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## ESTATE PLANNING AND POWERS OF APPOINTMENT

CHARLES L. B. LOWNDES\*

One of the significant developments in the area of tax and estate planning is the Powers of Appointment Act of 1951,<sup>1</sup> which was enacted on June 28, 1951, in an effort to find a just and permanent solution for the taxation of powers of appointment under the federal estate and gift taxes. The new law deserves careful scrutiny not only by the tax specialist, but by every lawyer who is interested in drafting wills and trusts or planning estates.<sup>2</sup> Powers of appointment in the broad sense in which that expression is used in the Powers of Appointment Act are one of the most valuable tools which the estate planner has; and the new law, which adopts a much more relaxed attitude toward the taxation of such powers than some of the earlier legislation, offers opportunities for tax economies which one can ill afford to overlook. Before passing to the taxation of powers of appointment, however, it may be helpful to look briefly at what the tax law means by a power of appointment.

### *Powers of Appointment*

In some respects a power of appointment is defined more broadly under tax law than it is under property law, and in some respects it is defined more narrowly.<sup>3</sup> For purposes of the federal estate and gift taxes, a power of appointment means any power to dispose of property which the holder of the power does not own, as long as the holder of the power received the power from someone else; that is, as long as the power is a "donated" power as distinguished from a "reserved" power. Thus, if A leaves property to T in trust to pay the income from the property to C for life, and at C's death to distribute the property to whomsoever C designates by his will, C has a power of appointment. However, as far as the federal estate and gift taxes are concerned, C would also have a power of appointment, if he were given power to withdraw principal from the trust, or to terminate the trust and compel the trustee to convey the trust property to C or to someone else. Moreover,

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<sup>1</sup> Pub. L. No. 58, 82d Cong., 1st Sess. (June 28, 1951) amending §§811(f) and 1000(c) of the Internal Revenue Code.

<sup>2</sup> For discussions of the new law see: Turk, *Powers of Appointment*, 90 TRUSTS & ESTATES 428 (July 1951); Craven, *Powers of Appointment Act of 1951*, 65 HARV. L. REV. 55 (November 1951); Lucas, *Taxation of Powers of Appointment under the New Law*, 31 TRUST BULLETIN 26 (December 1951); Johnson, *Powers of Appointment*, 29 TAXES 965 (December 1951).

<sup>3</sup> For the property law definition of a power of appointment see, RESTATEMENT, PROPERTY §318 (1940); SIMES, FUTURE INTERESTS 168 (1951).

any powers given to the trustee to affect the beneficial enjoyment of the trust, like a power to invade principal on behalf of the income beneficiaries of the trust, or to terminate the trust, are treated as powers of appointment for tax purposes. Thus as far as the federal estate and gift taxes are concerned, any power by which the holder of the power can dispose of property which he does not own is treated as a power of appointment, as long as it is a donated power.

Reserved powers, that is, powers to appoint property which are retained by the owner of the property in connection with a conveyance of the property, are not treated as powers of appointment for tax purposes, but as "strings" upon the property transferred which make the transfer itself taxable to the estate of the transferor.<sup>4</sup> The practical importance of the distinction between donated and reserved powers is that a reserved power may result in a tax, where a donated power would not be taxable. For example, if A conveys property to T in trust to pay the income from the property to C during C's life and at C's death to distribute the property among the children of C as A shall appoint, and in default of appointment to divide the property among C's children equally, the remainder after C's life estate will be taxed to A's estate under the federal estate tax. It will not be taxed upon the theory that A had a power of appointment, because his power is a special power which is not taxable. But it will be taxed upon the theory that A kept a "string" on the property which makes the transfer of the property taxable to his estate as a transfer which he could alter or amend.<sup>5</sup>

Tax lawyers use the same terminology as property lawyers in designating the parties to a power of appointment. Thus, the person who creates the power is called the donor of the power. The person to whom the power is given is known as the donee of the power. The person to whom the property is appointed is called the appointee; and the person who takes the property in default of appointment is known as the taker in default of appointment. For example, suppose that A leaves Blackacre to B for life with a power to appoint the remainder in the property by his will, with remainder in default of appointment to C and his heirs, and that B appoints the property to X. A is the donor of the power. B is the donee. X is the appointee. C is the taker in default of appointment.

Powers of appointment are ordinarily divided into general and special powers. Under property law, a general power means a power to appoint property to any one in the world, although there is a recent tendency to call a power under which the donee can appoint the property to himself

<sup>4</sup> INT. REV. CODE §§811(c) and 811(d).

<sup>5</sup> INT. REV. CODE §811(d); *Commissioner v. Chase Nat. Bank of New York*, 82 F. 2d 157 (2d Cir. 1936), *cert. denied*, 299 U. S. 552 (1936).

a general power, even though his choice of appointees is not unlimited.<sup>6</sup> A special power is a power to appoint to a restricted class of persons.<sup>7</sup> The tax distinction between general and special powers is somewhat more complex and will require more detailed examination.

Since a power of appointment is a power to dispose of property which the donee does not own, title passes from the donor of the power to the appointee, when the power is exercised, rather than from the donee to the appointee. If the power is not exercised, the taker in default acquires title from the donor of the power rather than the donee.<sup>8</sup> Perhaps the most graphic analogy to illustrate the common law operation of a power of appointment is what happens when a grantor of property makes a deed to the property with the grantee's name left blank and gives this to an agent with authority to fill in the name of the grantee and deliver the deed. When the agent fills in the name of the grantee and delivers the deed, title to the property passes from the grantor to the grantee, rather than from the agent to the grantee, because the agent has not transferred property which he owned; he has simply completed the original grant. A power of appointment operates in the same way. When the donee exercises the power and appoints the property he simply completes the transfer of the property from the donor of the power to the donee. The donee does not make a conveyance of his own property.

#### *Estate Planning and Powers of Appointment*

Powers of appointment are valuable in planning an estate because they give flexibility to an estate plan which makes it possible to accommodate the dispositive provisions of the plan to changes in circumstances. Illustrations of the use of powers of appointment in planning an estate could be multiplied almost indefinitely. Without attempting any detailed analysis of the role which powers of appointment play in planning an estate, consider several elementary examples which illustrate the value of powers of appointment in connection with a typical family settlement.

Frequently a man will leave his property in trust for his widow for life with remainders to his children. The principal vice of this type of disposition is its rigidity. If the income from the property proves inadequate for the widow's support, there is no way in which she can reach the principal. Moreover, the distribution of the remainder among the children will have to be determined at the husband's death. When the widow dies some of the children may have prospered mightily and have no need for the property. Others may have encountered misfortune and need more than their proportionate shares. Ordinarily a better method of disposing of the property will be to give the widow a power to withdraw any principal which she may need for her support during her life,

<sup>6</sup> RESTATEMENT, PROPERTY §320(1) (1940).

<sup>7</sup> RESTATEMENT, PROPERTY §320(2) (1940).

<sup>8</sup> SIMES, FUTURE INTERESTS 178-181 (1951).

with a further power to appoint the remainder among the children by her will. By the judicious use of powers of appointment a family settlement can be made sufficiently flexible to meet the needs of the family as they develop, rather than frozen in a rigid mold which cannot be adapted to changing conditions.

Another common situation where it is desirable to use powers of appointment occurs where a man leaves property in trust to a son for life, with remainders over to the son's children. This type of rigid settlement has another serious defect in addition to those which exist where property is left to a widow for life with remainders to children. Not only will the son be unable to reach any principal which he may need to support himself and his family during his life and to make a proper disposition of the property among his children at his death, but if his only estate consists of his interest in the trust fund, he will not be able to provide for his widow after his death. The son should be given power to withdraw whatever principal he needs for his support and that of his family during his life, and a power to appoint the remainder in the property among his children at death. In addition, he should be given power to appoint income or principal from the trust to his widow to take care of her after his death.

It probably is not an overstatement to say that any family settlement where property is tied up for a protracted period is presumptively defective unless it includes one or more powers of appointment. Even where the beneficiary of the estate is an incompetent who cannot be entrusted with a power of appointment, the possibility of giving powers to the trustee or some disinterested person should be carefully considered.

In dealing with powers of appointment it is important to consider their tax consequences. The Powers of Appointment Act of 1951<sup>9</sup> was expressly designed to encourage the use of powers of appointment. Consequently, it creates a sizeable area of tax-free powers, and it also contains a number of provisions for avoiding taxes on existing powers. A particular power of appointment should not be selected solely because it is not taxable. However, it will frequently happen that a non-taxable power will serve to reach a desired end equally as well as a taxable power. There are, moreover, cases where taxes in connection with existing powers can be minimized without the sacrifice of substantial advantages. The possible economies in connection with powers of appointment may be explored more intelligently after a consideration of how powers of appointment are taxed. Under the recent relaxation of the taxes on powers of appointment imposed by the federal estate and gift taxes, however, it would appear that there are very few situations where the purposes of an estate plan cannot be served as well by non-taxable

<sup>9</sup> Pub. L. No. 58, 82d Cong., 1st Sess. (June 28, 1951).

as taxable powers. One obvious exception, of course, is a marital deduction trust, where it is necessary to employ a taxable power to qualify the trust for the deduction.<sup>10</sup> Apart from the marital deduction trust, however, it will seldom be necessary to employ a taxable power.<sup>11</sup>

### *Taxation of Powers of Appointment*

Including the Powers of Appointment Act of 1951,<sup>12</sup> the taxation of powers of appointment has gone through four stages. In order to get some perspective on the new Act, it will be helpful to review the earlier law.

#### *A. The Prior Law*

The first federal estate tax enacted in 1916<sup>13</sup> made no explicit provision for taxing powers of appointment. In *United States v. Field*,<sup>14</sup> the Supreme Court held that property subject to a power of appointment was not taxable to the estate of the donee of the power, even where the power was a general power which the donee exercised by his will. The Court said that the property did not belong to the donee and was not distributable as part of his estate.

The 1918 Act<sup>15</sup> provided for a tax on powers of appointment, and the provisions of the 1918 Act upon this point remained substantially unchanged until the 1942 Act.<sup>16</sup> The tax imposed upon powers of appointment under the 1918 Act was restricted very narrowly. Congress limited the tax to property passing under the exercise of a general power of appointment by will or by a transfer in contemplation of, or taking effect, at death. In *Helvering v. Grinnell*,<sup>17</sup> the Supreme Court held that a power of appointment was not taxable even though it was a general power which the donee exercised by will, where the power was exercised in favor of the takers in default of appointment, who renounced under the will of the donee of the power and took under the default clause. The Court said that the property did not "pass" under the exercise of the power.

There was, of course, no gift tax in 1918. Prior to 1942 the gift tax made no mention of powers of appointment. The Treasury ruled that

<sup>10</sup> The rules about the type of power of appointment which must be given to a surviving spouse to qualify a trust for the marital deduction have not been changed by the Powers of Appointment Act of 1951.

<sup>11</sup> In the typical settlement where half of an estate is left to a surviving spouse under a marital deduction trust to take full advantage of the marital deduction, and the other half is tied up under a trust where the surviving spouse gets a life estate with remainders to the children, in order to avoid a "second tax," the possibility of introducing greater flexibility in the second trust by employing nontaxable powers of appointment might well be considered.

<sup>12</sup> Pub. L. No. 58, 82d Cong., 1st Sess. (June 28, 1951).

<sup>13</sup> 39 STAT. 756 (1916).

<sup>14</sup> 255 U. S. 257 (1921).

<sup>15</sup> 40 STAT. 1057 (1919).

<sup>16</sup> 56 STAT. 798 (1942).

<sup>17</sup> 294 U. S. 153 (1935).

the *inter vivos* exercise of a general power of appointment was taxable as a gift before 1942,<sup>18</sup> a position which seems questionable in view of the decision in *United States v. Field*,<sup>19</sup> and the fact that when the donee of a power of appointment exercises the power, title to the appointed property passes from the donor of the power to the appointee, rather than from the donee to the appointee.

In 1942 Congress adopted a new approach to the taxation of powers of appointment. For some time there had been increasing criticism of the method of taxing powers of appointment instituted by the 1918 Act. In 1939 Dean Griswold published an article<sup>20</sup> in which he contended that the existing tax on powers of appointment was too limited because it taxed only the exercise and not the non-exercise of powers of appointment and because the tax was limited to general powers. He also criticized the requirement that property had to "pass" under the exercise of the power of appointment. Griswold argued that the failure to exercise a power of appointment was another method of exercising the power and that the non-exercise as well as the exercise of powers should be taxed, which would also eliminate any requirement that property "pass" under the exercise of the power.<sup>21</sup> He also felt that restricting the tax to general powers of appointment was unsound because by creating a power, such as a power limited to residents of the United States, a man could in effect give the donee of the power what would for all practical purposes be a general power, although it was taxed as a special power.<sup>22</sup> Griswold intimated that he would be satisfied to exempt certain limited family powers, such as a power under which the donee might appoint property to his children or descendants, but he felt that generally both the exercise and the non-exercise of special as well as general powers should be taxed.

Professor Leach dissented<sup>23</sup> from Dean Griswold's views. He contended that if powers of appointment were taxed more extensively this would not increase the revenue from the estate tax, because people would

<sup>18</sup> U. S. Treas. Reg. 108, §86.2(b) (1943).

<sup>19</sup> 255 U. S. 257 (1921).

<sup>20</sup> Griswold, *Powers of Appointment and the Federal Estate Tax*, 52 HARV. L. REV. 929 (1939).

<sup>21</sup> Some of the difficulties which arose in connection with the rule laid down by *Helvering v. Grinnell*, 294 U. S. 153 (1935), that property must "pass" under the exercise of the power appear in *Rogers Estate v. Commissioner*, 320 U. S. 410 (1943).

<sup>22</sup> It was not clear whether or not in order to have a general power under the 1918 Act the donee of the power had to be authorized to appoint to anyone in the world. Griswold, *Powers of Appointment and the Federal Estate Tax*, 52 HARV. L. REV. 929, 938-942 (1939). In *Charles J. Hepburn, Ex'r*, 37 B. T. A. 459 (1938) a power which could only be exercised by the donee with the approval of a trustee was held to be a special power. In *Clausen v. Elizabeth R. Vaughan, Ex'r*, 147 F. 2d 84 (1st Cir. 1945) a power to anyone except one person or her family or assigns was held to be a special power.

<sup>23</sup> Leach, *Powers of Appointment and the Federal Estate Tax—A DISSENT*, 52 HARV. L. REV. 961 (1939).

dispose of their property by creating successive estates in order to avoid a second tax upon the death of the first beneficiary, without using powers of appointment. The result would simply be unwise and inflexible settlements without any offsetting tax advantages. Dean Griswold filed a reply to Professor Leach's dissent,<sup>24</sup> and Professor Leach came back with a rejoinder,<sup>25</sup> both of which added more heat than light to the controversy.

The argument between Griswold and Leach takes on added significance in view of subsequent developments. In 1942 a new system of taxing powers of appointment was adopted which paralleled very closely the suggestions which Dean Griswold made in his article. It seems, however, that Professor Leach may ultimately have the last word here just as he did in the original controversy, since the 1951 legislation repeals most of the 1942 ideas about taxing powers of appointment and vindicates the position which Leach espoused initially.

Under the 1942 Act,<sup>26</sup> the exercise or release of a general or a special power of appointment by will, or by a transfer in contemplation of, or taking effect at, death was taxed under the estate tax. Moreover, the non-exercise of either a general or special power was subject to the tax, provided the power was in existence at the donee's death. The 1942 Act expressly exempted powers under which the donee could only appoint to members of his immediate family or that of the donor of the power<sup>27</sup> or to a charity, and powers which could only be exercised by a disinterested fiduciary in favor of a restricted class of persons. However, these powers were taxed if they were exercised to create a second power, even an exempt power.

The estate tax amendments to the 1942 Act, which was enacted on October 21, 1942, applied to estates of decedents dying after the date of enactment of the Act.<sup>28</sup> However, an attempt was made to avoid a retroactive tax on powers created prior to October 22, 1942, by provid-

<sup>24</sup> Griswold, *In Reply*, 52 HARV. L. REV. 967 (1939).

<sup>25</sup> Leach, *Rejoinder*, 52 HARV. L. REV. 968 (1939).

<sup>26</sup> Revenue Act of 1942, §403, 56 STAT. 942 (1942).

<sup>27</sup> Section 403 of the 1942 Act provided that a power should not be taxable if the donee could only appoint "within a class which does not include any others than the spouse of the decedent, spouse of the creator of the power, descendants of the decedent or his spouse, descendants (other than the decedent) of the creator of the power or his spouse, spouses of such descendants," and charities. Although it seems pretty clear that Congress intended to treat any power under which the donee could appoint to himself as a taxable power, under a literal reading of the statute it could be argued that if the donee of the power was a spouse of the donor of the power and had power to appoint only to himself or herself, this would be an exempt power. In *Schwab v. Allen*, 78 F. Supp. 234 (M. D. Ga. 1948) the court held that a power to invade the corpus of a trust was not a taxable power when the beneficiary possessing the power was the spouse of the creator of the trust. If this decision was sound it seems to be the only situation where a power which was exempt under the 1942 Act will be taxable under the Powers of Appointment Act of 1951.

<sup>28</sup> Revenue Act of 1942, §401, 56 STAT. 941 (1942).



ing that such powers should not be taxed, if the donee of the power could not appoint to himself, his estate, his creditors or the creditors of his estate, unless the power was exercised.<sup>29</sup> Moreover, in the case of other powers created prior to October 22, 1942, no tax was imposed if the donee of the power released the power or reduced it to an exempt power prior to a prescribed date,<sup>30</sup> which was finally extended to July 1, 1951,<sup>31</sup> or died before the prescribed date without exercising the power. It was also provided that a donee under a disability at the time the 1942 Act was adopted could release or reduce a pre-existing power within six months of the removal of the disability without incurring any tax, and would incur no tax if he died within that period without releasing the power, provided he did not exercise the power.<sup>32</sup>

At the same time at which Congress amended the provisions of the estate tax taxing powers of appointment, it provided explicitly for the first time for a tax on powers of appointment under the gift tax.<sup>33</sup> The gift tax provisions were keyed to the estate tax amendments. Both the exercise and the release of either a general or a special power by the donee of the power during his life were taxed. The same two powers which were exempted from the estate tax were exempt under the gift tax, with, however, the same exception about the exercise of a non-taxable power to create a second power, which was taxable.

The gift tax amendments under the 1942 Act applied to gifts made on or after January 1, 1943.<sup>34</sup> However, no tax was imposed in the case of a power created prior to October 22, 1942, where the donee of the power could not appoint to himself, his estate, his creditors or the creditors of his estate, unless he exercised the power.<sup>35</sup> In the case of other powers created prior to October 22, 1942, the statute provided that if the donee was under a disability at the time the 1942 Act was adopted, he might release the power or reduce it to an exempt power at any time within six months of the removal of the disability without incurring a tax.<sup>36</sup> The statute also provided that there should be no gift tax if a power was released or reduced to a non-taxable power prior to January 1, 1943.<sup>37</sup> This privilege was not limited, expressly at least, to powers created prior to October 22, 1942. When the prescribed date for releasing or reducing powers without incurring any gift tax was subsequently extended by successive amendments to July 1, 1951,<sup>38</sup> the statutory

<sup>29</sup> Revenue Act of 1942, §403(d) (1), 56 STAT. 944 (1942).

<sup>30</sup> Revenue Act of 1942, §403(d) (3), 56 STAT. 944 (1942).

<sup>31</sup> Pub. L. No. 578, 81st Cong., 2d Sess. (June 27, 1950).

<sup>32</sup> Revenue Act of 1942, §403(d) (2), 56 STAT. 944 (1942).

<sup>33</sup> Revenue Act of 1942, §452, 56 STAT. 952 (1942).

<sup>34</sup> Revenue Act of 1942, §451, 56 STAT. 951 (1942).

<sup>35</sup> Revenue Act of 1942, §452(b) (1), 56 STAT. 952 (1942).

<sup>36</sup> Revenue Act of 1942, §452(b) (2), 56 STAT. 952 (1942).

<sup>37</sup> Revenue Act of 1942, §452(c) (3), 56 STAT. 952 (1942).

<sup>38</sup> Pub. L. No. 578, 81st Cong., 2d Sess. (June 27, 1950).

language did not restrict this privilege in the case of the gift tax, as it did under the estate tax, to pre-existing powers, although the Regulations did.<sup>39</sup>

The bar was never very happy about the provisions of the 1942 Act taxing powers of appointment. It was pointed out with considerable justification that the system of taxing powers of appointment initiated by the 1942 Act did not increase the revenue from the estate and gift taxes, since a "second tax" could still be avoided by creating successive estates and confining powers of appointment to the two classes expressly exempted under the 1942 Act, so that the only effect of the 1942 taxes was to hinder desirable family settlements. Finally, due principally to the efforts of the Taxation Section of the American Bar Association and the Tax Committee of the American Bankers Association, the Powers of Appointment Act of 1951<sup>40</sup> was passed, which, with some significant exceptions, undertakes to restore as nearly as possible the situation which existed prior to 1942.

#### *B. The Powers of Appointment Act of 1951*

Like most efforts to simplify the tax law, the Powers of Appointment Act of 1951 is a fairly intricate piece of legislation. However, the basic plan of the new law is fairly obvious and keeping it in mind will facilitate analysis of the finer details.

The new Act divides powers of appointment into powers created on or before the date when the 1942 Act was enacted, or powers created prior to October 22, 1942, which may be referred to as pre-existing powers, and powers created after October 21, 1942, which may be designated as post-1942 powers. The reason that the date of enactment of the 1942 Act rather than the time when the new law was passed is taken as the critical date under the Powers of Appointment Act is that the Powers of Appointment Act repeals the provisions of the 1942 Act taxing powers of appointment retroactively. The new law operates as though the 1942 Act had never been passed but the Powers of Appointment Act had been adopted in its stead.<sup>41</sup> It appears possible to get refunds for any taxes paid in connection with powers of appointment which were taxable under the 1942 Act and are not taxable under the 1951 law. However, since the 1951 Act makes no provision for tolling the statute of limitations or reopening closing agreements, any refunds are apparently limited to years which are still open and are not barred by the statute of limitations.

<sup>39</sup> U. S. Treas. Reg. 108, §86.2(b) (1943).

<sup>40</sup> Pub. L. No. 58, 82d Cong., 1st Sess. (June 28, 1951).

<sup>41</sup> The new law takes effect as of October 21, 1942, the date of enactment of the 1942 Act. It applies to estates of decedents dying after October 21, 1942 and to gifts made after December 31, 1942, the effective dates of the 1942 Act. Pub. L. No. 58, 82d Cong., 1st Sess. §§2(c), and 3(c). (June 28, 1951).

As far as pre-existing powers are concerned, the new law tries to restore the situation which existed prior to the 1942 Act. Only the exercise of a pre-existing general power, which the new law defines as a power under which the donee of the power can appoint the property subject to the power to himself, his estate, his creditors or the creditors of his estate, is taxed.

With regard to post-1942 powers the new law follows the law as it stood prior to 1942 by limiting the tax to general powers of appointment. However, in the case of post-1942 powers, both the exercise and the non-exercise of the power are taxed.

This is the broad outline of the new law. Consider its implementation.

### (1) *Pre-Existing Powers*

In the case of powers created prior to October 22, 1942, only the exercise of a general power of appointment is taxed.

This means that under the *estate tax* only the exercise of a general power of appointment by will, or by a transfer in contemplation of, or taking effect at, death is taxed.<sup>42</sup> The non-exercise or the release of a pre-existing power is not taxed. Neither the exercise nor the non-exercise of non-general powers are taxed.

As far as the *gift tax* is concerned only the *inter vivos* exercise of a general power is taxed.<sup>43</sup> The release of pre-existing powers of appointment is not taxed. Nor are non-general powers taxed.

The only significant difference between the treatment of pre-existing powers under the new law and the taxation of powers of appointment under the 1918 Act is that the requirement that property must "pass" under the exercise of the power has been eliminated from the 1951 Act. Thus, if the donee of a general power of appointment exercises the power in favor of the person who would have taken in default of appointment, there will be a tax, even though the appointee refuses to take under the appointment and elects to take under the default clause.<sup>44</sup>

If either a pre-existing or a post-1942 general power is partially released so that it is reduced to a non-general power, no tax is incurred upon the reduction. Moreover, if the reduced power was a pre-existing power and it was partially released before November 1, 1951, or in the case of a donee under a disability when the 1942 Act was passed, within

<sup>42</sup> Int. Rev. Code §811(f) (1). The statute provides for a tax where the power is exercised "by a disposition which is of such a nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under subsection (c) or (d)."

<sup>43</sup> INT. REV. CODE §1000(c) (1).

<sup>44</sup> It was so held under the 1942 Act which also omitted any requirement of "passing." *Guaranty Trust Co. v. Johnson*, 165 F. 2d 298 (2d Cir. 1948); *Wilson v. Kraemer*, 190 F. 2d 341 (2d Cir. 1951); *Moran's Estate*, 16 T. C. No. 100 (April 19, 1951).

six months of the removal of the disability, no tax will be incurred upon the later exercise of the power.<sup>45</sup> The general idea here is that the reduction of a general power to a non-general power has no tax consequences, since the donee of the power has not finally designated the persons to finally take the property subject to the power and there is no complete disposition of the property under either the gift<sup>46</sup> or estate taxes.<sup>47</sup> Ordinarily, if a pre-existing general power is partially released so that it is reduced to a non-general power, a tax will be incurred upon the further exercise of the power when the donee can no longer control the disposition of the property subject to the power. However, since under the 1942 Act it was possible to reduce a pre-existing power to an exempt power and escape a tax upon the later exercise of the power, if this was done before July 1, 1951, or within six months of the removal of a disability in the case of a donee under a disability when the 1942 Act was passed,<sup>48</sup> this privilege is preserved under the 1951 Act with the further extension of the tax-free release date to November 1, 1951.

## (2) *Post-1942 Powers*

As far as powers created after October 21, 1942, are concerned only general powers are taxed, with one exception which seems to have no application to North Carolina. The one exception where a special power is taxed is where such a power is exercised to create a second power under which the vesting of the property subject to the power may be suspended for a period ascertainable without reference to the date of the creation of the first power.<sup>49</sup> Apparently the only state where this can be done is Delaware.<sup>50</sup> Apart from this exception only general powers are taxed. However, both the exercise and the non-exercise of a general post-1942 power are taxed.

This means that under the *estate tax* a tax will be imposed where a general post-1942 power is exercised or released by a transfer in contemplation of, or taking effect at, death; or where the power is in existence at the donee's death, whether or not it is exercised by will.<sup>51</sup>

As far as the *gift tax* is concerned both the *inter vivos* exercise and release of a general post-1942 power are taxed, although the release of such a power is only taxed where it occurs after May 31, 1951.<sup>52</sup> The reason that the statute permits the tax-free release of general powers before June 1, 1951, under the gift tax is that such powers could be released without incurring any gift tax under the 1942 Act before July

<sup>45</sup> INT. REV. CODE §811(f) (1) (estate tax) and §1000(c) (1) (gift tax).

<sup>46</sup> Estate of Sanford v. Commissioner, 308 U. S. 39 (1939).

<sup>47</sup> Porter v. Commissioner, 288 U. S. 436 (1933).

<sup>48</sup> Revenue Act of 1942, §403, 452, 56 STAT. 942, 952 (1942), as amended by Pub. L. No. 578, 81st Cong., 2d Sess. (June 27, 1950).

<sup>49</sup> INT. REV. CODE §811(f) (4) (estate tax) and §1000(c) (4) (gift tax).

<sup>50</sup> DEL. REV. CODE c. 118, §4414 (1935).

<sup>51</sup> INT. REV. CODE §811(f) (2).

<sup>52</sup> INT. REV. CODE §1000(c) (2).

1, 1951.<sup>53</sup> It is not readily apparent why the date for the tax-free release of powers was moved back from July 1, 1951 to June 1, 1951. In this connection it is perhaps worth noting that only the gift tax permits the complete release of a post-1942 as well as a pre-existing power free of tax before June 1, 1951. Under the prior law as it was literally written both pre-existing and post-1942 powers of appointment could be released without incurring a gift tax before July 1, 1951, although the Treasury contended that this privilege did not extend to post-1942 powers,<sup>54</sup> and under the estate tax the privilege of releasing powers of appointment tax-free before July 1, 1951, was limited to pre-existing powers. The new Act permits the complete release of both pre-existing and post-1942 powers before June 1, 1951, without any gift tax. However, there is no similar privilege in connection with the estate tax. Consequently, if a post-1942 power were released by a transfer in contemplation of, or taking effect at, death before June 1, 1951, there would be no gift tax, but there would be an estate tax.

The reduction of a post-1942 general power to a non-taxable power has no tax consequences under either the estate or the gift tax.<sup>55</sup> When, however, the reduced power is later exercised or released so that the donee can no longer dictate who takes the property subject to the power, or if the reduced power is still in existence at the donee's death, there will be a tax. The Committee Report<sup>56</sup> said that where a post-1942 power is reduced to a non-taxable power before June 1, 1951, it may be later exercised or released without incurring any gift tax. There is no direct statutory language to support this conclusion. Apparently it represents an inference from the provision authorizing a complete release of such a power without incurring any gift tax before June 1, 1951.<sup>57</sup>

### (3) *Date of Creation of Powers*

The rules for determining whether a power is a pre-existing or a post-1942 power are somewhat artificial. A power created by deed is treated as a pre-existing power if the deed took effect prior to October 22, 1942. A power created by will is a pre-existing power if the testator who created the power died before October 22, 1942, so that the will took effect and the power was created before that date. However, a power created by will is also regarded as a pre-existing power, if it was created under a will which was executed on or before October 21, 1942,

<sup>53</sup> Revenue Act of 1942, §452(c) (3), 56 STAT. 952 (1942), as amended by Pub. L. No. 578, 81st Cong., 2d Sess. (June 27, 1950).

<sup>54</sup> U. S. Treas. Reg. 108, §86.2(b) (1943).

<sup>55</sup> SEN. REP. NO. 382, 82d Cong., 1st Sess. 4 (1951).

<sup>56</sup> *Supra*, note 55.

<sup>57</sup> There will, however, be an estate tax if the reduced power is later exercised by a transfer in contemplation of, or taking effect at death, since there is no provision for the tax-free release of post-1942 powers before June 1, 1951, under the estate tax.

and was never republished after that date, provided the testator died before July 1, 1949.<sup>58</sup> Any other power is treated as a post-1942 power.

#### (4) *General and Special Powers*

Since, with the one exception previously adverted to,<sup>59</sup> the statute taxes only general powers, it is important to distinguish between general powers and what may be called special powers, although non-general powers would be a more accurate designation. With certain qualifications, the statute defines a general power as a power where the donee can appoint to himself, his estate, his creditors, or the creditors of his estate.<sup>60</sup> He need not be empowered to appoint to all four of these objects. If he can appoint to any one of them, the power is general. Any other power is a special or non-general power.

There are certain powers, however, which are not treated as general powers although the donee of the power can appoint to himself, his estate, his creditors or the creditors of his estate.

Thus, in the case of either a pre-existing or a post-1942 power, a power under which the donee of the power can invade or consume property which is limited by an ascertainable standard related to the health, education, support or maintenance of the donee is not regarded as a general power.<sup>61</sup> For example, a power under which the income beneficiary of a trust can withdraw principal from the trust to the extent needed for his support in his accustomed manner of living would not be a general power. Although if the power were limited by some less ascertainable standard such as his "comfort" or "happiness" it would be taxable.<sup>62</sup> In this connection it is perhaps worth noting that in the case of pre-existing powers the statutory provision exempting powers of invasion limited by an ascertainable standard relating to the donee's health, education, support or maintenance is scarcely significant. Even an unlimited power of invasion in the case of a pre-existing power would not be taxable, since there would be no gift tax if the donee exercised the power, because a man cannot make a taxable gift to himself, nor would there be any gift or estate tax if the donee failed to exercise or released the power, since only the exercise of a pre-existing power is taxable.

A pre-existing power which the donee of the power can exercise only with the consent of some other person is not treated as a taxable power,

<sup>58</sup> Pub. L. No. 58, 82d Cong., 1st Sess. §§2(b), 3(b) (June 28, 1951).

<sup>59</sup> *Supra* p. 235.

<sup>60</sup> INT. REV. CODE §811(f)(3) (estate tax) and §1000(c)(3) (gift tax).

<sup>61</sup> INT. REV. CODE §811(f)(3)(A) (estate tax) and §1000(c)(3)(A) (gift tax).

<sup>62</sup> The cases raising the question of whether a remainder to a charity after a life estate to a beneficiary who has a power to invade corpus is deductible seem to be in point. See *Ithaca Trust Co. v. United States*, 279 U. S. 151 (1929); *Merchants Nat. Bank v. Commissioner*, 320 U. S. 256 (1943); *Henslee v. Union Planters Bank*, 355 U. S. 595 (1949).

although the donee could exercise the power in favor of himself.<sup>63</sup> The "other person" need not be a person having any substantial adverse interest in the power.

A post-1942 power will be treated as a general power, however, if the donee can exercise the power in favor of himself, his estate, his creditors or the creditors of his estate, even though the donee can only exercise the power with the consent of some other person, unless the other person is the donor of the power or a person having a substantial adverse interest in the power. A power which can only be exercised by the donee in conjunction with the donor of the power or a person having a substantial adverse interest in the power is not a general power.<sup>64</sup> It is not particularly clear what a substantial adverse interest is. The statute provides that a person who may appoint the property subject to the power of appointment in his own favor after the death of the donee of the power, is a person who has a substantial adverse interest in the property.<sup>65</sup> The Committee Reports<sup>66</sup> add that the taker in default of appointment also has a substantial adverse interest, and for further guidance as to what is a substantial adverse interest refer to the cases dealing with this problem under the gift and income taxes, which shows, perhaps, a rather naïve faith in the predictability of those cases.

If the only interest which the person who must join with the donee in the exercise of the power has in the power is the fact that the property might be appointed to him, he has not a substantial adverse interest in the power. However, in this case the statute provides that only a fraction of the property subject to the power equal to the value of the property divided by a number made up of the donee and the number of persons to whom the property might be appointed and who must concur in the exercise of the power shall be taxed.<sup>67</sup> For example, if A is given power to appoint Blackacre to anyone whom he chooses with the consent of B and C, and with their consent A appoints the property to X, only one-third of the value of Blackacre is taxed.

#### (5) *Lapsed Powers*

Under the 1942 Act there was considerable controversy about whether the lapse of a power could be taxed as a release of the power. For example, suppose that C is the income beneficiary of a trust and that he has a non-cumulative power to withdraw \$10,000 a year from the princi-

<sup>63</sup> INT. REV. CODE §811(f)(3)(B) (estate tax) and §1000(c)(3)(B) (gift tax).

<sup>64</sup> INT. REV. CODE §811(f)(3)(C) (estate tax) and §1000(c)(3)(C) (gift tax).

<sup>65</sup> INT. REV. CODE §811(f)(3)(C)ii (estate tax) and §1000(c)(3)(C)ii (gift tax).

<sup>66</sup> H. R. REP. NO. 327, 82d Cong., 1st Sess. 5 (1951); SEN. REP. NO. 382, 82d Cong., 1st Sess. 5 (1951).

<sup>67</sup> INT. REV. CODE §811(f)(3)(C)(iii) (estate tax) and §1000(c)(3)(C)(iii) (gift tax).

pal of the trust. C does not make any withdrawals and after several years dies. The Treasury argued under the 1942 Act that the lapse of the power to withdraw \$10,000 a year was a release of the power which was taxable as a gift and that the aggregate amount which could have been withdrawn during the donee's life under the lapsed powers was taxable to his estate under the estate tax as a release of the powers by way of a transfer taking effect at death.

Under the new law it does not matter as far as pre-existing powers are concerned whether the lapse of a power is a release of the power or not, because the release of pre-existing powers is not taxed. However, the 1951 Act expressly provides that the lapse of a post-1942 power is a release of the power, although this is qualified by providing that it is only taxable to the extent that the property which could have been appointed under the lapsed power exceeds the greater of \$5,000 or 5 per cent of the value of the aggregate assets out of which the power could have been satisfied at the time the lapse occurred.<sup>68</sup> The purpose of the provision is to tax lapses of post-1942 powers with an exception which will permit a moderate amount of principal to be withdrawn from a trust each year without incurring a tax. For example, suppose that C is the income beneficiary of a trust, which was created in 1951, under which he is given a non-cumulative power to withdraw up to \$20,000 a year of the principal of the trust each year. Suppose further that in 1951 C does not withdraw anything and the value of the trust at the end of the year is \$200,000; and that in 1952 C makes no withdrawals and dies when the value of the trust is \$300,000; and finally that his executor elects to value C's estate for purposes of the federal estate tax as of the date of C's death. In this case C made a taxable gift of \$10,000, discounted for his life expectancy in the income from this amount, in 1951, because the property subject to the power of withdrawal, which lapsed in 1951, exceeded 5 per cent of the value of the trust fund (\$10,000) at the end of the year, when the power lapsed, by this amount. C is not, of course, taxed on a gift of the full \$10,000 because, since he retained the income from this amount, he did not give away a full \$10,000. As far as the federal estate tax is concerned C will be taxed on \$35,000 because of his interest in the trust, which is made up as follows: He will be taxed on \$20,000 because he had a power to withdraw \$20,000 from the trust fund at his death. The full amount which C could have withdrawn in 1952 is taxed to his estate, instead of the excess of \$20,000 over 5 per cent of the trust fund, since the tax is imposed on the basis of a general power which was in existence at the donee's death, rather than a lapsed power. C's estate is taxed on an additional \$15,000 because of the lapse of the power in 1951. This is taxable under the estate tax as a release of the

<sup>68</sup> INT. REV. CODE §811(f) (5) (estate tax) and §1000(c) (5) (gift tax).



power by way of a transfer taking effect at death, because C retained the right to the income during his life from the property subject to the power. The reason that \$15,000 rather than \$10,000 is taxed is that the amount which is taxed because of the lapse of the power under the estate tax based on the value of the property, not at the time the power lapses, but at the time of the donee's death, or one year after his death, if the optional valuation date is used. The simplest way to determine this amount is to take a fraction of the trust fund at death, or one year after death, if the optional valuation date is used, which has for its numerator the amount by which the property subject to the lapsed power exceeded the greater of \$5,000 or 5 per cent of the trust fund at the time of the lapse, and its denominator the value of the trust fund at the time of the lapse. Thus, in the hypothetical case the amount by which the property subject to the lapsed power exceeded 5 per cent of the trust fund at the time the power lapsed was \$10,000 and the value of the trust fund at that time was \$200,000. Since the value of the trust fund at the time of the donee's death was \$300,000 one-twentieth of this amount or \$15,000 will be taxed to his estate because of the power which lapsed in 1951.

#### (6) *Renunciation*

Although the release of a post-1942 power is taxed under the 1951 Act, it is expressly provided that a disclaimer or renunciation of a power of appointment is not taxable either under the estate tax<sup>69</sup> or the gift tax.<sup>70</sup> Ordinarily a power must be disclaimed or renounced promptly when the donee learns of the power. If the power is once accepted, the only way to get rid of it is by a release which is taxable.

#### *Tax Planning Under the Powers of Appointment Act of 1951*

The purpose of the Powers of Appointment Act of 1951 is to encourage the use of powers of appointment by freeing a number of powers from the federal estate and gift taxes. Consequently, the new law offers the estate planner a number of interesting opportunities for tax economies. Without attempting to explore all of the tax-saving opportunities which are opened up by the 1951 Act, some of the more obvious ways to avoid taxes under the new law may be noted briefly.

In general there are two ways to save taxes in connection with powers of appointment. One method is to use nontaxable powers instead of taxable powers in creating future powers of appointment. The other is to take whatever steps the law allows to minimize taxes on existing powers.

#### *A. Planning Future Powers*

The choice of the kind of power of appointment to be embodied in an estate plan should not be determined primarily by tax considerations,

<sup>69</sup> INT. REV. CODE §811(f)(2).

<sup>70</sup> INT. REV. CODE §1000(c)(2).

and a particular power should not be selected solely because it is not taxable. However, where a nontaxable power will achieve the same result as a taxable power it is obvious common sense to use the nontaxable power.. In the typical family settlement a power of appointment is usually employed for one of two purposes: (1) to give the donee of the power power to dispose of the property subject to the power to someone else; or (2) to give the donee of the power power to acquire the property for himself. The 1951 Act offers a variety of nontaxable powers by which it is usually possible to achieve either of these ends without incurring a tax.

For example, suppose that a man wishes to leave his property to his wife or child for life with a power of appointment over the remainder. Ordinarily the donor of the power will have some definite class of persons in mind to whom he wishes the remainder to be appointed such as his children or grandchildren or their spouses or some member of his family. By phrasing the power in terms of the donor's actual intentions and limiting the power of appointment explicitly to the classes of appointees he has in mind, it is possible to carry out his wishes just as completely as though the donee were given a general power. In fact his intentions may usually be carried out more accurately by a power of this kind, since it insures against the donee appointing the property to someone outside the family whom the donor of the power would not want to take the property.

It may be possible to create a nontaxable power by phrasing the power in the words of the statute and giving the donee power to appoint to anyone in the world except the donee himself, his estate, his creditors or the creditors of his estate. There is authority to the effect, however, that if the donee of such a power exercises the power his creditors may reach the appointed property,<sup>71</sup> which makes it a little hard to distinguish such a power from a power which the donee can exercise in favor of his creditors. Apparently the Commissioner has ruled informally that such a power is a nontaxable power.<sup>72</sup> Until the matter is definitely settled, however, it seems wiser to phrase a power which you want to be nontaxable in terms which limit the exercise of the power to definite classes other than the donee, his estate, his creditors or the creditors of his estate.

An interesting question arises as to whether or not what is sometimes called a "reverse" power is a general power. For example, suppose that a person is given power to appoint property to a definite class of persons which excludes himself, his estate, his creditors or the creditors of his estate, is this a general power because the donee or his estate will benefit

<sup>71</sup> *State Street Trust Co. v. Kissell*, 302 Mass. 328, 19 N. E. 2d 25 (1939), noted in 52 HARV. L. REV. 1019 (1939); RESTATEMENT, PROPERTY §329, comment c (1940).

<sup>72</sup> See Johnson, *Powers of Appointment*, 29 TAXES 965 at 970 (1951).

from the failure to exercise the power? More specifically, suppose that C is the income beneficiary of a trust who has power to appoint the principal from the trust outright and free from the trust to his children during his life. During his life C appoints the trust property to his son John. The sensible way to view this situation and apparently the way in which Congress intended for it to be viewed<sup>73</sup> is to regard the power as a special power which is not taxable and to treat C as having made a gift only of his life estate. In other words, powers of appointment are confined to powers to appoint property which the donee of the property does not own. In the hypothetical case C owned a life estate in the trust property and he also had a special power to appoint the remainder in the trust property. When he exercised the power he appointed the remainder over which he had a power of appointment and he also conveyed his life estate in the trust, which was quite separate and distinct from the power. The exercise of the power is not taxable, but the conveyance of his life estate is.<sup>74</sup> Consequently, a power to appoint property to a class of persons which does not include the donee, his estate, his creditors or the creditors of his estate seems to be a special nontaxable power, although the donee may benefit incidentally by the failure to exercise the power. If, in exercising the power, the donee conveys some other interest which he owns, he should be taxed only upon the transfer of this interest. However, the property subject to the power should not be taxed. Moreover, if the interest which the donee owns in the property is so remote or speculative that it cannot be valued there should be no tax even on the transfer of this interest. For example, suppose that X is a contingent remainderman under a trust, who has a remote interest too speculative for valuation, and X also has a power to appoint principal from the trust to the income beneficiary. X exercises this power by deed during his life. He should not incur a gift tax. The power is a nontaxable power. The interest which he has transferred in the trust is too tenuous to be susceptible of valuation for purposes of the gift tax.

It is, of course, conceivable that the donee of a special power might be regarded as possessing a general power because the failure to exercise the power might result in some benefit to the donee. For example, in the situation where an income beneficiary of a trust has power to appoint principal from the trust outright and he does so during his life by deed, it might be argued that he had exercised a general power and that

<sup>73</sup> See Turk, *New Rules on Powers of Appointment*, 90 TRUST & ESTATES, 428 at 430, 482 (1951).

<sup>74</sup> The Committee Reports provide: "The provisions relating specifically to powers of appointment, which are proposed to be inserted in the Internal Revenue Code by this bill, are not intended to limit the scope of other subdivisions of the Code (such as subsections (a), (c), and (d) of Section 811 and subsection (a) of Section 1000) which apply to the transfer at death or during life of any interest in property possessed by the taxpayer." H. R. REP. No. 327, 82d Cong., 1st Sess. 6 (1951); SEN. REP. No. 382, 82d Cong., 1st Sess. 6 (1951).

he was, therefore, subject to a gift tax not merely upon the value of the life estate which he had transferred, but upon the entire property. Although this seems untenable it is not an impossible point of view, and it may be well, therefore, to exercise caution in giving nontaxable powers to a donee who will benefit from the failure to exercise the power.

It is not clear to what extent a contingent power will be treated as a taxable power, if the contingency does not occur. The statute provides that a power of appointment "shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."<sup>75</sup> It seems clear under this language that a power which the donee could exercise in his favor will be treated as existing at the donee's death and taxable, even though the power could only be exercised upon giving a certain notice which had not been given at the donee's death. It is arguable that since the statute specifies that this type of condition shall not prevent a power from being treated as in existence, any other contingency which had not occurred at the donee's death should prevent the power from being treated as existing at the donee's death. For example, if C is given power to appoint principal from a trust fund if he is married and he dies unmarried, it could be argued that the property subject to the power was not taxable to C's estate under the federal estate tax since C had not married and the condition necessary to bring the power into existence had not happened at C's death. The language in section 811(f)(2) which provides that a power of appointment shall be deemed to be in existence although it is subject to giving notice which has not been given appears to have been copied from the language in Section 811(d)(3) where there is a similar provision with respect to when a power to alter, amend, revoke or terminate a trust shall be deemed to exist. According to the Regulations in the case of revocable transfers, the mention of one kind of condition in the statute which does not prevent the power to alter, amend, revoke or terminate a trust from existing does not mean that powers based upon other contingencies are not in existence,<sup>76</sup> although there are decisions to the contrary.<sup>77</sup> Presumably the Treasury will adopt a similar attitude with respect to powers of appointment and will hold that contingent powers are in existence and taxable. Possibly there will be the same dissent upon the part of the courts. Until the matter is definitely settled, however, it would be unwise to assume that a contingent power of appointment will not be taxed.

<sup>75</sup> INT. REV. CODE §811(f)(2).

<sup>76</sup> U. S. Treas. Reg. 105, §81.20(b) (1943).

<sup>77</sup> *Jennings v. Smith*, 161 F. 2d 74 (2d Cir. 1947).

The statute offers several methods for creating a nontaxable power by which the donee of the power can acquire the property subject to the power. Thus, for example, the beneficiary of a trust can be given a power to withdraw the principal from a trust which will not be taxable if the power is limited by some ascertainable standard related to the health, education, support or maintenance of the beneficiary. If the creator of the trust does not wish to limit the beneficiary's power to withdraw principal by some ascertainable standard, he can give the beneficiary a nontaxable power to invade the trust fund in the form of a non-cumulative power to make annual withdrawals not in excess of the greater of \$5,000 or 5 per cent of the value of the trust fund at the end of the year. Since the amount which the beneficiary can withdraw free of tax is apparently determined by the number of trusts in connection with which this privilege is granted, it would appear possible to increase the amount which the beneficiary can withdraw tax-free by creating multiple trusts. For example, the maximum amount which the beneficiary could be empowered to withdraw from a single trust fund of \$100,000 would be \$5,000 a year. However, there appears to be no reason why two trust funds of \$50,000 each could not be created and the beneficiary authorized to withdraw \$5,000 a year from each trust, for a total of \$10,000.

If the creator of the trust wishes to give still broader powers of withdrawing principal from the trust this can be done by giving the trustee unlimited discretion to pay over principal to a beneficiary.<sup>78</sup> There seems to be no reason, moreover, why several of these tax-free powers cannot be combined without incurring any tax. For example, the creator of a trust might give the beneficiary power to withdraw \$5,000 a year from the principal of the trust and any additional amounts of principal which he may need for his support in his accustomed manner of living, without creating a taxable power.

One way to create a nontaxable power of appointment is to create a joint power which can only be exercised by the holder of the power in conjunction with the donor of the power or a person having a substantial adverse interest in the power. If the power could only be exercised in conjunction with the donor of the power, this would, however, usually make the property subject to the power taxable to the estate of the donor of the power.<sup>79</sup> It seems doubtful whether joint powers will be employed to any great extent to avoid taxes except in unusual situations.

<sup>78</sup> If the trustee has an unfettered discretion about making payments to the beneficiary this would clearly appear to be a nontaxable power since the donee of the power, who is the trustee, cannot exercise the power in favor of himself, his estate, his creditors or the creditors of the estate. Care should be observed to make sure that the beneficiary cannot compel the trustee to make payments to him. Otherwise the power might be construed as a general power vested in the beneficiary.

<sup>79</sup> INT. REV. CODE §811(d).

## B. *Avoiding Taxes on Existing Powers*

The new law offers more favorable opportunities for avoiding taxes on pre-existing powers than it does for avoiding taxes upon powers created after the 1942 Act. It may be well, therefore, to consider the two situations separately.

### (1) *Pre-Existing Powers*

Ordinarily, the best way to avoid a tax upon a pre-existing general power is not to exercise the power, since only the exercise and not the non-exercise of such powers are taxed. If the power of appointment is one which can be exercised by will care should be taken to avoid an inadvertent exercise of the power. In many states, including North Carolina<sup>80</sup> a general residuary bequest or devise exercises a power of appointment unless a contrary intention appears in the will. If, therefore, the donee of a power of appointment exercisable by will does not intend to exercise the power, an explicit statement to that effect should be inserted in his will.

If the beneficiary of a trust has a pre-existing power to withdraw principal from the trust the power will not be taxable even though it is an unlimited power. If the beneficiary exercises the power, there will be no tax because a man cannot make a taxable gift to himself. If he releases the power or lets it remain unexercised until his death, there will be no tax because only the exercise of a pre-existing power is taxed. It would probably be wiser in this situation not to exercise the power if the beneficiary actually does not need the principal. By exercising the power he would draw that amount of principal into his estate, and, unless he disposed of the principal during his life, increase his estate tax to that extent. On the other hand, by refraining from exercising the power, he can retain the privilege of reaching the property subject to the power at any time he wishes and avoid any tax at his death.

A tax on a pre-existing general power can be avoided by releasing the power. It is difficult to see any reason for doing this, however, unless the donee is afraid of his own improvidence, or fears that he may exercise the power inadvertently, since the retention of the power without exercising it is not taxable.

Pre-existing non-general powers are not taxable, so no steps need be taken to avoid a tax in connection with them. Thus, for example, if there is a pre-existing power under which the beneficiary of a trust could appoint the trust property with the consent of the trustee of the trust, the power can safely be left alone. It will not be taxed if it is exercised or not exercised.

Most wills which were drawn while the 1942 Act was in effect which included powers of appointment were careful to phrase such powers in

<sup>80</sup> N. C. GEN. STAT. §31-43 (1950).

terms of one of the two powers which were exempt under the 1942 Act.<sup>81</sup> With one possible exception the powers which were not taxable under the 1942 law are not taxable under the Powers of Appointment Act, so there is no need to redraft any such will, unless the draftsman wishes to broaden the powers which it contains to take advantage of the new law. Under the literal language of the 1942 Act a power under which the donee of the power could appoint to himself was an exempt power, if the donee was a spouse of the donor of the power. For example, if a man died and left property in trust for his wife for life and gave the wife a power to withdraw principal from the trust this would under a literal reading of the 1942 Act have been an exempt power. It is very doubtful whether such a power actually was exempt under the 1942 Act, although there was one rather casual decision which held that it was.<sup>82</sup> It is clear that such a power would be taxable under the present law. If, therefore, such a power were put in a will on the theory that it was not taxable, it would be well to revise it now, if the will is still open to revision.

If a general pre-existing power was reduced to a non-taxable power prior to November 1, 1951, no tax will be incurred upon the exercise of the power. However, if the partial release consisted of providing that the donee of the power should be able to appoint to anyone except himself, his estate, his creditors or the creditors of his estate, it is possible that the power was not actually reduced to a nontaxable power. If the donee exercises the power, in some states, at least, his creditors may be able to reach the property subject to the power,<sup>83</sup> so that it can be argued that the power may still be exercised in favor of the donee's creditors. Probably since the release of the power followed the literal words of the statute it will ultimately be held that the reduction of the power to a nontaxable power was effective. However until this is decided definitely, it might be wiser to refrain from exercising a power which has been reduced in this fashion, since it seems clear that the non-exercise even of a general pre-existing power is not taxable.

## (2) *Post-1942 Powers*

It is more difficult to escape a tax on a post-1942 power than it is on a pre-existing power. The statute provides that there will be no tax if the donee of the power renounces or disclaims the power. However, prompt action is usually required to renounce a power, and after the power has once been accepted the only way to get rid of it is by exercising or releasing the power, which is taxable unless the release occurred

<sup>81</sup> *Supra*, p. 231.

<sup>82</sup> *Schwab v. Allen*, 78 F. Supp. 234 (M. D. Ga. 1948). See note 27 *supra*.

<sup>83</sup> *Supra* note 71.

before June 1, 1951. Moreover, even in the case of a release prior to June 1, 1951 this will only avoid a gift tax and not an estate tax.

A possible way of minimizing a tax on a post-1942 power which can be exercised by deed as well as by will, is to exercise the power during the donee's life in order to incur a gift tax instead of an estate tax, since the gift tax is usually lower than the estate tax. In attempting this, however, care should be taken to avoid incurring both taxes. For example, suppose that the income beneficiary of a trust has power to appoint the remainder in the trust either by will or by deed and he exercises the power to appoint the remainder during his life to escape an estate tax. Unless the donee also transfers his life estate, this will be treated as an exercise of the power of appointment by way of a transfer taking effect at death, since the donee retained a life estate in the appointed property during his life. Even if the donee gave up his life estate during his life it is still possible that the exercise of the power of appointment would be taxed under the estate tax on the theory of a transfer in contemplation of death.