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ESTATE TAXATION OF POWERS OF APPOINTMENT

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I. POWERS OF APPOINTMENT PRIOR TO THE 1942 REVENUE ACT

A. Powers under the 1916 act

For centuries powers of appointment have been a favorite tool of legal draftsmen seeking to accomplish by indirection what could not be done directly.[1] With the advent of the first Federal estate tax in 1916, the use of such powers was seized upon as a convenient and effective tax avoidance device.

You will recall that under the rules of real property law the recipient of property passing under a power of appointment is viewed as receiving nothing from the donee who exercised the power in his favor, but rather as receiving title to the property directly from the donor or the creator of the power. In other words, when A gave to B the power to name the person to whom the property shall pass and B exercised that power in favor of C, in theory C took the property directly from A, B having merely filled in the blank left by A in the instrument creating the power.

No specific reference was made in the Revenue Act of 1916 regarding the taxation of powers of appointment for federal estate tax purposes. Efforts of the Treasury Department to include property passing under broad powers of appointment in the estate of the donee proved unavailing when the Supreme Court, following the technical rules of real property law, held that under the 1916 Act no property or property interest passed from the donee upon his exercise of the power.[2]

Congress soon realized that the power to appoint might be so broad as to be tantamount to economic ownership of the appointable property. Therefore, in 1918 Congress provided for the inclusion in the donee's estate of the value of property passing upon his exercise of a general power. The taxation of powers of appointment remained substantially unchanged from the enactment of the Revenue Act of 1918 to the passage of the Revenue Act of 1942.

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[1] As a matter of general interest, we note that it is said by our legal historians that the use of powers of appointment had its inception in the minds of medieval conveyancers who, prior to the enactment of the Statute of Wills in 1540, sought to circumvent the existing restriction prohibiting the devise of real property by transferring the land intervivos to another to the use of such persons as the transferror should by will appoint and until, or in default of, appointment to the use of the transferror and his heirs.

[2] United States v. Stanley Field, 225 U.S. 257 (1921).

B. Taxation of powers from 1918 to 1942

For the estate planner, the problem was, of course, how to insulate effectively the property subject to the power in such a fashion that it would not have to run the exhausting gamut of successive estate taxes, after the property was once subjected to tax upon the death of the donor of the power. The estate tax law as it existed during the period from 1918 to 1942 left ample room for the avoidance of the "second tax," upon the death of the donee, by the judicious use of powers of appointment.

To better understand and appreciate the limitations imposed by the Revenue Act of 1942, which embodies the present law with reference to taxation of powers, we pause briefly to see how matters stood immediately prior to that Act.

Where the donee died on or before October 21, 1942 (the effective date of the Revenue Act of 1942), the statute included in his gross estate property (exclusive of real estate outside the United States) *passing* under a *general* power of appointment actually *exercised* by will or, broadly speaking, by a disposition made in contemplation of, or intended to take effect at or after, death, or reserving a life estate or retaining power to designate future beneficiaries (either alone or in conjunction with any person).[3]

The statute did not define the term "general power of appointment," nor did it state what was meant by a "limited or special power of appointment." Ordinarily, a general power is one to appoint to any person in the discretion of the donee, or, however limited as to the persons in whose favor the appointment may be made, is exercisable in favor of the donee, his estate, his creditors, or the creditors of his estate; whereas, under a special power, the donee may appoint only from among a restricted or designated class of persons other than himself, his estate or the creditors of either.[4] Of course, state law was not controlling with reference to what powers were to be classified as general or special for federal tax purposes.[5]

C. Renunciation of superflous appointments

We have seen that under the prior law, to be included in the donee's estate, the property subject to the power must have *passed* to the appointee by reason of its *exercise* by the donee. Therefore, even if the power was a general power and actually exercised by the donee, the property was not included in the donee's estate if the appointee was

[3] INT. REV. CODE § 811 (f); U. S. Treas. Reg. 105, § 81.24 (a).

[4] U. S. Treas. Reg. 105 § 81.24 (a).

[5] J. B. Morgan v. Commissioner, 309 U.S. 78 (1940); Whitlock-Rose v. McCaughn, 21 F. 2d 164 (C.C.A. 3d 1927); Lester v. Burnet, 46 F. 2d 756 (C.C.A. 4th 1931); Commissioner v. Solomon, 124 F. 2d 86 (C.C.A. 3d 1941).

the same person who would have taken under the donor's instrument creating the power, and received only what he would have received, had the donee failed to exercise the power.[6] There was considerable confusion as to whether (in order to avoid inclusion in the donee's estate) it was necessary for the appointee to renounce such a superfluous appointment and elect to take directly under the instrument of the donor. Since the decision in the *Rogers Estate* case,[7] it appears that renunciation was not necessary if the appointment, in favor of the person who would have taken had the power not been exercised, exactly "echoes" the devise in default; if, in exercising the power, the donee gave more *or less* than what the appointee would have received in default of appointment the property is included in the donee's estate.

D. Tax avenues of escape prior to the 1942 act

By way of summary, prior to the 1942 Act, the restrictions imposed upon the use of powers of appointment were sufficiently limited so that such powers could still be used effectively to transfer property from generation to generation without incurring the cost of but one federal estate tax, i.e., to the donor's estate. Several convenient alternatives were available to preclude the tax upon the donee's estate; First, the donor in the instrument creating the power could render the power "special" by disqualifying the donee, his estate or the creditors of either as persons for whose benefit the power could be exercised; second, the donor could create a special power by defining specifically the group of eligible appointees; third, though the power was general, the donee could fail to exercise it so that the recipients of the property would take directly from the donor, and not as appointees under the power; and, fourth, though the power was general and exercised by the donee, the appointees could renounce and elect to take directly from the donor in those cases where the appointees were the same persons who, under the instrument by which the donor created the power, would have taken in default of its exercise.

II. Powers of Appointment after the 1942 Revenue Act

A. Changes made by the 1942 act

It was inevitable that Congress would clamp down on the extensive use of tax-free powers of appointment, and it did so in the Revenue

[6] See Helvering v. E. Morgan Grinnell, 294 U.S. 153 (1935). It has also been held that property which was the subject of a will contest suit *passed* under the power where the contestants assumed the validity of the exercise. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 (1942).

[7] Rogers Estate v. Helvering, 320 U.S. 410 (1943), where the entire appointed property was held subject to the estate tax, notwithstanding the fact that part of the appointed property went to persons who would have received a larger share had they taken in default of appointment. See also Charlotte D. M. Cardeza Estate, 5 T.C. 202 (1945); Edith Fitz Estate, 4 T.C.M. 968 (1945); Louise V. Kerr Estate, 9 T.C. 359 (1947).

Act of 1942, which contains the present law regarding taxation of such powers.

The 1942 Act changed the pre-existing law in several very important respects: First, not only general, but also certain special powers (not specifically exempted by the Act) were made taxable; second, such powers were taxable whether exercised or not—a recognition of the theory that failure of the donee to exercise a power was in effect tantamount to an exercise in favor of those who would have taken in default of appointment and a repudiation of the theory that the appointee took from the donor; and third, powers exercised or released intervivos were made taxable to the donee's estate, if in contemplation of death or intended to take effect at or after death, or if he reserved a life estate or retained the power to designate future beneficiaries (either alone or in conjunction with any person).[8]

Under the present law, to be excluded from the donee's estate, the property must be subject to a power to appoint person or persons within the group prescribed by the statute, which includes only: the spouse of the decedent-donee, spouse of the donor, descendants of the decedent or his spouse, descendants (other than the decedent) of the donor or his spouse, spouses of such descendants and specified charities, religious and educational organizations, and state and federal governments for public purposes.[9]

The powers listed in the preceding paragraph are the privileged powers which a donee may have, notwithstanding the fact that he received from the donor a beneficial interest of his own, such as a life interest in the appointable property.

In cases where the donee receives no beneficial interest of his own and is expected to act in a disinterested fiduciary capacity in exercising the power, the eligible class of persons for whose benefit the power may be exercised is not confined to the persons listed above, but may include any person of a "restricted class," provided, of course, the eligibles do not include the decedent, his estate or the creditors of either. The statute does not define what is meant by a "restricted class," but ac-

[8] INT. REV. CODE § 811(f) as amended by the Revenue Act of 1942, § 403 (a).

[9] The statute defines the term "descendant" to include adopted and illegitimate descendants, and the term "spouse" to include a former spouse.

A word of caution in drafting powers, in exact conformity with the statutory enumeration, to include as eligible appointees all members of the family group: The Regulations define as taxable power any power which may be exercised directly or indirectly for the donee's benefit. Therefore, where, for example, the donee is the donor's spouse, such a power (listing as eligible appointees the persons named in the statute) may be construed to be taxable because exercisable in favor of the donor's spouse who is also the donee of the power. To avoid such a result, the instrument creating the power should affirmatively state that the power cannot under any circumstances be exercised in favor of the donee, his estate, or the creditors of either.

cording to the Regulations[10] it refers to a relatively small class, which need not necessarily be related to each other or to the donor or the donee, nor is the restricted character of the class affected by the fact that the decedent has the power to appoint any number of organizations qualifying as charitable, religious, educational, etc., under the statute. However, the class is not sufficiently restricted merely because the donee of the power is prohibited from appointing to anyone except a named individual or his family or merely because the power is not exercisable in favor of the decedent, his estate or the creditors of either.

Another important qualification imposed by the statute, intended to forestall successive tax-free transfers by use of powers, is that if the power is *exercised* by creating *another* power to appoint, the first power is not tax-exempt to the extent of the value of property subject to the second power; also, if the second power is created subject to any precedent or subsequent interest, such as a life estate, the value of the life interest will not be deducted in determining the value of the property includible in the original donee's estate.

The legal draftsmen might do well to note also the provision in the 1942 Act which provides that the estate of a donee of a power of appointment, which is taxed because of the power, may recover from the recipient of the appointable property the portion of the donee's estate tax allocable to the property.[11] It is evident that this provision for reimbursement will not work equitably in all cases. For example, the appointee's share of the tax may be high because of the great value of the other assets in the donee's estate, or the donee's estate might not have been sufficient in amount to be subject to any estate tax at all had it not been for the inclusion of the appointable property. The donor might do well to make some specific provision for reimbursement in a manner equitable under the circumstances of the particular case.

B. Constructive powers of appointment

The statute does little to enlighten us as to what is meant by a "power of appointment," but the Regulations[12] remind us that the term includes any power which in substance and effect is the power to designate a beneficiary. For example, if a life tenant has the right (even though consent of a trustee is required) to invade the corpus or to amend or terminate the trust, that right may be treated as a kind of power of appointment because by exercising or not exercising that right the life tenant can control how much, if any, of the property will pass to the remaindermen.[13] Likewise, a grantor of an intervivos trust re-

[10] U. S. Treas. Reg. 105, § 81.24(b). [11] INT. REV. CODE § 826(d).
[12] U. S. Treas. Reg. 105 § 81.24(b) (1).
[13] In cases where provision is to be made for application of the corpus for the benefit of the life tenant, it would seem wise to put the right of invasion within the absolute and uncontrolled discretion of an independent trustee to avoid taxa-

serving powers to amend, revoke or terminate may be held to have retained a power of appointment.[14] Other examples of "constructive" powers of appointment are set forth and discussed in the Regulations. These examples should suffice to put the estate planner on notice that a "rose by any other name smells just as sweet" to the Commissioner of Internal Revenue and that powers of any kind must be granted only after careful consideration of possible estate tax consequences.

C. Release of powers of appointment

Because of the drastic changes wrought by the 1942 law, Congress provided escape clauses for powers *created*[15] *on or before* October 21, 1942 (the effective date of the Revenue Act of 1942) which were tax-exempt under the pre-existing law, but taxable under the new. Briefly, these provisions were as follows:

1. If the power is a special power under the pre-existing law (i.e., *not* exercisable in favor of the donee, his estate or the creditors of either), the property subject to the power will not be taxed to the donee's estate, if not exercised, regardless of when the donee dies;
2. If the power is a general power under the pre-existing law (i.e., exercisable in favor of the donee, his estate or the creditors of either), the property subject to the power will not be taxed to the donee's estate, if he either dies or releases the power, prior to July 1, 1949.

If the donee was under a legal disability (a fact generally to be determined under local law) to effect a release, or was in military or naval service, *on* October 21, 1942, such release must be accomplished prior to July 1, 1949 or within six months after termination of the disability, or after termination of the war (in cases where the donee was in the service), whichever is the later date.[16]

bility of this right on the ground that it is a power exercisable in favor of the donee. If the life tenant himself is to be given the right to invade the corpus for his own benefit, the amount of the corpus that could be included in his estate at death can be minimized by limiting his right to invade only up to a fixed annual, non-cumulative maximum; such a provision would limit the amount includible in his estate to that part of the corpus which he either withdrew, or might have withdrawn, in the year of his death. It is possible, however, that amounts not withdrawn in prior years might be subject to gift tax on the ground that the election of the life tenant, not to invade the corpus to the extent of the allowable maximum, in effect constituted a taxable release of a power. See U. S. Treas. Reg. 108, § 86.2(b).

[14] Ordinarily, powers of management with respect to property in trust, such as determination of whether distribution shall be annually or quarterly, the making of investments and reinvestments, or the determination of items of income and principal under recognized rules of accounting, are not construed to be powers of appointment. U. S. Treas. Reg. 105, § 81.24(b)(1).

[15] A power is "created" when the instrument giving the power becomes effective. In case of a will providing a power of appointment, the effective date is, of course, the date of the testator's death, not the date of the instrument.

[16] Revenue Act of 1942, § 403(d) as amended. This section has been amended eight times in order to extend the time within which powers created prior to

It is obvious that substantial tax savings can be effected by timely release or amendment of a pre-1942 power, in order to tailor it to fit the pattern of a non-taxable power under the 1942 Act. If accomplished prior to the statutory deadline, such a release can be made free of gift tax. For example, if the donee has a general power created in 1941, unless this power is released within the prescribed time limited the donee will have to pay a gift tax if he voluntarily releases or exercises the power during his lifetime or his estate will be taxed if he dies without having previously released or exercised the power. On the other hand, if the power can be amended or partially released before the prescribed deadline, so that the eligible appointees include only the privileged persons within the family group designated by the Act, the appointable property can be immunized from both the gift tax upon the release and the estate tax at the donee's death.

These provisions for tax-exempt release of powers have no application to *taxable* powers created *after* October 21, 1942; the estate tax at the donee's death may be avoided by the release of such powers intervivos (assuming, of course, that this is not done in contemplation of death), but a gift tax may be imposed because of the release. However, a *non-taxable* power under the 1942 Act may be released or exercised intervivos without incurring any gift tax. Thus the estate planner may find that an attractive feature of fitting the power into the privileged category, under the 1942 Act, is that it can thereafter be released or amended without incurring any additional gift tax or exercised without incurring any additional gift or estate tax.

III. Use of Powers of Appointment under the 1948 Act

A. The marital deduction

The so-called "marital deduction" provisions of the recently enacted Revenue Act of 1948,[17] allowing married couples in non-community as well as community, property states, the right to dispose of up to one-half their property to each other without estate tax liability, have brought about a new use of powers of appointment as a means of minimizing estate taxes, for those desiring to make use of the marital deduction.

In brief, the new law permits as a deduction for estate tax purposes

October 22, 1942, could be released to avoid gift and estate taxes. The most recent amendment was effected by Pub. L. No. 635, 80th Cong., 2d Sess., (June 12, 1948) which prescribed July 1, 1949, as the deadline for such releases. The fact that a power is not releasable under state law does not constitute a legal disability under the statute. These repeated extensions have been occasioned in part by the fact that only a few of the states have adopted the necessary enabling legislation for the accomplishment of such releases. North Carolina is one of the states which has adopted legislation to facilitate such releases. See N. C. Gen. Stat. §§ 39-33 to 39-36 (1943).

[17] The provisions of the Revenue Act of 1948 are effective with respect to the estates of all persons dying on or after January 1, 1948.

the value of any *interest in property passing*[18] (or which has passed by lifetime gift) from the decedent to the surviving spouse, with the over-all limitation that the aggregate amount of the deduction may not exceed 50 per cent of the decedent's "adjusted gross estate."

Property passing to the surviving spouse (whom we will assume is the wife for the purposes of this discussion), in order to qualify for the marital deduction, must be property which is included in determining the value of the decedent's (that is, the husband's) gross estate. Also the property must pass to the wife outright or under circumstances whereby she has what is tantamount to absolute ownership of the property. The underlying theory behind this requirement is that the property will not be permitted to pass tax-free at the husband's death if the transfer to the wife would also insulate the property from taxation while in her hands or upon her death.

B. The terminable interest rule

Consequently, the new law provides that no marital deduction shall be allowed with respect to certain life estates or other "terminable interests" transferred from the husband to the surviving wife. For present purposes, we will not go into all the refinements of the Act with reference to "terminable interests," but we will pause long enough to review briefly what is meant by this term in order that we will be able better to understand the use of powers of appointment under the new law in connection with certain of these terminable interests.

A "terminable interest" is defined by the Act as an interest which may or will fail or terminate, either by lapse of time or because of the occurrence or non-occurrence of any event or contingency. The benefit of the marital deduction is lost with respect to such terminable interests only if one of two conditions exist: (1) If an interest in the same property passes, for less than an adequate consideration in money or money's worth, from the decedent to any person, other than his surviving spouse or her estate, who *may* possibly possess or enjoy the property *after* the termination or failure of the interest passing to the surviving spouse, or (2) if the terminable interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.[19]

[18] INT. REV. CODE § 812(e) (1) (A). For the purpose of determining the marital deduction, what is meant by the "passing" of a property interest from the decedent to another is defined in INT. REV. CODE § 812(e) (3).

[19] INT. REV. CODE § 812(e) (1) (B). For the purposes of this discussion we need not be particularly concerned with the second condition disallowing the marital deduction in cases where the property is to be acquired for the surviving spouse, pursuant to the directions of the decedent, by his executor or by the trustee of a trust. This is the one case where the wife is considered as having a terminable interest although no interest passes from the decedent to any person other than the wife. This provision was included to prevent the circumvention

Several examples recited in the Senate Finance Committee Reports[20] may tend to clarify what is meant by the first of these two conditions: If the decedent husband transferred Blackacre by gift to his son, but retained a 20 year lease which he bequeathed to his surviving wife, no marital deduction would be allowed with respect to that bequest since the son acquired Blackacre by gift and had an interest in the property which he might enjoy after the expiration of the lease. However, if the son had paid his father a fair price for Blackacre, it would appear that the terminable interest (i.e., the 20 year lease) passing to his wife would qualify for the marital deduction, because the decedent had what was the equivalent of Blackacre—the 20 year lease plus the sale price received. Another example, illustrative of a terminable interest which would run afoul of the conditions imposed by the law, would be where the decedent devised Blackacre to his wife and daughter as joint tenants; both the wife and the daughter would have terminable interests, and since by right of survivorship the daughter *might* possess or enjoy the property after the wife's death, no marital deduction would be allowable with respect to the interest passing from the decedent to his wife.

The Act provides for a number of exceptions to the "terminable interest rule" but we will direct our attention only to those which particularly affect the use of powers of appointment.

C. Terminable interests coupled with powers of appointment

Generally, a power of appointment is not an "interest in property" and therefore if the decedent gave his wife power to appoint property, the property subject to the power would not qualify for the marital deduction because no "interest passes" to the wife. If the decedent gave his wife a life estate in the property, no marital deduction would be allowed because the life estate is a terminable interest which cannot qualify.

However, one of the most important exceptions to the "terminable interest rule" prescribed by the statute, is the one with respect to a life estate given the decedent's surviving spouse in trust when coupled with a broad power of appointment.[21] Six separate conditions are set forth with respect to this exception:

1. The trust must be created by a transfer of property by the decedent during his lifetime or by his direction under his will.
2. The surviving spouse must be entitled for her life to all the income from the corpus of the trust.

of the other terminable interest provisions of the statute; for example, where the decedent directed that after his death his executor should buy annuity for his wife for her life or a term of years.

[20] SEN. REP. No. 1013, 80th Cong., 2d Sess. Part 2 (1948).

[21] INT. REV. CODE § 812(e)(1)(F).

3. The surviving spouse must be entitled to the income from the corpus of the trust annually, or at more frequent intervals.
4. The surviving spouse must have power to appoint the entire corpus free of trust, and such power must be exercisable in favor of such surviving spouse or in favor of her estate (regardless of the fact that the power might also be exercisable in favor of others).
5. If any person other than the surviving spouse had a power to appoint any part of the corpus, such power must be exercisable only in favor of the surviving spouse.
6. The power possessed by the surviving spouse to appoint any part of the corpus free of trust must be exercisable alone and in all events.

These provisions have the effect of allowing a marital deduction with respect to the value of property transferred in trust by or at the direction of the decedent where the surviving spouse by reason of her right to the income and a power of appointment is the virtual owner of the property. This provision is designed to allow the marital deduction for such cases where the value of the property over which the surviving spouse has a power of appointment will (if not consumed) be subject to either the estate or the gift tax in the hands of the surviving spouse. However, a trust will not qualify for deduction merely because the surviving spouse is given a power which would be subjected to estate tax; the power must fall precisely within all these requirements of the statute.

The requirement that the wife must be entitled for her life to all the income of the trust corpus does not mean that the trust must not terminate until her death, but rather that she must be entitled to all the income from the corpus during the existence of the trust, even though by her exercising the power, or by some other person exercising the power in her favor, the trust could be terminated at an earlier date. The requirement that the income must be payable to the wife at least annually disqualifies for the marital deduction any trust the income of which is or may be accumulated.

If the surviving spouse is given the power of appointment, the fact that she can exercise the power in favor of others or that she has only a limited right to invade the corpus during her life, or that the property will go to other named persons upon her failure to exercise the power, will not disqualify the property for the marital deduction as long as she has the power to appoint the corpus free from trust in favor of herself or her estate. If the power is given to some other person, to qualify it must be exercisable only in favor of the surviving spouse.

The requirement that the power given the surviving spouse to appoint the corpus free of trust must be exercisable "alone and in all events," will not be satisfied if exercisable only with the consent of, or in conjunction with, another person, or if her right to exercise the power is subject to some contingency which might defeat her power to appoint. For example, if the wife were given a power exercisable by will as long as she remained unmarried or terminable at a specified date or at death, whichever occurred first, the appointable property would not qualify for the marital deduction in the husband's estate.

Another important exception to the "terminable interest rule" is made in the case of proceeds under a life insurance, endowment or annuity contract passing from the decedent.[22] This exception is limited to those cases where under the terms of the contract the principal installments, or the interest payments on the proceeds, are payable only to the surviving spouse at least annually (commencing within thirteen months after the decedent's death) and where under the contract she is given the power to appoint all amounts payable under the contract in favor of herself of her estate. The fact that she may also have the power to appoint the proceeds to others will not disqualify the proceeds for purposes of the marital deduction as long as she can, if she wishes, exercise the power in favor of herself or her estate. This exception is also limited by substantially the same conditions and requirements which we discussed concerning a trust with power of appointment in the surviving spouse. To qualify for a marital deduction all these requirements must be met by the terms of the contract, viewed as of the date of the decedent's death.

[22] INT. REV. CODE §812 (e) (1) (G), as amended by Pub. L. No. 869, 80th Cong., 2d Sess. (1948). The amendment to this section changed the provisions originally enacted in the Revenue Act of 1948 in several material respects: The original provision applied only to proceeds of insurance upon the life of the decedent, where some part of the principal was payable to the surviving spouse annually or at more frequent intervals. The amendment extends the application of this section to annuity and endowment contracts and to proceeds under an insurance contract upon the life of another where the insured predeceases the decedent, and also to cases where the proceeds are held by the insurer subject to an agreement to pay only interest to the surviving spouse annually or at more frequent intervals. Further, the amendment extended from one year to thirteen months the period within which the first payment of installment or interest must be made to the surviving spouse. The amendment also clarified the original provision by stating specifically that the surviving spouse must have power to appoint amounts payable under the contract either in favor of herself *or* her estate. The amendment is applicable with respect to estates of decedents dying after December 31, 1947. See, H. R. REP. No. 2370, 80th Cong., 2d Sess. (1948) to accompany H. J. Res. 429.