By **Robert J. Kolasa**

Creditor General Powers of Appointment

What are the tax considerations if state law limits appointive property to the underlying debt for GPAs?

Basis optimization for credit shelter and irrevocable trusts often involves granting the trust beneficiary a general power of appointment (GPA) over trust assets to achieve stepped-up basis. One planning variation limits appointees to the powerholder's creditors or creditors of his estate (creditor GPAs). This seemingly achieves basis step-up without much risk of having property diverted to appointees outside the donor's dispositive scheme.

Some practitioners caution against creditor GPAs because of uncertainty under local law regarding the girth of the appointive property. Presume that John owes Paul $1,000, and John is granted a GPA over $1 million of trust property to appoint to creditors of his estate. Does state law limit the appointive property to Paul at $1,000, because once Paul is appointed that sum, he's no longer a creditor and a permissible appointee? Is estate tax inclusion under Internal Revenue Code Section 2041 fixed at $1,000 or $1 million?

Common Law Deference

The Revenue Act of 1916 imposed estate taxes to the extent the decedent's interest in property was distributable as part of the estate and subject to the payment of charges and administration expenses.[1] In *United States v. Field*, the Internal Revenue Service argued that property passing under an exercised GPA was taxable to the donee powerholder under such law, but the U.S. Supreme Court disagreed because the statutory requirement that the property pass under the donee's estate wasn't met.[2]

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The IRS recovered from its defeat when Congress enacted the Revenue Act of 1918, which defined the "gross estate" to specifically include property passing under a GPA exercised by the decedent (this was the law until 1942).[3] The law didn't define what constituted a GPA, leading many to conclude that Congress meant for the common law to prevail without references to variations in state law.[4]

The common law defined a "GPA" as a power the donee could exercise to appoint to whomsoever he pleases, including himself. If a power was exercisable in favor of certain persons or objects, or classes of persons or objects other than the donee, it wasn't a GPA and was classified as a special power of appointment (SPA).[5] Such distinctions were conducive to substantial argument and litigation. When was a power sufficiently lacking in generality to be classified as an SPA? What restrictions, however nominal, would take a power out of the GPA taxable class? What effect was to be given to state law in the definition of a GPA?[6]

The IRS in its regulations initially adopted the common law view that a GPA was a power "to appoint to any person or persons, in the discretion of the donee."[7] The regulatory definition was tweaked in 1937 to count powers as GPAs if they were exercisable "in favor of the donee, his estate, or his creditors."[8] This made some sense. If creditors are permissible appointees, the power looks like a GPA because it benefits the powerholder who could exercise such power to pay his debts or otherwise contract with appointees for financial gain.

The 1937 regulations on the surface seemed to approve creditor GPAs because creditor appointments satisfied one of the three stated conditions. Still, the underlying statute was grounded in the "leaky" common law, and cases had never addressed the precise question of whether creditor appointments by themselves were GPAs. Could creditor appointments

possibly be SPAs under the common law because such appointments were illusory (who would do this?) or otherwise confined to a group not unreasonably large?

The 1942 Act

The compelling need for war revenues propelled Congress to pass the Revenue Act of 1942 (1942 Act),[9] which, in addition to increasing tax rates, broadened GPA taxability. This latter outcome was chronicled in an entertaining public debate between Professors Erwin N. Griswold[10] and W. Barton Leach of Harvard.[11] Prof. Griswold, whose viewpoints prevailed in the new law, advocated taxation of all exercised and unexercised powers (GPAs and SPAs), except for narrowly defined powers limited to family members or a restricted class. Prof. Leach retorted that taxing unexercised powers was a double tax. He also felt it was socially reprehensible to tax familial SPAs because they admirably allocated family resources based on need.

At the heart of the dispute was the subjective determination regarding the quantum of sufficient property rights needed for estate tax inclusion. Prof. Griswold thought that many SPAs were ownership equivalents. Prof. Leach disagreed and remarked that the SPA powerholder isn't the property owner, and to tax such power is to say that the powerholder is "analogous to an owner rather than to a simple life tenant; and, legally and factually, this is not true."[12]

Under the 1942 Act, estate tax inclusion was required for property over which the decedent had, at the time of his death , a power of appointment (POA). The prior requirements of property "passing" under an "exer-cised" power were eliminated in one fell swoop, as were distinctions between GPAs and SPAs. Instead, all POAs were taxed at death, whenever made, whether or not exercised, except for defined appointments to a speci-fied family or restricted class. An escape hatch was that the law didn't apply to pre-enactment powers if released before Jan. 1, 1943, which critics contended was a trap for the unwary.[13]

The 1951 Act

After passage, the 1942 Act became engulfed by a groundswell of criticism.[14] So much ire was produced that Congress took the unusual step of retroactively repealing it by the Powers of Appointment Act of 1951 (1951 Act).[15]

The 1951 Act changed the landscape. GPAs created on or before Oct. 21, 1942 (the 1942 Act's enactment date) were taxed at death only if exercised, while powers created after that date were taxed whether exercised or not. Estate taxes were now imposed only for GPAs that were defined in the statute (current law IRC Section 2041) as powers exercisable in favor of the decedent, his estate, his creditors or the creditors of his estate.[16]

The legislative history indicates that the new definition was meant to make the law simple and definite enough to be understood and applied by the average lawyer and avoid prior law complications that had forced property dispositions into narrow and rigid patterns.[17] The changes were significant and allowed draftsmen to create GPAs by merely inserting the federal definition into the appointive grant. The leaky common law and state law variations as to what constituted a GPA were now largely irrelevant. All that was required was that permissible appointees qualify as one of the four disjunctive statutory objects (the decedent, his estate, his creditors or the creditors of his estate).[18] Creditor GPAs are thus validated because creditors are two of the statutory objects.[19]

State laws can create different rights for the same power, resulting in varying taxation.

The 1951 Act did violence to the traditional norms as to what constituted a GPA. A GPA under the common law was equated with outright ownership and the full bundle of property rights. The powerholder could appoint to anyone, an extremely large appointive class. On the other hand, creditor GPAs have a more narrowly defined appointive class, at least when compared to the "anyone" of the common law.

The planning idea that followed (widely used today) was to create SPAs not technically qualifying as GPAs, but with an extremely large appointive class, such as granting the power to appoint to anyone, except for the benefit of the powerholder, his estate, his creditors and

the creditors of his estate.[20] This, theoretically, seems like enough for the imposition of estate taxes because of the power's extremely broad appointive class, yet it flunks as a GPA under the 1951 Act's definition. Not a bad deal for clients. Common law ownership rights without annoying estate taxes.

Effect of State Law

The Supreme Court in *Morgan v. Commissioner*[21] held that the definition of a GPA was a matter of federal law, explaining that while state law defines the legal rights relating to the power, federal law determines whether such rights are taxable. State law determines the nature of the donee's interest in property and the scope of that interest, such as the existence of an ascertainable standard under IRC Section 2041(b)(1)(A) or whether appointments are made to the four statutory objects (the decedent, his estate, his creditors or the creditors of his estate). State laws can create different rights for the same power, resulting in varying taxation.[22]

There's no guidance on state law rules regarding how much trust property may be appointed to creditors.

For example, under most jurisdictions, a powerholder's ability to appoint "to whomever he desires" constitutes a GPA because the appointive class quite reasonably is construed to include the statutory objects of Section 2041. But, under the peculiarities of long-standing Maryland law, such power isn't a GPA unless the underlying instrument specifically allows appointments to the powerholder, his estate, his creditors or the creditors of his estate.[23] Alaska has a similar law.[24] This precedent isn't a problem for creditor GPAs, because creditor appointments are allowed in the appointive grant.

It's commonly recognized that GPAs in favor of the powerholder's creditors or the creditors of his estate are generally exercisable only in favor of those creditors; other appointments are to impermissible appointees.[25] However, there's no guidance on state law rules regarding how much trust property may be appointed to creditors.

In our example, John owes Paul $1,000 and holds a creditor GPA over a $1 million trust. Presume that John appoints $100,000 to Paul. Common sense dictates that Paul is an impermissible appointee to the extent trust property exceeds John's debt. This is because John tendered Paul $99,000 more than the underlying debt, thereby exceeding the discretion given him to appoint to creditors (after the first $1,000, Paul is no longer a creditor).

Yet, can it somehow be contended that because Paul is a creditor when the power is exercised, the entire $1 million trust can be appointed to him? This argument becomes more convincing if the power is limited to the creditors of the estate, because creditor status is fixed and determinable at the moment of death without regard to the amount of indebtedness.

Commentators have noted that the question isn't entirely academic. Creditor GPAs are popular because they're perceived to be narrow powers unlikely to be exercised. But, if creditor appointments aren't limited to the amount the creditor is owed, then the power isn't as narrow and arguably less desirable.[26] A simple drafting solution to avoid these concerns is to define "creditor appointments" as applying only to the amount of the legally enforceable debt (rather than blindly hoping that creditor appointments are limited under state law to the amount owed). A happy consequence under the Uniform Trust Code is that the powerholder of a creditor GPA may represent and bind trust beneficiaries.[27]

If state law limits the appointive property to Paul at $1,000, is estate tax inclusion under Section 2041 confined to such amount? If Paul was the only permissible appointee available, the answer to such question should be in the affirmative. But, while state law likely limits the appointive property to Paul at $1,000 for that particular appointment, indisputably John under his creditor GPA could appoint the remaining trust property for the benefit of other creditors. There's no mismatch for state law and tax purposes, as in both cases the entire $1 million can be appointed to creditors. Thus, that's the amount includible in the gross estate under Section 2041.

It makes no difference that at John's death, his actual indebtedness may be less than the appointive property.

It's John's ability to appoint trust assets to creditors that sets the tax consequences. The important consideration is the breadth of the control the decedent can exercise over the property and not the actual exercise of the power.[28]

Treasury Regulations Section 20.2041-1(c)(1) supports this notion by classifying as a GPA a power exercisable to pay estate taxes, or any other taxes, debts or charges that are enforceable against the estate. This rejects the bean counter philosophy that actual taxes and debts must be tallied to measure the size of the appointive property. For creditor GPAs, the entire trust is included in the gross estate because of the ability of the powerholder to impose charges against the appointive property, whether or not such charges are incurred.

Excessive appointments exceeding the donor's dispositive grant are concerning. This malfeasance may divert trust property to appointees outside the donor's dispositive scheme. Careful drafting is necessary. Can a treacherous family member holding a creditor GPA pledge appointive property to a new boyfriend or spouse (not known to the donor, with the intention of creating a creditor relationship) in exchange for financial assets or the waiver of marital or other contractual rights? The ploy is entertaining and has some merit, but in many circumstances can probably be attacked as a "fraud on the power" under state law.[29]

To avoid undesirable appointments, consider requiring the consent of a non-adverse party to exercise the power,[30] inserting notice requirements[31] or excluding perceived non-family interlopers from qualifying as permissible appointees.

Asset Protection View

An irony is that, while it's not typically expected that creditor GPAs will be exercised, possessing such power may be detrimental from an asset protection point of view if the powerholder has creditors. The traditional

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common law rule was that if the powerholder didn't create the GPA, creditors couldn't reach the appointive property unless the power was exercised.[32] The newer rule is that creditors can attach the appointive property of presently exercisable and testamentary GPAs to the extent the powerholder's property is insufficient to satisfy creditor claims.[33] To confront this change, the planner should evaluate the solvency of the powerholder and consult local law.

Endnotes

1. 39 Stat. 756 (1916), Section 202(a).
2. *United States v. Field*, 255 U.S. 257 (1921).
3. 40 Stat. 1057 (1918), Section 402(e).
4. Erwin N. Griswold, "Powers of Appointment and the Federal Estate Tax," 52 *Harv. L. Rev.* 929, 942 (1939).
5. George Gump, "The Meaning of 'General' Powers of Appointment Under the Federal Estate Tax," 1 *Md. L. Rev.* 300, 301 (1937). The *Restatement of Property*, Section 320 (1940), initially defined a "general power of appointment" (GPA) as a power exercisable in favor of the donee or the estate of the donee, with a special power of appointment (SPA) limited to certain persons, not including the donee, who constituted a group not unreasonably large. The Powers of Appointment Act of 1951's (1951 Act) GPA definition (discussed herein) has been adopted by the Uniform Powers of Appointment Act (UPAA), Section 102(6) (2013) and later *Restatements* (*Restatements (Second)* and *(Third) of Property: Wills and Other Donative Transfers*, Section 11.4 (1986); Section 14.3 (2011)).
6. Paul G. Kauper, "The Revenue Act of 1942: Federal Estate and Gift Taxation," 41 *Mich. L. Rev.* 369, 375 (1942). Griswold, *supra* note 4, at pp. 940-941.
7. Treasury Regulations Section 37, Art. 30 (1918).
8. Treas. Regs. Section 80, Art. 24 (1937). The new regulation changed the analysis as it made the power to appoint to creditors part of the GPA definition, elevating it from the majority common law rule that creditors could attach the appointive property of exercised GPAs. *Field*, *supra* note 2, at p. 263.
9. Pub. L. 753 (1942).
10. Griswold, *supra* note 4.
11. W. Barton Leach, "Powers of Appointment and the Federal Estate Tax—A Dissent," 52 *Harv. L. Rev.* 961 (1939).
12. *Ibid.*, at p. 965.
13. Harrop A. Freeman, "If this Be Simplification—a View of Pre-1942 Powers of Appointment and the 1954 Internal Revenue Code," 40 *Cornell L. Rev.* 500, 502 (1955).
14. Lucius A. Buck, George Craven and Francis Shackelford, "Treatment of Powers of Appointment for Estate and Gift Tax Purposes," 34 *Virginia L. Rev.* 255, 257-261 (1948).
15. Pub. L. No. 58 (1951).
16. *See* George Craven, "Powers of Appointment Act of 1951," 65 *Harv. L. Rev.* 55, 64 (1951). The 1951 Act adopted safe harbors wherein prescribed powers could benefit the powerholder without estate taxation, such as powers subject to adverse party consent, ascertainable standards and "5 and 5" powers. Internal Revenue Code Section 2041(b).
17. H. Rep. No. 327, at pp. 3-4; S. Rep. No. 328, at pp. 1530-1531, 82d Cong., 1st Sess. (1951).
18. A GPA results from a power that can be exercised in favor of any one of the four disjunctive statutory objects. *Edelman Est. v. Commissioner*, 38 T.C. 972, 977 (1962), *Jenkins v. U.S.*, 428 F.2d 538, 544 (5th Cir. 1970). *In accord* Private Letter Rulings 9110054 (Dec. 12, 1990) and 8836023 (June 13, 1988).
19. It isn't advisable to materially change the statutory objects. For example, is a creditor GPA illusory for an accumulation trust limiting appointments to creditors not older than the age of a very young trust beneficiary? Edwin P. Morrow III, "The Optimal Basis Increase and Income Tax Efficiency Trust," *https://ssrn.com/abstract=2436964*, at pp. 38-39 (revised April 28, 2018).
20. There was initial skepticism whether this would work. *See* Allan McCoid, "The Non-General Power of Appointment—A Creature of the Powers of Appointment Act of 1951," 7 *Vand. L. Rev.* 53, 60 (1953). The strategy is now blessed by Treas. Regs. Section 20.2041-1(c)(1)(b).
21. *Morgan v. Comm'r*, 309 U.S. 78 (1940).
22. Christopher P. Cline, 825-3rd T.M., "Powers of Appointment—Estate, Gift, and Income Tax Considerations," at pp. A-20-22 (2007).
23. *Guiney v. U.S.*, 425 F.2d 145 (4th Cir. 1970).
24. AS 34.40.115.
25. *Restatement (Third) of Property*, *supra* note 5, Section 19.15; UPAA, Section 305(b), and underlying comments therein.
26. *Ibid.*, Section 19.15; UPAA, Section 102(6) and underlying comments therein. Turney P. Berry and Sarah S. Butters, "Powers of Appointments in the Current Planning Environment," 49 U. Miami Heckerling Institute on Estate Planning, Ch. 13, at pp. 28-29 (2015). Steve R. Akers, "Estate Planning Current Developments and Hot Topics (Final for 2018)," *www.bessemertrust.com/for-professional-partners/advisor-insights*, at p. 91.
27. Uniform Trust Code (UTC), Section 302 (2003). The Illinois UTC extends this power to broad SPAs. 760 ILCS 3/302(a).
28. *Morgan*, *supra* note 21, at p. 83.
29. *Restatements (Second)* and *(Third) of Property*, *supra* note 5, Sections 20.1 to 20.4 (1986), Section 19.15, 19.16 (2011); UPAA Section 307.
30. IRC Section 2041(b)(1)(C)(ii) and Treas. Regs. Section 20.2041-3(c)(2).
31. Section 2041(a)(2) and Treas. Regs. Section 20.2041-3(b).
32. *Field*, *supra* note 2, at p. 262.
33. UPAA, Section 502; *Restatement (Third) of Property*, *supra* note 5, Section 22.3.