By **Robert J. Kolasa**

Formula General Powers of Appointment To the Rescue

They can use the surviving spouse's otherwise unused estate tax exclusion and cause credit shelter trust assets to receive stepped-up basis

The current stratospheric $11.4 million federal estate tax exclusion ensures that most clients are no longer subject to estate taxes. Many credit shelter trusts (CSTs) and irrevocable trusts are inefficient because they don't save estate taxes, yet will deprive the family of stepped-up basis treatment at the beneficiary's death.

An outstanding strategy to mitigate this dilemma involves drafting CSTs to grant the surviving spouse a testamentary general power of appointment (GPA)[1] that's based on a formula (formula powers). The formula is usually crafted in such a way to use the spouse's otherwise unused applicable exclusion amount (federal exclusion)[2] to award stepped-up basis for CST assets that have significant appreciation or are subject to high income tax rates, while preserving carryover basis for loss assets.

Competing Techniques

Besides formula powers, there are other competing techniques[3] that achieve the desired result of stepped-up basis for appreciated CSTs. A common resolution involves the CST trustee simply distributing appreciated property to the surviving spouse so that stepped-up basis results under Internal Revenue Code Section 1014(b)(1) when the property is included in the survivor's estate at death. This approach involves no special effort other than convincing the CST trustee (who's hopefully an independent trustee with broad discretionary powers) to identify appreciated assets suitable for distribution.

Often, the trust instrument doesn't authorize substantial distributions to the surviving spouse, especially if the spouse is the trustee with principal distributions limited by an ascertainable standard.[4] Unauthorized distributions may generate scrutiny by the Internal Revenue Service to reverse estate tax inclusion[5] or subject the trustee to fiduciary liability. This latter circumstance arises when other trust beneficiaries (typically children) object to the possibility that the spouse may transfer the distributed property to strangers, consume it or lose it to creditors.

The Delaware tax trap (the trap)[6] deals with successive powers of appointment (a first power that's exercised to create a second power). If certain enumerated conditions are met regarding the second power, the first power is "magically" converted to a GPA that triggers estate tax inclusion. The trap is grounded in arcane property law involving the rule against perpetuities and alienation, the interpretation of which sparks technical disagreements that vary considerably depending on trust situs.[7] While some practitioners embrace the trap as a basis step-up solution, the method's drawbacks include its complexity, varied interpretations and challenges in explaining to clients the mechanics of the trap.

Another basis step-up remedy that's gained increasing popularity involves giving a trust protector the power to grant the surviving spouse a GPA over CST assets. Any individual given this authority should be worried about fiduciary liability from other trust beneficiaries for unwisely exercising (or failing to exercise) the power. To mitigate liability, consider giving the power to a trust protector or third party in a non-fiduciary capacity who has no other trust responsibilities, along with broad exculpatory provisions.

Benefits

The above basis enhancement techniques all require affirmative action to achieve stepped-up basis, with the authorized party having knowledge of the relevant facts

Robert J. Kolasa is an estate-planning attorney in Lake Forest, Ill.

to determine whether to act. Many planners live in a world of darkness in that they help clients execute their estate plan, have no communication for years and are contacted after the death of the surviving spouse, which usually precludes basis-saving measures from being employed. Formula powers offer a better way because the basis step-up mechanism is hardwired in the underlying documents and is automatically effective at the survivor's death.

Formula powers are GPAs forcing inclusion of trust assets in the gross estate of the powerholder, subject to two special rules: (1) a capping rule, limiting estate tax inclusion to the federal exclusion, or other predefined limits; and (2) an ordering rule, selecting the particular assets subject to the GPA. The ordering rule is calibrated to apply only to appreciated property, doesn't step down the basis of loss assets and becomes irrelevant if the federal exclusion exceeds appointive trust property (resulting in stepped-up basis for all appreciated trust assets). The preservation of built-in losses means that formula powers can deliver tax advantages when compared to portability planning.

"Formula Power Advantages," p. 20, shows the sizzle of formula powers from a basis preservation standpoint.[8] In the chart's example, the family is $300,000 better off when compared with portability planning and $1.2 million better off when compared with a non-formula driven CST. The latter result demonstrates the remedial nature of formula powers to improve the carryover basis regimen of the traditional CST. The former result shows the ability of formula powers to conserve pre-death losses (compared to portability), which is hard to discount for those of us who remember the market declines of the Great Recession.

The admirable benefit of formula powers, in addition to basis optimization, is that it enables clients to take full advantage of the trust structure. Planning now becomes possible for asset protection, disabled beneficiaries, second marriages, generation-skipping transfer (GST) tax and federal and state estate tax purposes. While formula powers can form the backbone of a client's mainstay estate plan, the method can be easily integrated in other modes. Trust protectors having the power to grant GPAs should consider granting formula powers to the surviving spouse over CST assets. Or, why not spring the trap by formula powers, use them in CSTs funded by disclaimers[9] or stitch an ordering rule to the exercise of a GPA without one? There are many opportunities to incorporate this valuable planning tool.

Do Formula Powers Work?

Using formula powers for basis harvesting is a relatively recent phenomenon. The seminal question is whether this planning strategy is permissible under existing law. The reasons for a positive response are substantial.

Treasury Regulations Section 20.2041-1(b)(3) expressly provides that a power of appointment may apply "as to part of an entire group of assets or only over a limited interest in property." While this language by itself arguably sanctions formula powers, there are analogous tax provisions supporting a formula to determine if property is includible or excludible from the taxable estate.

It would be incongruous for the IRS to permit capped GPAs for marital deduction purposes, yet disallow highly identical capped GPAs under formula powers.

Foremost in mind are capping rule formulas tied to tax exemptions for CST and GST funding purposes that have longstanding regulatory and administrative approval.[10] IRC Section 2056(b)(5) allows a marital deduction for granting the surviving spouse a GPA that can be expressed in a formula, funding the CST up to the maximum point to avoid estate taxes. It would be incongruous for the IRS to permit capped GPAs for marital deduction purposes, yet disallow highly identical capped GPAs under formula powers.

The disclaimer regulations also take a broad view of the bundle of sticks comprising property rights that can be disclaimed in the trust context, including the blessing of a capping rule limiting the disclaimer of a residuary trust to the extent necessary to avoid estate taxes.[11] Taking into account the aforesaid authority, perhaps the IRS has already conceded the issue as it's issued private

Formula Power Advantages

They improve the carryover basis regimen of traditional credit shelter trusts (CSTs)

Formula Power Advantages (in $1,000s)					
			Basis		
Assets at Death of Surviving Spouse	Fair Market Value	Pre-Death Basis	CST w/o Formula Powers	Portability Plan (all to spouse)	CST with Formula Powers*
Asset #1	$2,000	$1,000	$1,000	$2,000	$2,000
Asset #2	$700	$500	$500	$700	$700
Asset #3	$500	$800	$800	$500	$800
Total	**$3,200**	**$2,300**			
Total Basis			**$2,300**	**$3,200**	**$3,500**

*Spouse's unused federal exclusion is at least $2,700 to cover appointive property (Assets #1 and #2)

— Robert J. Kolasa

letter rulings capping a deceased spouse's formula GPA to the spouse's unused federal exclusion.[12]

The analysis regarding the ordering rule becomes a bit more novel. A liberal construction of Treas. Regs. Section 20.2041-1(b)(3) and the above authorities present a good case for validity. Yet, the IRS in the past has limited strategies that enabled the family to cherry pick favorable transfer tax attributes, such as requiring that assets be fairly representative of post-death appreciation or depreciation for marital[13] and GST[14] pecuniary funding purposes. But, these situations are different from formula powers, because the IRS in such circumstances was trying to curb results that couldn't be obtained, except for employment of the abusive strategy.

Consider that a surviving spouse with $2 million of unused federal exclusion is the beneficiary of a $4 million CST containing two assets each valued at $2 million, having a basis of $1 million and $2 million, respectively. A trust protector grants the surviving spouse a GPA over the asset with the $1 million basis. It seems unlikely that the IRS could prevail in stopping such appreciated asset from being includible in the spouse's estate, resulting in a $1 million basis increase. Why should a $2 million formula power having an ordering rule mechanically selecting the same appointive property be treated differently? For CSTs exceeding the survivor's federal exclusion, the consequence of invalidating the ordering rule (however remote) is that estate inclusion and stepped-up basis would be allocated on a pro rata basis[15] among trust assets, meaning only a $500,000 basis increase for the appreciated asset in our example.

Some dismiss formula powers on the theory that because the surviving spouse can freely make marital and charitable gifts (thereby increasing the girth of the CST appointive property),[16] the spouse effectively has a GPA over the entire CST. This position is inspired by *Kurz Estate v. Commissioner*,[17] whereby a spouse had a 5 percent withdrawal power over CST assets subject to the contingency that the marital trust must first be fully exhausted but also retained a full marital trust withdrawal power. The IRS contended that the spouse held a GPA over 5 percent of CST assets at her death because the contingency of marital trust exhaustion was within her control. The Tax Court agreed with the IRS but used a different rationale by finding the contingency was illusory because it didn't have significant non-tax consequences independent of the spouse's ability to exercise the GPA. It would seem that charitable and marital gifts have sufficient independent significance in the context of formula powers and won't increase the appointive property unless such gifts are actually made.

Creditors and Control

Using formula powers may backfire in some jurisdictions if the spouse has creditors. The traditional

common law view is that if the powerholder didn't create the GPA, creditors can't reach the appointive property unless the power is exercised.[18] The newer rule is that creditors can attach the appointive property of a presently exercisable or testamentary GPA to the extent the powerholder's property is insufficient to satisfy creditor claims.[19] You should research local law to determine whether this is a concern. If the unexercised GPA allows creditors to seize appointive property, possible remedies are to release the power, authorize a trust protector to amend the formula power or limit its scope by creating a threshold for insolvent estates.[20]

Problems may also exist if the surviving spouse exercises the formula power in a way that's inconsistent with the underlying estate plan. No good may be achieved from the vantage of the first to die if CST assets receiving stepped-up basis are diverted to the survivor's new boyfriend, spouse or other person outside the CST dispositive scheme. Customary attempts to discourage trust fleecing are to narrow permissible appointees to creditors,[21] provide that GPAs be exercised only with satisfaction of extensive notice provisions[22] or require the consent of nonadverse parties.[23] Independent trustees or non-family members who possess no beneficial interests in the CST are typically sufficient to earn the nonadverse party moniker. The presence of a nonadverse party may also help in the fight against creditors when local law allows them to reach appointive property without GPA exercise.

Capping Rule

The capping rule frequently is expressed as a fractional formula[24] based on the spouse's taxable estate limiting inclusion of the appointive property to the maximum that won't cause federal estate taxes. Another approach is to begin with the available federal exclusion and deduct taxable gifts and testamentary transfers not receiving a marital or charitable deduction.[25] If the *Kurz* case is seen as a problem, the formula could be tweaked to provide that marital and charitable deductions not increase the available federal exclusion. This means some of the spouse's federal exclusion may be unused, but the quandary is reversed by the trust protector granting the spouse a GPA for the shortfall.

When the federal exclusion exceeds the GST tax exemption, formula powers may create trust shares that are non-exempt from GST tax. If the benefits of GST planning are deemed to override stepped-up basis, the fix is to limit the capping rule to the available GST tax exemption to avoid the creation of non-exempt shares. Another solution bases the capping rule on the federal exclusion but allocates non-exempt shares to trusts not triggering GST tax.

For jurisdictions with state estate taxes, the capping rule is often set at the applicable state exclusion to ensure no state estate taxes are triggered relating to the inclusion of the appointive property in the survivor's estate. This dramatically lessens the basis relief effects of formula powers, because the federal exclusion is usually much higher than the state exclusion. It should be viable to tweak the formula power so as to force estate inclusion (and state estate taxes) when the income tax savings of stepped-up basis exceeds incremental state estate taxes. A simpler tactic is capping the formula power at the state exclusion and relying on the trust protector to grant the spouse an additional GPA to generate overall income tax savings, despite the payment of state estate taxes.

The trick is to draft the formula in a manner that selects the best mix of assets to achieve estate tax inclusion and stepped-up basis.

Ordering Rule

The ordering rule is the yardstick that determines the specific property to be includible in the survivor's estate, when the federal exclusion is less than CST assets. The trick is to draft the formula in a manner that selects the best mix of assets to achieve estate tax inclusion and stepped-up basis. Perfection is hard to achieve in this endeavor.

The ordering rule usually has stated criteria creating a series of tiered GPAs on an asset-by-asset basis. One approach bases the criteria on the highest tax rates (such as collectibles taxed at higher capital gains rates or depreciable assets subject to recapture) incurred in a hypothetical pre-death sale of CST assets. Assets with

the highest tax rate would be selected first, cascading to each next individual asset with the next highest tax rate and so on until the capping rule stops the appointive process. This doesn't achieve the best results when assets with high tax rates have little appreciation. A formula power selecting an asset with $100,000 appreciation subject to a 35 percent income tax rate is less productive than choosing another asset of the same value with $900,000 appreciation and a 20 percent tax rate.

Property appreciation seems to be a better criterion in most cases to model the ordering rule. The most appreciated asset would be selected first, cascading down to the next property with the next highest appreciation level and so on until the capped limits are reached. A combination of approaches bases the formula on the highest amount of income tax liability, taking into account both tax rates and appreciation. Another refinement is to select appreciated assets that have the highest income tax costs relative to fair market value. Countless formula permutations are achievable.

In picking the ordering rule, the client needs to consider increases in the accounting work as the selection criterion becomes more complex. For trusts with many assets, a substantial spreadsheet would be needed if the ordering rule is based on appreciation, but at least the numbers should be easily determined. Calculating the income tax liability for each asset is much more complicated and subjective, producing an even longer spreadsheet. Query whether an ordering rule can be so complex or arbitrary that it's voided as not existing at the decedent's death under Treas. Regs. Section 20.2041-3(b)? If so, presumably only the ordering rule is thrown out (resulting in pro rata basis allocation), with the rest of the formula power intact. Practitioners should embrace formula powers only if they're willing to accept the substantial compliance burden this strategy imposes.

Specific appointive property may encourage the planner to create custom-drafted ordering rules. A depreciable asset that has substantial appreciation perhaps deserves a special clause deeming it to be in the top ordering tier, along with assets expected to be sold. Appreciated assets unlikely to be sold[26] could be relegated to lower tiers or excluded from the formula altogether (by definition, income in respect of a decedent and loss assets are excluded). If the family's financial information is frequently reviewed, the client may prefer that the trust protector annually adjust granted GPAs over specific property in lieu of formula powers. Formula powers can become stale and inaccurate over time, although this is generally better than not having such powers in the first place. Consider giving trust protectors the power to update formula powers.

Practitioners should embrace formula powers only if they're willing to accept the substantial compliance burden this strategy imposes.

Endnotes

1. A general power of appointment (GPA) is defined under Internal Revenue Code Section 2041(b)(1) as a power of appointment that's exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate.
2. IRC Section 2010(c)(2).
3. Steve R. Akers, "Estate Planning Current Developments and Hot Topics," *www.bessemertrust.com/portal/site/Advisor,* at pp. 89-99 (Jan. 10, 2019); Edwin P. Morrow III, "The Optimal Basis Increase and Income Tax Efficiency Trust," *https://ssrn.com/abstract=2436964,* at pp. 18-20 (revised April 28, 2018).
4. IRC Section 2041(b)(1)(A).
5. *See* Private Letter Ruling 9338011 (June 22, 1993), holding that assets improperly distributed to a trust beneficiary were held in a constructive trust and not included in the beneficiary's estate.
6. Section 2041(a)(3).
7. Robert J. Kolasa, "Problems in Springing the Delaware Tax Trap," *Trusts & Estates* (April 2018).
8. *See* Morrow, *supra* note 3, at p. 25 for a similar table.
9. Treasury Regulations Section 25.2518-2(e)(5), Ex. (7) allows the disclaiming spouse to retain a *Crummey* withdrawal power (a GPA) over the nonmarital trust, implying that formula powers can be used in credit shelter trust (CST) disclaimer scenarios. The contrary view is that this is prohibited under Treas. Regs. Section 25.2518-2(e)(1).
10. Morrow, *supra* note 3, at p. 27.
11. Treas. Regs. Section 25.2518-3(d), Ex. (20).

12. PLRs 200604028 (Jan. 27, 2006) and 200403094 (Jan. 16, 2004). *See also* PLRs 9527024 (April 7, 1995) and 9110054 (Dec. 12, 1990), approving formula GPAs causing estate taxation in lieu of generation-skipping transfer taxation.
13. Revenue Procedure 64-19.
14. Treas. Regs. Section 26.2642-2(b)(2)(i)(B).
15. For application of the pro rata rule, *see Prokopov v. Commissioner,* T.C. Memo. 1997-229, *aff'd*, 166 F.3d 1201 (2d Cir. 1998).
16. For example, assume a surviving spouse with $6 million unused federal exclusion and a $5 million estate has a $1 million formula power (computed after charitable deductions) over a $4 million CST. If the spouse gives $2 million to charity, the formula power is increased to $3 million; another $1 million charitable gift makes the formula power applicable to the entire CST.
17. *Kurz Estate v. Comm'r,* 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995).
18. *See* Paul S. Lee, Ellen K. Harrison and Turney P. Berry, "Putting It On & Taking It Off: Managing Tax Basis Today (for Tomorrow)," 52nd Annual Heckerling Institute on Estate Planning (2018), Ch. 2, at pp. 75-77.
19. *Ibid.*, at p. 77. *See also* Uniform Powers of Appointment Act (2013), Section 502 and *Restatement (Third) of Property: Wills and Other Donative Transfers*, Section 22.3 (2011).
20. Morrow, *supra* note 3, at pp. 43-44.
21. A contrarian position is that the power to appoint to creditors isn't a GPA as to all trust assets because it's exercisable only up to the amount of the debt. Akers, *supra* note 3, at p. 91.
22. Section 2041(a)(2) and Treas. Regs. Section 20.2041-3(b).
23. Section 2041(b)(1)(C)(ii) and Treas. Regs. Section 20.2041-3(c)(2).
24. A fractional formula is recommended to avoid nettlesome gain issues related to the use of pecuniary formulas. *See* Revenue Ruling 60-87, Treas. Regs. Sections 1.661(a)-2(f)(1) and 1.1014-4(a)(3).
25. For a good analysis on the variables involved in designing formula powers, *see* Akers, *supra* note 3, at pp. 93-96; Morrow, *supra* note 3, at pp. 23-46; Lee, Harrison and Berry, *supra* note 18, at pp. 78-81; Lester B. Law and Howard M. Zaritsky, "Basis After the 2017 Tax Act—Important Before, Crucial Now," 53rd Annual Heckerling Institute on Estate Planning, at pp. 85-99 (Jan. 14, 2019, Fundamentals program materials).
26. Also consider ordering rules that exclude or downgrade assets having statutory gain exclusions, such as small business stock (IRC Section 1202), qualified opportunity funds (IRC Section 1400Z-2) and principal residences distributable to beneficiaries (IRC Section 121).

SHARE this article Click for more ESTATE PLANNING