for one's own benefit is a general power of appointment, with potential gift and estate tax consequences, whether the power is held in a fiduciary or nonfiduciary capacity.[134] Con-

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[130] *See* I.R.C. §§ 61, 1001.

[131] *See* I.R.C. § 2512.

[132] *See* I.R.C. § 2031 *and cf.* Estate of DiMarco v. Comm'r, 87 T.C. 653 (1986), *acq. in result*, 1990-2 C.B. 1 (holding a transfer was one taking effect at death where an incomplete gift had been made during lifetime and continued to be treated as incomplete until the transferor died).

[133] *See* I.R.C. §§ 2601(a), 2612(a).

[134] *See, e.g.*, O'Malley v. United States, 383 U.S. 627 (1966); Estate of Lanigan v. Comm'r, 45 T.C. 247 (1965).

versely, a power to distribute trust property only to persons other than the powerholder, his or her estate, creditors, or creditors of his or her estate, is a special, nongeneral power of appointment under section 2514, without regard to any fiduciary standards that may apply.[135]

A. Income Tax

For income tax purposes, decanting may be analyzed by analogy to the treatment of conventional trust distributions when made by a trustee. In some situations, discretionary distributions made by a trustee will be taxed in the same manner as a distribution by a trustee mandated by the exercise of a power of appointment held by a beneficiary. Both transfers, as a general rule, will be deemed to consist of the trust's distributable net income (DNI) to the same extent.[136] Any distribution from a trust is deemed to consist of the trust's DNI to the extent of the lesser of the amount distributed or the amount of DNI, which is the trust's taxable income for the year of distribution as specially computed under section 643(a).[137] Not all trust distributions are deemed to consist of DNI or, at least, not completely of DNI. Exceptions exist for distributions described in section 663(a)(1), for distributions made in satisfaction of certain specific bequests, and to the extent that DNI is allocated pursuant to section 663(c) to another separate share or other shares of the estate or trust.

Private Letter Ruling 200736002 may be read as suggesting that if the entire trust property is decanted into another trust—the "new trust"—then the new trust is the same trust for income tax purposes as the one from which the payment was made—the "old trust".[138] Whether the new trust is considered the same as the old one when the entire trust corpus is decanted may be largely academic: even if the new trust is a different trust from the old one, all of the old trust's DNI—which would include, under Treasury Regulation section 1.643(a)-3(e), Example 7,[139] capital gain because the year of decanting would be the year of termination of the old trust—would be shifted to the new trust.

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[135] *See* I.R.C. § 678. (A power held in a fiduciary capacity to distribute income or principal from a trust to the powerholder may not trigger grantor trust status under section 678, as it would if held in a nonfiduciary capacity.) *See* discussion in Blattmachr et al., *supra* note 92.

[136] *See* I.R.C. §§ 651, 652, 661, 662.

[137] *See* I.R.C. §§ 652, 662.

[138] *See* Priv. Ltr. Rul. 07-36-002 (Sept. 7, 2007).

[139] *See* Treas. Reg. § 1.643(a)-3(e), ex. 7 (2004).

The trust's identity might make a difference where the undistributed taxable income of the old trust will be subject to a state or local income tax, but the new trust's undistributed taxable income is not.[140] The distribution from the old trust to the new trust would then eliminate that state or local income tax, as there would be no undistributed income left in the old trust. The opposite result could be effected as well—that is, the old trust may not have been subject to state or local income tax but the new one will be; in which event, the decanting may expose the trust plan to income taxation that otherwise could have been avoided.

The argument that there is no change in the trust by decanting is perhaps strongest where the trustees of the old trust create, or declare, the new trust, rather than paying corpus to another trust which a beneficiary or another party has created. If the assets of the old trust are paid to a trust created by someone other than the trustees, it may seem that the new trust is not merely a continuation of the old one. Also, it seems appropriate to keep in mind that the new trust, if created by someone other than the original grantor or the trustees acting as such of the old trust, presumably will hold property received from the new grantor because a trust is usually created only if it has a *res* (that is, holds property contributed by someone).[141]

This analysis should, perhaps, be informed by whether or not state law treats a power to decant as a special power of appointment. A special power of appointment is typically viewed as nothing more than an extension of the intent of the original settlor to dispose of his or her property in trust.[142] Thus, it is generally construed as an authority that must operate within the confines of the original settlor's intent, which intent includes the incorporation of applicable common law or statutory law at the time the original trust was created.

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[140] *See, e.g.*, N.Y. TAX LAW § 605 (McKinney 2009) (exempting from New York income tax the income of a trust created by a New Yorker if, among other conditions, the trust has no trustee who is a New Yorker).

[141] *See* RESTATEMENT (THIRD) OF TRUSTS § 2 (2007). *But see* N.Y. EST. POWERS & TRUSTS LAW § 3-3.7 (requiring no res in some situations). For purposes of determining who is the grantor of a trust for income tax purposes, the grantor who contributed property to the old trust will remain the grantor of the new trust as to the property derived from the old trust as a result of the decanting. *See* Treas. Reg. § 1.671-1(e)(5) (1980) (stating that if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust).

[142] *See, e.g.*, Self v. United States, 142 F. Supp. 939 (1956).

Case law will sometimes describe a trust created by the exercise of a power of appointment as being "read back into" the original trust.[143] This generally means that the new trust must be created within the scope of the authority conferred on the powerholder by the original trust. In addition, the Rule Against Perpetuities begins to run from the date the original trust became irrevocable. But where the power of appointment is exercised to create a different dispositive plan, as opposed to different governance, such as changing the identity or authority of the trustees, it would seem that the new trust follows the terms set forth in the instrument of the powerholder, even if that instrument incorporates by reference terms of the original trust, and is indeed a new trust. In that case, the tax analysis should follow from the property law and a decanting treated as a power of appointment under state law should be consistent with the treatment of a nonfiduciary who is granted a lifetime power of appointment over the trust.

B. Negative Basis Assets

Where the property paid by the trustee pursuant to a decanting has a liability against it that exceeds the property's income tax basis, that is, a "negative basis" asset, whether gain will be recognized under *Crane v. Commissioner*[144] is uncertain. Under the *Crane* doctrine, the amount realized, which will be used to determine tax profit or loss, includes indebtedness discharged, including nonrecourse indebtedness.[145] There is no developed law as to whether, or when, an estate or trust realizes gain by distributing a negative basis asset to the beneficiary.

Some have contended that section 643(e), which provides in general for the fiduciary's basis in distributed property to carry over to the beneficiary, may override the *Crane* doctrine.[146] This argument may not be persuasive, however, as the section by its own terms provides that the basis of the property distributed by the fiduciary to the beneficiary is "adjusted for . . . any gain . . . recognized to the . . . trust on the distribution."[147]

Because it is possible that gain would be recognized by the trust on the distribution (by decanting or otherwise) by the trustee, such a distribution

[143] *See, e.g.*, N. Trust Co. v. Porter, 13 N.E.2d 487, 491 (Ill. 1938) (stating the Rule Against Perpetuities begins to run from the date of the original trust). For a discussion of the Relation Back Doctrine, see *supra* Part I.

[144] 331 U.S. 1 (1947).

[145] Jonathan G. Blattmachr & Bridget J. Crawford, *Grantor Trusts and Income Tax Reporting Requirements: A Primer*, 13 PROB. PRAC. REP. 1 (2002).

[146] *See* I.R.C. § 643(e)(1); *see also* Treas. Reg. § 1.661(a)-2(F).

[147] I.R.C. § 643(e)(1).

should be made only after careful consideration. The trustee might ask for a private ruling from the Service clarifying the issue—perhaps seeking to have the Service rule that no gain will be recognized if the entire trust is decanted because the new trust is the same trust as the old one. Alternatively, the trustee could simply leave the negative basis assets in the old trust.

The law seems well developed that the conversion of a grantor trust under chapter 1, subchapter J, part 1, subpart E of the Code, during the grantor's lifetime, to a nongrantor trust is a gain recognition event to the extent that liabilities with respect to an asset owned by the trust exceed its basis.[148] Whether the same result would occur by reason of decanting is uncertain.

C. Beneficiary Gain

Another question is whether the beneficiary realizes any gain by reason of decanting. Normally, under section 662(a), a beneficiary may realize income by reason of a trust distribution only to the extent of the trust's DNI. It is possible, however, that the Service might contend that a "change" in the quality of the beneficiary's interest in the trust could cause the beneficiary to experience income.

In *Cottage Savings Association v. Commissioner*,[149] the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other such notes that were "materially different."[150] The Service has indicated that it may view a beneficiary as experiencing gain under *Cottage Savings* where, for example, the beneficiary's income interest is "converted" into a unitrust interest, unless the conversion is pursuant to a state statute or opinion of the highest court of the state.[151] Also, Treas-

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[148] *See* Madorin v. Comm'r, 84 T.C. 667 (1985) (the court assumed that the power to add to the class of beneficiaries under section 674 conferred grantor trust status, and thus relinquishment of the power eliminated grantor trust status, triggering income tax realization).

[149] 499 U.S. 554 (1991).

[150] *Id.* at 566.

[151] See Priv. Ltr. Rul. 00-13-015 (Mar. 31, 2000), in which the Service held that the partition of the trust and changes in administrative provisions pursuant to New York Estate Powers & Trusts Law section 10-6.6 would not cause the beneficiaries, whose interests remained the same in the "new" trusts as in the old, to realize gain under *Cottage Savings Assn.*, 499 U.S. 554. *But see* Priv. Ltr. Rul. 07-36-002 (Sept. 7, 2007) (in which the Service indicated that a beneficiary might realize gain if the beneficiary's interest in a successor trust, pursuant to a pro rata division of a trust, was "materially" different than in the original trust); Priv. Ltr. Rul. 02-31-011 (Aug. 2, 2002) (in which the Service held, under *Cottage Savings*, that a court-approved settlement under which an annuitant received a unitrust interest instead of the annuity stream constituted an income-taxable exchange.).

ury Regulation section 1.643(b)-1 provides in part that a "switch" from an income interest to a unitrust interest, if "not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of [s]ection 1001."[152]

Nevertheless, it seems that if the trustee were expressly authorized in the governing instrument to change the beneficiary's interest from an income interest to a unitrust interest, there should be no gain recognition by the beneficiary because the beneficiary's interest in the trust was always subject to that potential conversion. In Private Letter Ruling 200810019, the Service "approved," without any adverse income, gift, or GST tax consequences, the conversion under state law of an income interest to a unitrust interest.[153] It does not appear, for this purpose, that state law permitting a unitrust conversion must have been in effect from the inception of the trust.

A partial answer also may be found in Treasury Regulation section 1.1001-1(h), which deals with the severance of a trust, including without limitation a severance that meets the requirements of Treasury Regulation section 26.2642-6—the qualified severance regulation—or of Treasury Regulation section 26.2654-1(b)—retroactive severances at death.[154] It provides that a severance is not an exchange of property for other property differing materially either in kind or extent if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro-rata funding, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.[155]

"Severance" for this purpose is not defined by the Code. The term, however, implies an action by the trustee, without judicial intervention or beneficiary consent, which is authorized by the governing instrument or applicable state law. Accordingly, if a complete decanting to one trust may be treated as a continuation of the original trust, a decanting to create more than one trust might be treated as a severance likewise having no gain realization consequences. The severance regulations treat certain divisions of a trust that produce new trusts with different beneficiaries as a kind of quali-

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[152] Treas. Reg. § 1.643(b)-1.

[153] *See* Priv. Ltr. Rul. 08-10-019 (Mar. 7, 2008).

[154] *See* Treas. Reg. § 1.1001-1(h).

[155] *See id.*

fied severance.[156] And Treasury Regulation section 1.1001-1(h) does not appear to require a "qualified severance." Instead, the result seems to turn on the ability of the trustee to take the action under the terms of the governing instrument or under state law.

Therefore, it seems that the exercise by a trustee of a decanting power, whether conferred under the instrument itself or pursuant to state law, should not result in any beneficiary recognizing any gain or loss. It seems critical to this conclusion that beneficiary consent, and possibly court approval—which may indirectly require that the beneficiary consent or at least acquiesce—not be required for the trustee to distribute to the new trust. This may raise a concern about what could be perceived as "stealth" modifications of trusts by ill-motivated trustees. Such concerns caused the drafting committee for the Florida decanting statute to include a notice—but not consent—requirement, and an express statement that beneficiaries retain all rights under the law, which would include a right to contest the action if the exercise of the decanting power is an abuse of discretion or otherwise a breach of trust, which presumably would occur only if exercised beyond its scope.[157]

D. Collateral Tax Consequences

There can be "collateral" consequences of decanting as well. For example, the old trust might not be a grantor trust but the new one is, or vice versa.[158] In that regard, it may be appropriate to note, as mentioned above, that gain may be recognized with respect to a negative basis asset by reason of the conversion of a grantor trust to one that is not such a trust. Nevertheless, the mere conversion of a nongrantor trust to a grantor trust would not appear to have tax consequences.[159]

Similarly, the conversion of a United States (domestic) trust to a foreign trust may result in gain recognition under section 684, although if the grantor is living, it is likely that the grantor trust exception under section 684(b) could apply.[160] It seems likely that the result would be the same if the assets of a U.S. trust were paid, by decanting or otherwise, to a foreign trust.

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[156] *See, e.g.*, Treas. Reg. § 26.2642-6(j), ex. 2 (the trustee of a discretionary trust for T's children, A and B, and their descendants, divides the trust pursuant to state law into two trusts, one for A and A's descendants and one for B and B's descendants; the "severance" constitutes a "qualified severance").

[157] *See* FLA. STAT. ANN. § 736.04117(4) (West 2010).

[158] *See* I.R.C. §§ 671–679.

[159] *See* I.R.S. Chief Couns. Adv. (Feb. 17, 2009); Rev. Rul. 2004-64, 2004-2 C.B.

[160] *See* I.R.C. § 684.

Another possible concern under the grantor trust rules arises under section 674. Some of the decanting statutes do not appear to prohibit advancing a remainder beneficiary into the class of current beneficiaries. The power to add to the class of beneficiaries is an exception to the exceptions under section 674 and, therefore, could cause the trust to be a grantor trust from its inception even if it were not otherwise one. Thus, if the decanting power permits beneficiaries to be added, perhaps it causes grantor trust status for every trust that includes the power. This exception is articulated five times in section 674, including in section 674(c) relating to the use of independent trustees to avoid grantor trust status.[161]

Accordingly, in a trust that is intended to be a nongrantor trust, one may wish, in an abundance of caution, to preclude the use of a decanting power in a manner that would permit the trustees to add to the class of beneficiaries within the meaning of section 674. It would seem that some statutes avoid this issue, such as New York's, which permits decanting only in favor of "proper objects" of the exercise of the power to invade principal.[162] Furthermore, it seems that the other statutes should be construed to contain a similar prohibition, or else they would be inconsistent with the concept that one is invading in further trust for the benefit of the beneficiaries in respect of whom the power to invade exists.

Yet another question that arises is whether giving a beneficiary a lifetime power of appointment constitutes a power to add to the class of beneficiaries, implicating section 674. Generally, under Florida law neither a permissible appointee under a power of appointment nor the takers in default are necessary parties in a proceeding concerning the administration of a trust, and can be virtually represented by the powerholder.[163] Accordingly, the permissible appointee may be more properly regarded as a person with a mere expectancy and not a beneficiary of the trust for any property law purpose that would implicate section 674.

Powers of appointment generally are regarded as personal powers that may be exercised without holding the powerholder to any fiduciary standard.[164] This also might support the conclusion that the permissible appointees under a lifetime power of appointment are not beneficiaries of the trust, and therefore, also not beneficiaries for any tax purpose. In that case, per-

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[161] *See* I.R.C. § 674(c).

[162] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002).

[163] *See* FLA. STAT. ANN. § 736.0302 (West 2010).

[164] *See* RESTATEMENT (THIRD) OF TRUSTS § 75 (2007).

missible appointees under a power of appointment could not be regarded as persons that may be added to the class of beneficiaries.

E. GST Tax Issues with Decanting—Grandfathering

The final GST tax "grandfathering" regulations contain perhaps the most enlightening comparison of a nonfiduciary power of appointment and a power to decant held by a trustee. Under Treasury Regulation section 26.2601-1(a), an irrevocable trust and distributions from it created before September 26, 1985, are exempt or grandfathered from GST tax.[165] In addition, the trust remains grandfathered even if a beneficiary holds and exercises a special power of appointment, as long as the vesting of ownership of the trust property occurs by the end of the historic Rule Against Perpetuities—that is, lives in being plus 21 years—or 90 years from the inception of the trust under which the special power was granted.[166]

There does not appear, at least under the common law, to be any restriction on the class of measuring lives that may be selected for purposes of the Rule Against Perpetuities, so long as the members of the class are ascertainable.[167] An otherwise grandfathered trust also remains exempt from GST tax if the trustee has the power to pay the trust property over to another trust, or to keep it in the initial trust, as long as the vesting occurs within the time period specified in the regulations (that is, 90 years or lives in being plus 21 years) and the trustee's power to pay the corpus over to another trust

[165] *See* Treas. Reg. § 26.2601-1(a).

[166] *See* Treas. Reg. § 26.2601-1(b)(1)(v)(B)(2) (referring to "any life in being at the date of creation of the trust").

[167] At common law, there was no restriction on the class of persons that could be used as measuring lives for purposes of complying with the Rule Against Perpetuities so long as the lives used in the instrument of transfer were identifiable so that proof of the deaths of the individuals taken as measuring lives could be obtained. *See* Thellusson v. Woodford, 32 Eng. Rep. 1030; GRAY ON PERPETUITIES (4th ed., 1942) § 217; RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFER, § 1.3, Reporter's Note 3 (1983). English trusts from the late 19th and early 20th centuries commonly utilized a class consisting of all the lineal descendants of Her Late Majesty Queen Victoria, which at the time was thought to include approximately 120 persons. *See In re* Villar, [1927] 858 A.C. 243. In Private Letter Ruling 09-28-013 (July 10, 2009), the holder or a power of appointment pointed to the language of the regulation prohibiting any trust funded by exercise of a special power of appointment from postponing or suspending vesting for a period, measured from date of creation of original trust, extending beyond "any life in being at the date of creation plus 21 years." The Service ruled that grandfathering was preserved, which is remarkable since the language, read literally, would seem to encompass a class consisting of everyone in the world living on the date of creation of the trust. *See id.*

or to keep it in trust was granted to the trustee under the original trust instrument or by state law in effect at the time the trust was created.[168]

Although decanting is not explicitly described as a power of appointment under the GST tax regulations, the treatment under those regulations with respect to powers of appointment and powers to decant should be similar. The trustee's power to decant, the exercise of which—subject to the vesting restrictions discussed above—will not cause grandfathering to be lost, must have been contained in or be authorized by a state law applicable to the original trust. Thus, granting a beneficiary a power of appointment by any means after September 25, 1985, with respect to a grandfathered trust, where that authority to grant the power was not contained in or authorized by a state law applicable to the original trust, may cause grandfathering to be lost if the power could be exercised to postpone the vesting of ownership of the trust property beyond the time otherwise provided in the original trust.[169] However, because decanting powers exist inherently under common law,[170] decanting powers would have existed at the creation of the trust. Hence, it seems that the final GST tax regulations treat a special power of appointment and a trustee-held decanting power in a similar manner.[171] Note, however, that no decanting statutes were yet in effect when the GST tax took effect.[172] Thus, the requirement that state law authorized the distribution when the trust became effective, if based solely on the existence of

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[168] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A).

[169] *See* Treas. Reg. § 26.2601-1(a)(4)(i)(D) ("A modification of the governing instrument of an exempt trust (including a trustee distribution) . . . will not cause an exempt trust to be subject to the [GST tax provisions] if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest [in the trust] prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.").

[170] *See, e.g.*, Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).

[171] The qualified severance regulations under Treasury Regulation section 26.2642-6(h) appear to permit trusts created as a result of a decanting that does not take the form of a qualified severance to be respected as separate trusts on a prospective basis if state law would treat the new trusts as separate. *See generally* Carol A. Harrington, Julie K. Kwon, Carlyn S. McCaffrey, Lloyd L. Plaine & Pam H. Schneider, *Breaking Up Is No Longer Hard to Do: Final GST Tax Qualified Severance Regulations*, 107 J. TAX'N 273 (Nov. 2007); Carol A. Harrington et. al, *Breaking Up May Get Even Easier to Do—Proposed GST Tax Severance Regulations*, 107 J. TAX'N 331 (Dec. 2007).

[172] *See supra* Part VIII.B.

such a statute, would not be met for a trust that is exempt by reason of the grandfathering rule.[173]

As to a grandfathered trust, even if vesting may be postponed, the duration of the trust may not be extended beyond the GST Rule Against Perpetuities.[174] If the trust is not a grandfathered one, but rather a trust that is exempt from the tax by reason of an allocation of GST exemption, the Service appears to agree that a change to a trust that would not affect the GST-exempt status of a grandfathered trust should likewise not affect the GST-exempt status of a trust exempt by reason of an allocation of GST exemption.[175]

The regulations deal with discretionary powers, like a decanting, differently from a modification. Treasury Regulation section 26.2601-1(b)(4)(i)(A) states that a distribution of trust principal from an exempt trust to a new trust will not cause loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorize the distribution to the new trust without the consent or approval of any beneficiary or court, and the terms of the governing instrument of the new trust will not extend the time for vesting beyond any life in being at the date the original trust became irrevocable plus a period of 21 years.

If the vesting of interests is not postponed, then other changes that do not shift beneficial interests to lower generations will not cause loss of exempt status, even if done pursuant to a decanting statute enacted after the trust became irrevocable.[176] Furthermore, it appears, if the vesting of the interest is not postponed but the decanting pursuant to statute shifts interests to lower generations, that there should be no loss of exempt status even if the decanting statute was enacted after the trust was created. Nonetheless, it

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[173] Certain trusts created after the initial effective date of the GST tax are exempted (for example, where the settlor was incompetent). *See* Treas. Reg. § 26.2601-1(b)(3). One of the state decanting statutes might have been enacted for such special-date grandfathered trusts by the time such a trust became irrevocable.

[174] *See* I.R.C. § 2632.

[175] *See, e.g.*, Priv. Ltr. Rul. 09-19-009 (May 8, 2009).

[176] *See* Priv. Ltr. Rul. 97-37-024 (Sept. 12, 1997) (no loss of grandfathering where no change in quality, value, or timing of any beneficiary's interest or power pursuant to decanting under N.Y. EST. POWERS & TRUSTS LAW § 10-6.6); Priv. Ltr. Rul. 98-04-046 (Jan. 23, 1998) (no loss of grandfathering where spendthrift provision changed by decanting under N.Y. EST. POWERS & TRUSTS LAW § 10-6.6); Priv. Ltr. Rul. 02-27-020 (July 5, 2002) (no loss of grandfathering where situs of trust changed from New York pursuant to decanting under N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 where the trust would end at the same time); Priv. Ltr. Rul. 94-38-023 (Sept. 23, 1991).

is understood that the Service has expressed, during the ruling process involving certain requests for private letter rulings, some concerns about such a result.

The exercise by the trustee of a state-conferred decanting power that extends the term of the trust created before the effective date of the GST tax could cause grandfathering of the trust from the tax to be lost.[177] The regulations indicate that the distribution of trust principal in a grandfathered trust to a new or continuing trust will not cause the property to lose its exemption from taxation if either (1) the terms of the exempt trust instrument authorize such distribution or (2) state law, in effect when the trust became irrevocable, authorized the distribution without the consent of a court or any beneficiary.

There seems to be at least three issues with respect to the question of whether the trustee may exercise the power to invade in trust without negative GST tax effects. The first issue is whether the applicable state common law permitted decanting. As discussed above, under Florida law, it seems a decanting power was present, and it is at least arguable that it existed under the common law of all states.

Second, the Service has not construed the regulation strictly. For example, it has allowed trustees under New York law[178] to exercise the power of a grandfathered trust to make the trust a spendthrift one and to change the situs of the trust.[179] It may well be that, as long as the trustee does not extend the term of the trust or shift beneficial interests to a lower generation, grandfathering is not lost. This may mean that the trustee could grant a beneficiary a special power of appointment, which perhaps, could be exercised without loss of grandfathering.

Third, it seems that the trustee could exercise the power for the shorter of (1) a standard Rule Against Perpetuities period of lives in being when the original trust became irrevocable plus 21 year term and (2) the maximum period so that the trust would not lose grandfathering protection.[180] The

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[177] *See* Treas. Reg. § 26.2601-1(b)(4)(A). *But see* Priv. Ltr. Rul. 05-20-023 (May 20, 2005) (inclusion of a spendthrift clause in the appointed trust would not affect GST-exempt status).

[178] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6.

[179] *See, e.g.*, Priv. Ltr. Rul. 99-42-013 (Oct. 22, 1999); Priv. Ltr. Rul. 02-27-020 (July 5, 2002).

[180] In Priv. Ltr. Rul. 02-27-020 (July 5, 2002), the Service ruled that grandfathering would not be lost in decanting a trust and explicitly noted that the new trust "will provide that, notwithstanding any other provision, no exercise of a power of appointment granted in the trust shall result in a termination date for a trust or a share thereunder or created pursuant

challenge in this approach is that the trustee will not know when the trust in fact terminates, and thus when payments of GST tax are due.

F. Non-Grandfathered but GST Exempt in Whole or Part

A generation-skipping trust may be exempt, in whole or in part, from GST tax not just by reason of grandfathering but also by reason of allocation of GST exemption to transfers to the trust.[181] Although, as previously mentioned, the Service in private rulings has applied certain grandfathering rules to trusts that are exempt by reason of allocations of GST exemption,[182] it is uncertain whether the exercise of a state decanting power would cause such exemption from taxation to be lost.[183]

Many new trusts likely were irrevocable when the applicable decanting statute—at least in Alaska, Delaware, New York, and Tennessee[184]—was enacted. Therefore, applying the literal grandfathering requirements to a GST-exempt trust would not cause exemption from taxation to be lost.

Also, the policy considerations with respect to trusts that are exempt from tax by reason of allocation of GST exemption seem quite different from those with respect to trusts exempt from tax by reason of their effective date. It would seem difficult to contend successfully that exemption from taxation is lost for a trust that is exempt from tax by reason of an allocation of GST tax exemption when the trustee exercises a decanting power even if the term of the trust is extended or beneficial interests are shifted—if the authority to decant existed, either in the governing instrument or under state law, at least where statutory decanting was in effect when the trust became irrevocable.

The effects of decanting on a trust that is not grandfathered from GST tax, but is not subject in its entirety to the tax by reason of allocation of GST exemption are not covered by the regulations or other authority. Many of the rulings addressing trusts exempt by reason of an allocation of GST exemption include the following language:

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to a power of appointment granted thereunder which is later than the date twenty-one years after the death of the survivor of all of Sister's descendants living at Decedent's death."

[181] *See* I.R.C. § 2631(a).

[182] *See, e.g.*, Priv. Ltr. Rul. 05-51-020 (Sept. 21, 2005).

[183] *See* Priv. Ltr. Rul. 98-49-005 (Dec. 4, 1998) (holding that GST exemption allocation to a trust that made it exempt from the tax would continue if the trust were to use N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 to pay the corpus over to a trust with "identical" terms).

[184] *See* ALASKA STAT. § 13.36.157 (2012); DEL. CODE ANN. tit. 12, § 3528 (2007); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002); TENN. CODE ANN. § 35-15-816(27) (2007).

> No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.[185]

Because a trust exempt, in whole or in part, by reason of allocation of GST exemption could have postponed vesting for whatever period was permitted under applicable law, it seems decanting to attain that result should not result in the loss of that exemption. Moreover, at least in some states, such as New York, the decanting statutes have been in place for a sufficiently long enough period that the decanting law may well have been in effect when the trust was created, suggesting that using it should not result in loss of exemption effected through the allocation of GST exemption.

It also is possible that the decanting of a trust pursuant to applicable state law might be construed as a severance that does not meet the requirements of a qualified severance.[186] In that event, even though the severance is not qualified, after the date of severance, the trusts will be treated as separate trusts for purposes of GST tax, provided the trusts resulting from such severance are recognized as separate trusts under state law.

Assuming the trusts are treated as separate trusts, GST tax exemption may be effectively allocated to any one or more of the trusts without being treated as having been allocated ratably to all the trusts. This would permit, for example, a trust to be divided in order to permit a late allocation of GST exemption to only part of the trust estate, resulting in one or more trusts having an inclusion ratio of zero, and one or more trusts having an inclusion ratio of one.

In addition, if the severance results in a taxable termination as to a portion of the trust, for example, because one of the trusts is a skip person, the taxable termination will be deemed to occur only with regard to that particular resulting trust with no GST tax impact on any other trust resulting from the severance. Each trust resulting from such a severance, prior to the allocation of any additional GST exemption, will have the same inclusion ratio as the original trust. It would seem that changes to the governance of the trust permitted under state law, or by judicial reformation should all be re-

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[185] Priv. Ltr. Rul. 08-39-025 (Sept. 26, 2008).

[186] *See* Treas. Reg. § 26.2642-6(h).

spected, particularly if these occur prior to the time GST exemption is allocated to the trust.

IX. GIFT TAX ISSUES WITH DECANTING

At least two potential gift tax issues arise in the context of decanting. First, does a beneficiary who acquiesces to a decanting and thereby dilutes or forfeits a beneficial interest in the trust make a taxable gift? Second, does the power to decant itself, if held by a beneficiary acting as trustee, have gift tax consequences?

A person makes a gift for Federal tax purposes to the extent she transfers property worth more than what she receives, in money or money's worth, in exchange.[187] It seems that a beneficiary who neither created the trust nor holds a fixed interest in it—such as a right to income—or a general power of appointment described in section 2514(b) should not be treated as making a gift if the trust is invaded by placing the property in further trust pursuant to a decanting power.

In fact, Treasury Regulation section 1.643(b)-1 provides in part that a switch or conversion from an income interest to a unitrust interest, if "not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may . . . result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances."[188] That contention seems inconsistent with the apparently well-established law that a person may make a taxable gift only by making a voluntary transfer.[189] But it is consistent with the GST Regulations cited above, in which implied consent or acquiescence to changes effected by judicial proceedings or nonjudicial settlement can have tax consequences different from the exercise of fiduciary powers, at least where the fiduciaries are not independent. Accordingly, in the case where the beneficiary is acting as the trustee—or one of the trustees—who chose to decant trust assets, and in the process "gave up" certain property interests, the beneficiary could quite reasonably be charged with making a gift by the act of decanting.[190] If, however, decanting is akin to a

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[187] *See* I.R.C. § 2512.

[188] Treas. Reg. § 1.643(b)-1.

[189] *See* Harris v. Comm'r, 340 U.S. 106, 109 (1950); Estate of DiMarco v. Comm'r, 87 T.C. 653, 658 (1986), *acq. in result*, 1990-2 C.B. 1.

[190] *See generally* Jonathan G. Blattmachr, Stephanie E. Heilborn & Mitchell M. Gans, *Gifts by Fiduciaries by Tax Options and Elections*, PROB. & PROP., Nov.-Dec. 2004, at 39.

power of appointment, a beneficiary-trustee may have tax consequences even if the beneficiary's interests in the trust are discretionary.[191]

The statutes that require the trustee to have absolute discretion to invade principal, such as the current Florida statute and former New York statute, do not appear to create additional tax difficulties for the beneficiary acting as a trustee over and above those already present as a result of the absolute distribution authority. A trustee who is a beneficiary of the trust would be treated as holding a general power of appointment within the meaning of sections 2514 and 2041 if the trustee had absolute discretion to distribute principal to herself.

In addition, a trustee who is also a beneficiary and who is not permitted to make distributions to herself, but is permitted to make distributions to other beneficiaries, might be treated as making a taxable gift on the exercise of such authority.[192] Accordingly, a trustee who is also a beneficiary typically would be afforded tax protection either by a restriction in the governing instrument, or by means of a state statute,[193] which would restrict distributions by a beneficiary who is also a trustee to an ascertainable standard of health, education, maintenance, and support within the meaning of section 2041(b)(2). In either case, the trustee-beneficiary would not, as a result of the application of the standard, be deemed to have the authority to decant under the New York or Florida statutes.

To attempt to ensure that any gift a beneficiary of a decanted trust may be charged with making would not be complete, it may be appropriate to grant the beneficiary a special power of appointment so as to render any gift incomplete and, therefore, not subject to gift tax.[194]

X. ESTATE TAX ISSUES WITH DECANTING

If the decanting resulted in a beneficiary's making a gift for federal gift tax purposes, it may well be that his or her gross estate would have to in-

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[191] *See* Priv. Ltr. Rul. 02-43-026 (Oct. 25, 2002) (exercise of a lifetime special power by the spouse who was also a discretionary beneficiary was a taxable gift and direct skip); *see also* Rev. Rul. 75-550, 1975-2 C.B. 357 (cited in Priv. Ltr. Rul. 02-43-026 for the possible method of computing the taxable gift; Rev. Rul. 75-550 concluded that the value of the spouse's income interest in a trust for purposes of section 2013 was computed "by taking into account the estimated amount of all possible invasions from the corpus on a year-to-year basis").

[192] Priv. Ltr. Rul. 98-11-044 (Mar. 13, 1998); *cf.* Rev. Rul. 67-370, 1967-2 C.B. 324; Estate of Regester v. Comm'r, 83 T.C. 1 (1984). *But see* Self v. United States, 142 F. Supp. 939 (1956).

[193] *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-7.2 (McKinney 2002).

[194] *Cf.* Treas. Reg. § 25.2511-2(c).

clude the trust property so decanted if the beneficiary's transfer fell under any of sections 2035, 2036, 2037, 2038, 2039, or 2042. If the beneficiary otherwise would be treated as making a gift for federal gift tax purposes by the decanting, and was given a special power of appointment to prevent any such gift from being complete, it seems likely that the decanted property would be included in her gross estate under sections 2036(a)(2), 2038, or both.

Under Revenue Ruling 95-58, powers described in section 2036 or 2038 held by a trustee are attributed to the trust's settlor—causing estate tax inclusion in the settlor's estate—if the settlor may remove the trustee and name another as trustee, unless the settlor is barred from appointing herself or anyone who is related or subordinate to the settlor within the meaning of section 672(c).[195] This attribution of the trustee's powers has been extended, unofficially, by the Service to beneficiaries acting as trustees, potentially causing them to be deemed to hold a general power of appointment.[196]

If a beneficiary acting as a co-trustee can, with the consent of a nonadverse trustee, participate in a decanting, does that raise tax concerns for the beneficiary? The powers of a co-trustee should not be attributed to the beneficiary merely because decanting is one of those powers. If the co-trustee is required to acquit his, her, or its fiduciary duties appropriately, and is not, via a removal and replacement power, deemed to be a puppet of the beneficiary, then the beneficiary's ability to participate in the decision to decant should not by itself ordinarily raise tax concerns. That being said, if the power to decant confers authority on the beneficiary-trustee that would enable that individual to participate in making distributions not limited by an ascertainable standard within the meaning of section 2041, this clearly creates an estate tax inclusion problem, as the decanting power then constitutes a general power of appointment.

Thankfully, many states have enacted legislation that would prohibit this result as a general matter.[197] Furthermore, because many decanting statutes specifically include language to the effect that the power to decant is to be construed as a nongeneral power of appointment,[198] and expressly prevent trust assets from being decanted in a way which broadens the standard

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[195] Rev. Rul. 95-58, 1995-2 C.B. 191.

[196] *See, e.g.*, Priv. Ltr. Rul. 05-51-020 (Dec. 23, 2005).

[197] *See, e.g.*, FLA. STAT. ANN. § 736.0814(2) (West 2010), which provides that a trustee's authority to make distributions to himself or herself as a beneficiary will be construed as limited to an ascertainable standard (for health, education, welfare and support).

[198] *See, e.g.*, ALASKA STAT. § 13.36.157(c) (2012); DEL. CODE ANN. tit. 12, § 3528(c) (2007).

for further invasions of trust principal,[199] these statutes should prevent a beneficiary-trustee from participating in a decanting that would confer upon him or her an interest in the trust tantamount to a general power of appointment.

Finally, certain decanting statutes contain an exception to the prohibition on a beneficiary-trustee's participation in the power to decant, if distributions are limited by an ascertainable standard.[200] The exception appears intended to reflect the fact that if a beneficiary-trustee's authority with respect to distributions or a power of appointment is limited by an ascertainable standard, then under section 2041, the power would not be construed as a general power of appointment. The Delaware statute states that if the original trust contains an ascertainable standard for distributions, the exercise of the power to decant must be in furtherance of that standard.[201] Other statutes simply permit a beneficiary-trustee to participate in the decanting only if distributions are limited to a standard. The question, then, is whether practitioners should infer that the same standard also must be contained in the trust to which property is decanted. The answer would seem to be in the affirmative.

XI. CONCLUDING THOUGHTS

This Article has reviewed the history, potential, and limits of powers of appointment, and interpreted the emerging world of trust decanting through the lens of appointment. It has attempted to convey the broad scope of powers: that they can be mandatory or not; taxable or not; fiduciary or not; and subject to creditors or not. Importantly, what all powers of appointment have in common is that they can be of immense utility and flexibility in the creation of an estate plan. Nothing illustrates this better than decanting, which, based largely on the modern understanding of powers of appointment, has grown from an initially obscure, 70-year-old case to become a major area of debate for legal practitioners, state legislatures, and the Service. This discussion also illustrates the ways in which this powerful legal tool should be utilized deliberately and with appropriate forethought. The terms and presumptions under which a power is created in a donor's or testator's initial instrument may have ramifications many years or decades later, based in no small part on the thoughtful design of a power which both limits and structures the future decisions of trustees and beneficiaries.

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[199] *See, e.g.*, ALASKA STAT. § 13.36.157(a)(4) (2012).
[200] *See, e.g.*, DEL. CODE ANN. tit. 12, § 3528 (2007).
[201] *Id.*