POWERS OF APPOINTMENT IN THE CURRENT PLANNING ENVIRONMENT

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"The power of appointment is the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out."
– W. Barton Leach (1938)

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¶ 100 Introduction and Basic Principles

¶ 100.1 Introduction.

A power of appointment is a nonfiduciary power of disposition over property. The power is granted by the owner of property—the "donor"—in a will or trust and is given to a person traditionally called the "donee" in the Restatements of Property but called the "powerholder" in the Uniform Powers of Appointment Act promulgated by the Uniform Law Commission in 2013 (see www.uniformlaws.org for extensive information about all uniform acts, including the text of and comments to the acts and enactment information). A powerholder appoints property to an appointee who must be a "permissible appointee," and the person who would receive the property if no appointment is made is the "taker in default."

A power of appointment may be exercisable currently or upon the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified time. A power that is exercisable currently is a "presently exercisable" power of appointment. Many powers of appointment are exercisable at the death of the powerholder, and these are referred to as testamentary powers of appointment.

There are general and nongeneral powers of appointment. The latter are sometimes referred to as "special" or "limited" powers of appointment but these terms can be confusing. A general power of appointment is a power of appointment exercisable in favor of any one or more of the powerholder, the powerholder's estate, a creditor of the powerholder, or a creditor of the powerholder's estate. A nongeneral power of appointment is a power of appointment that is not a general power. Traditionally, a nongeneral power of appointment is created either by specifically limiting the permissible appointees, such as "my then living descendants" which is colloquially referred to as a limited or narrow nongeneral power, or by allowing the powerholder to appoint to any person other than the powerholder, the powerholder's estate, a creditor of the powerholder, or the creditors of the powerholder's estate, which is colloquially referred to as a broad nongeneral power. A right to withdraw assets from a trust is considered a general power of appointment because withdrawing assets is the equivalent of appointing those assets to the powerholder.

¶ 100.2 The Doctrine of Relation Back.

As a technical matter of property law, there is no doubt that a powerholder — as such — is not the owner of the appointive assets. The distinction between beneficial ownership and a power is stated in the Restatement Third of Property: Wills and Other Donative Transfers ("Restatement Third") §17.1 comment c:

> The beneficial owner of an interest in property ordinarily has the power to transfer ownership interests in or confer powers of appointment over that property to or on others by probate or nonprobate transfer.... By contrast, a power of appointment

> traditionally confers the authority to designate recipients of beneficial ownership interests in or powers of appointment over property that the [powerholder] does not own.

Upon the exercise of a power of appointment, the *doctrine of relation back* provides that the appointed property passes directly from the donor to the appointee. The powerholder's appointment is deemed to relate back to and become part of the *donor's* original instrument. The powerholder is viewed as akin to the donor's agent, as it were; an appointment retroactively fills in the blanks in the original instrument.

Technical ownership aside, when it comes to federal taxation and the rights of the powerholder's surviving spouse and creditors, the law does not always follow the relation-back doctrine. The likelihood that the powerholder will be treated as the owner of the appointive property is greater in the case of a reserved power, as distinguished from a power conferred on the powerholder by another. We discuss issues of taxation, creditors' rights, and the surviving spouse's elective share later in these materials.

¶ 100.3 Tax Treatment of Powers of Appointment.

Section 2041 of the Internal Revenue Code of 1986, as amended (the "Code"), defines a general power is the manner explained above. There are numerous cases and rulings dealing with whether powers are general. For example, in McMullen v. Commissioner, 56 T. C. M. 507 (1988), the court held that the power to appoint to the powerholder's "heirs or devisees" was a general power.

However, section 2041 excepts three circumstances from the definition of general power:

A. if the powerholder's authority is limited by an ascertainable standard relating to the powerholder's health, education, support or maintenance (see Treas. Reg. § 20.2041-1(c)(2) for further elaboration on what is, and is not, an ascertainable standard, discussion of which is beyond the scope of these materials);

B. if the power is exercisable only in conjunction with the donor of the power; or

C. if the powerholder can exercise the power only in conjunction with a person holding an adverse interest in the property (typically the takers in default; see Revenue Ruling 79-63 and Greve v. Commissioner, TCMemo 2004-91 for a discussion of this issue).

Section 2041 requires the estate of a powerholder to include all property over which the powerholder has at death a general power of appointment. Mere existence of the power is sufficient, even if the powerholder does not know about the power or is incapable of exercising it at death (for instance, due to incapacity).

See Estate of Freeman v. Commissioner, 67 T. C. 202 (1976). Section 2207 provides that a powerholder's estate may recover from the recipient of property subject to a general power unless that right of recovery is waived by the powerholder/decedent; this mitigates the unfairness of including property in a powerholder's estate if the powerholder did not know of or could not exercise the power.

Section 2514 provides that the *exercise* or *release* of a general power of appointment is deemed to be a transfer of the property by the powerholder.

If the power expires by its terms, rather than by an action of the powerholder, then the power is said to *lapse*, and section 2514(e) provides that the lapse of a power during the life of the powerholder is considered a release of the power—and thus a transfer of property—but only to the extent the amount of property subject to the release exceeds $5,000 and 5% of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied. These "5 and 5" powers may lapse every year without transfer tax consequences, thus enabling a donor to give a beneficiary the right to take any amount from a trust, so long as the amount does not exceed 5%, with the right lapsing at the end of the year. All that is included in the beneficiary-powerholder's estate is the amount that could be appointed at the powerholder's death. A right to withdraw 1% - 5% of the trust assets each year (perhaps if the beneficiary is living on the last day of the year) is common, but other creative uses abound; for example, "my spouse may withdraw on the first day of each calendar year an amount equal to the amount my spouse gave to my descendants during the previous calendar year, provided, however, that such amount may not exceed 5% of the fair market value of the trust assets on the first day of such calendar year"). Crummey withdrawal rights are often structured to lapse within the limits of a 5 and 5 power; these are commonly referred to as "hanging" powers because, although the right to withdraw is set at a limited period of time (for example, 30 days), the annual exclusion amount is $14,000 per year, and if the trust is not well funded the power may continue for several years until the lapse is fully protected by the 5 and 5 exception.

The transfer tax effects of nongeneral powers of appointment are variable. The exercise or release, itself, of a nongeneral power has no transfer tax effect. However, if the exercise or release has an effect on the powerholder's other interests in the trust, a transfer tax argument may ensue. For example, suppose a powerholder is entitled to receive all the income from a trust during the powerholder's life and also has a presently exercisable power to appoint the trust property to the powerholder's children. If the appointment of the trust property eliminates the powerholder's income interest and vests the property, and the income, in the powerholder's children, the powerholder has made a gift in some amount.

TAM 9419007 is illustrative. There the grandchild of the creator of the power exercised a nongeneral power to create new trusts; at the time of exercise, the powerholder had a contingent remainder interest in the trust (which would ripen

into absolute ownership of the property upon the powerholder reaching age 30) and the right to receive current trust income until reaching age 30. The exercise of the power terminated those interests. The IRS concluded that the powerholder made a gift, following the Regester case and refusing to follow the Self case, discussed as follows:

> This analysis is supported by the Tax Court decision in Regester v. Commissioner, 83. T.C. 1 (1984). In Regester, the Donor was the income beneficiary of a trust and possessed a limited power of appointment over the trust corpus. The Donor exercised her limited power of appointment, thereupon relinquishing her income interest. The Service asserted that the taxpayer's inter vivos exercise of the limited power of appointment over the corpus of the trust concomitantly effected a gift of her life income interest in the trust. The court agreed with the Service's position. Finding that the taxpayer had made an independent taxable gift of her income interest when she exercised her power of appointment over the corpus, the court stated: When a person has the right to income for life and the ability to transfer that right to anyone or to retain it as long as she lives, transfer of the property without consideration gives rise to a taxable gift. Had [taxpayer] chosen to transfer her life interest to a third party prior to her exercise of the special power of appointment, she would have made a taxable gift of her life interest . . . The fact that she chose to convey that interest to the ultimate owner of the corpus does not disguise the fact that she chose to give her income from the trust property to another without compensation. The transfer of the property should, therefore, be treated as a gift by the life tenant, i.e, [taxpayer], who had an absolute interest in the income. Secs. 2501(a), 2511(a). Such a transfer is taxable irrespective of section 2514.
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> The Donor relies on Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956) to support her position that her relinquishment of the interests on the exercise of the power is not taxable. In Self, the taxpayer was a trust income beneficiary who also possessed a limited power to appoint the underlying trust corpus. The taxpayer exercised the power with the result that his income interest terminated and the trust corpus thereupon passed outright to the appointees. The Service, relying on the regulatory predecessor to section 25.2514-1(b)(2), contended that the taxpayer made a gift of his income interest when he exercised the power of appointment. However, the court held that the taxpayer's power of appointment was a limited power and property (such as the income interest) passing pursuant to the exercise of a limited power is not subject to gift tax. The court found

> support in Commissioner v. Walston, 168 F.2d 211 (4th Cir. 1948), in which the Fourth Circuit indicated that an income interest relinquished pursuant to the exercise of a limited power of appointment would not be subject to the gift tax. The court specifically disagreed with the regulatory predecessor to section 25.2514-1(b)(2). The Service, in Rev. Rul. 79-327, 1979-2 C.B. 342, announced that it will not follow Self. As discussed below, we believe the continued viability of the Self decision is questionable. Further, we believe the Donor's position conflicts with basic and longstanding estate and gift tax principles. The pivotal question is whether the Donor's characterization of the transfer as the exercise of a limited power of appointment precludes the application of the gift tax to the Donor's transaction. In Helvering v. Clifford, 309 U.S. 331 (1940), Helvering v. Hallock, 309 U.S. 106 (1940), Helvering v. Safe Deposit and Trust Co. of Baltimore, 316 U.S. 56 (1942), and Commissioner v. Church's Estate, 335 U.S. 632 (1949), the Court established the position, for gift tax purposes, that the economic substance of a transfer prevails over the nomenclature given it in the instrument of transfer or state law characterizations of the transaction. See Sanford v. Commissioner, 308 U.S. 39 (1939), (stating that the gift and estate tax are in pari materia). Thus, in the present case, the fact that the trust instrument characterized the right granted the Donor as a limited power of appointment and that the Donor chose to dispose of her interests in an instrument labeled "Exercise of Limited Power of Appointment" does not change the substance of the transaction. The Donor was the beneficial owner of the interests, and she transferred them to the Family Trusts. Consequently, for purposes of section 2511, the Donor is regarded as gratuitously transferring her contingent remainder interest and her income interest to the Family Trusts.

After Regester came the Supreme Court's opinion in Jewett that the IRS concluded rendered Self inapposite. The ruling notes:

> The specific question raised here, whether a contingent remainderman's power of appointment (such as that in the present case) over the contingent remainder interest is a general or limited power of appointment, was addressed by the Supreme Court in Jewett v. Commissioner, 455 U.S. 305, aff'g, 638 F.2d 93 (9th Cir. 1990), aff'g, 70 T.C. 430 (1978). In Jewett, the taxpayer held a contingent remainder interest that would vest on his mother's death if he survived his mother. If he failed to survive his mother, the remainder would pass to his two children. The taxpayer renounced his contingent remainder interest and, under the terms of the trust instrument creating the interest, the interest thereupon passed to his two children. The taxpayer contended that his renunciation was an

effective disclaimer for gift tax purposes. In Jewett, the government asserted that the transaction was subject to the gift tax because the taxpayer had not made a timely disclaimer under the applicable regulations. The taxpayer's primary argument was that the disclaimer was timely for federal tax purposes and, therefore, the transaction was not subject to gift tax. This argument, of course, was ultimately rejected by the Supreme Court. However, the taxpayer raised an alternative argument. The taxpayer argued that his disclaimer was tantamount to the exercise of a limited power of appointment over his contingent remainder interest since, under state law, the disclaimer could effectuate a transfer of property to only the limited class of individuals named in the original trust agreement as takers if the taxpayer predeceased termination of the trust. Noting that the exercise of a limited power of appointment is not subject to the gift tax, the taxpayer contended that, even if the disclaimer was not considered timely, the transaction should be recast, instead, as the exercise of a limited power of appointment and, thus, the transfer should not be subject to the gift tax. In response, the government asserted that the power of appointment described by the taxpayer (i.e., a contingent remainderman's power to appoint the contingent remainder in favor of his children) is in the nature of a general power of appointment. Brief for Appellee at 27, 638 F.2d 93 (9th Cir. 1980). The government's brief stated:

> Taxpayer is correct in stating that the holder of a limited power of appointment only has the ability to select recipients of the property from among a specified class of donees which does not include himself, his estate, his creditors or the creditors of his estate, and that the exercise . . . of such a power is not taxed as a gift under Section 2514 . . . CLEARLY, HOWEVER, TAXPAYER HERE POSSESSED A SIGNIFICANTLY GREATER POWER over his future interest; unlike the holder of a limited power of appointment, taxpayer could wait and eventually receive his interest as long as he survived the life tenant, or disclaim and let the interest pass to his children. [Emphasis added.] The Ninth Circuit affirmed the Tax Court's conclusion that the taxpayer had made a taxable gift, but did not address this alternative argument. On appeal to the Supreme Court, the taxpayer again argued that the passage of property as the result of his disclaimer was comparable to the transfer of property pursuant to the exercise of a limited power of appointment, in which the donee of the power can select the recipients of property from a specified class of donees that does not include himself, his estate, his creditors, or the creditors of his estate. Brief for Appellant at 22. Jewett v. Commissioner, 455 U.S. 302 (1982) (No. 80-1614).

In response, the government asserted in its brief: Petitioner . . . pursues his argument that the decision below is inconsistent with estate tax principles by analogizing a disclaimer to a special power of appointment . . . But petitioner's analogy falls wide of the mark. A disclaimant's control over property more closely resembles a general power of appointment, the release of which is a taxable transfer under section 2514 of the Code. A DISCLAIMANT, UNLIKE THE HOLDER OF A SPECIAL POWER OF APPOINTMENT, CAN DECIDE TO ACCEPT THE PROPERTY FOR HIMSELF, IN THE SAME MANNER AS THE HOLDER OF A GENERAL POWER. [Emphasis added.]Brief for Respondent at 34, Jewett v. Commissioner, supra. The taxpayer responded in his reply brief as follows: III. THE COMMISSIONER'S ANALOGY OF JEWETT'S DISCLAIMER TO THE EXERCISE OF A GENERAL POWER OF APPOINTMENT IS INAPT. As Petitioner has argued . . ., if the exercise of a limited power of appointment is not a taxable transfer, then a fortiori a disclaimer, involving a lesser degree of control, should not be taxable . . . It is the Commissioner's analogy which fails. Reply brief for Appellant at 3, Jewett v. Commissioner, supra.

Thus, in Jewett, the question of the nature of a power of appointment (characterized as a limited power) held by a contingent remainderman over his contingent remainder interest was fully briefed for consideration by the Ninth Circuit and the Supreme Court. Although the Ninth Circuit did not directly respond, the Supreme Court considered the question and agreed with the government's position, stating: [P]etitioner argues that the disclaimer of a contingent remainder is not a taxable event by analogizing it to an exercise of a special power of appointment, which generally is not considered a taxable transfer. 26 U.S.C. section 2514. As the Commissioner notes in response, however, a disclaimant's control over property more closely resembles a GENERAL power of appointment, the exercise of which is a taxable transfer . . . Unlike the holder of a special power -- but like the holder of a general power -- a disclaimant may decide to retain the interest himself. 455 U.S. at 317-318. The interests and powers held by the Donor in the present case are identical to those possessed by the taxpayer in Jewett. That is, just as in Jewett, had the Donor in the present case failed to exercise her power, she would have continued to hold the contingent remainder subject to the power until receiving the trust property outright at age 30. In addition, she would have continued to receive the trust income (subject to the power) until reaching age 30. Thus, just as in Jewett, the Donor, as the contingent remainderman and income beneficiary, could at all times have appointed the interests subject to the power to herself by simply not exercising the power.

> The statement in the trust instrument that the power could not be exercised in favor of the holder of the power was clearly a meaningless limitation, in view of the trust terms. Therefore, the Court's conclusion in Jewett, that the power held by the taxpayer was a general power of appointment, rather than a limited power, controls in this case as well. Consequently, the power of appointment held by the Donor in the present case is properly characterized as a general power of appointment within the meaning of section 2514(c). Thus, for purposes of section 2514, the Donor exercised a general power of appointment and made a taxable gift when she executed the instrument entitled "Exercise of Limited Power of Appointment" transferring the contingent remainder and income interests to the Family Trusts.
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> THE PRECEDENTIAL VALUE OF SELF The Donor anticipates commencing a refund action in the Court of Federal Claims and opines that the Court of Claims' decision in Self would constitute binding precedent in the Court of Federal Claims as well as the Federal Circuit. 2 We do not agree with the Donor's assertion that, if the Court of Federal Claims and the Federal Circuit were to consider the issue today, Self would be followed by those courts. We believe that the conclusion of Jewett, that the taxpayer's transfer, even if characterized as the exercise of a power of appointment, would be subject to gift tax, effectively overrules Self. The Donor argues that the Supreme Court's characterization of the taxpayer's interest in Jewett as a general power of appointment was dictum. We disagree. As demonstrated above, the taxpayer raised this issue as an alternative ground for relief. That is, the taxpayer was arguing that, even if the disclaimer was not timely for federal gift tax purposes, nonetheless, the taxpayer did not make a taxable gift because the transfer was made pursuant to the exercise of a limited power of appointment. The issue was fully briefed by both parties in the Ninth Circuit and again in the Supreme Court. Thus, the Supreme Court was rendering a decision on an issue specifically raised by the taxpayer on several occasions and one which, if decided in the taxpayer's favor, would relieve the taxpayer from any gift tax liability. The Court's ruling on this issue can hardly be characterized as gratuitous or not essential to the determination of the taxpayer's gift tax liability.

For purposes of section 2042, a power of appointment will be an incident of ownership over a life insurance policy. See PLR 201327010.

There are income tax consequences to powerholders. Section 678(a)(1) provides that a powerholder will be treated as the owner for income tax purposes of any portion of a trust from which the powerholder has the power, exercisable by herself, to vest the corpus or income in herself unless the grantor of the trust is treated as

the owner for income tax purposes. If a power is released or lapses, whether the powerholder is treated as the owner of the portion over which the power existed depends on whether the powerholder would have been treated as the owner of the trust were the powerholder the grantor of the trust. An exception is that a powerholder may have the power as fiduciary to direct the trust income to the support and maintenance of a person to whom the powerholder has a support obligation without income tax consequence except to the extent the income is actually distributed to satisfy this obligation.

There are also income tax consequences to those who receive assets either by the exercise of a general power of appointment or the takers in default if a general power is not exercised. Section 1014(b)(9) provides that property required to be included in a powerholder's estate by reason of a power of appointment will be deemed to have been acquired from the decedent powerholder and thus under section 1014(a) will have, in the hands of the recipients, basis equal to the fair market value of the property at the decedent's death (with well-known exceptions for certain kinds of property, including IRD property, and property acquired by the powerholder by gift from the recipient within one year of the powerholder's death (section 1014(e)).

General powers of appointment may arise in unexpected circumstances. For instance, a small trust termination provision may be a general power if the trustee is potential beneficiary. See PLR 9840020. In TAM 8330004 the ability to purchase trust property at below fair market value was a general power.

¶ 100.4 Exercising a Power to Create a Power: Taxation, and the Delaware Tax Trap.

In many instances, a powerholder may exercise the power to create a new power of appointment. See, e.g., Uniform Act § 305. If the first power is a general power and the exercise occurs by will, the appointive assets will be subject to federal estate taxation. See IRC § 2041(a), (b). If the first power is a general power and the exercise occurs inter vivos, the exercise "shall be deemed a transfer" for federal gift tax purposes. IRC § 2514(a), (b)

If the first power is a nongeneral power, the exercise (to create a new power) will have tax consequences only if the "Delaware Tax Trap" provisions of IRC § 2041(a)(3) or § 2514(d) are satisfied. As summarized by Jonathan Blattmachr & Jeffrey Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap*, 24 REAL PROP., PROB. & TR. J. 75, 82 (Spring 1989):

> These arcane and little known sections provide that property subject to a nongeneral power of appointment will be includible in the estate of the powerholding beneficiary (or will be subject to gift tax upon exercise) to the extent the power is exercised to create another power of appointment that "can be validly exercised so as to postpone the

> vesting of any estate or interest in [the] property, or suspend the absolute ownership or power of alienation of [the] property, for a period ascertainable without regard to the date of creation of the first power." In more simple terms, exercise of a nongeneral power of appointment to create a new power of appointment that has the effect of postponing the period of the Rule Against Perpetuities converts the nongeneral power of appointment into a taxable power for purposes of sections 2041 and 2514.

The reason why these IRC provisions are known as the "Delaware Tax Trap" is that the provisions, enacted in 1951, responded to an unusual feature of Delaware law. Under the traditional perpetuities law of most states, the exercise of a nongeneral power to create a new nongeneral power would not extend the period of the Rule Against Perpetuities. In other words, the exercise of the second nongeneral power would "relate back" for perpetuities purposes, meaning that for perpetuities purposes the exercise by the second powerholder would be treated as an exercise by the first powerholder. Delaware law (Del. Code tit. 25 § 501), however, provides that the exercise of a power of appointment — even a nongeneral power — changes the "time of creation" for perpetuities purposes; the perpetuities clock begins running anew from the time of the power's exercise. This has the effect of allowing the successive exercise of nongeneral powers to frustrate the goals of the Rule Against Perpetuities. In response, Congress enacted §§ 2041(a)(3) and 2514(d).

After the advent of the generation-skipping transfer tax, some commentators (including Blattmachr and Pennell) observed the potential planning benefits of the Delaware Tax Trap. Depending on the facts of a particular case, it may be more advantageous to trigger estate or gift tax liability rather than generation-skipping transfer tax liability. One way to trigger estate or gift tax liability is to "spring" the Delaware Tax Trap: to have the powerholder of a nongeneral power exercise that power to create a new power so as to extend the period of the Rule Against Perpetuties. As Blattmachr and Pennell observed (24 REAL PROP., PROB. & TR. J. at 75):

> Best of all, under the Delaware Tax Trap, it is the powerholding beneficiary, not the trustee or some third party, who decides which tax will apply. Indeed, even if the nongeneral power were granted in the first instance only in the trustee's discretion, it will still be the powerholding beneficiary who ultimately makes the decision whether to expose trust assets to estate or gift tax rather than generation-skipping transfer tax, and to what extent. … The tax to be incurred is totally within the discretion of the powerholding beneficiary who, presumably, is best able to judge whether to incur estate or gift tax and who, presumably, cannot be sued for the consequences of exercising (or failing to exercise) the power.

Whether the exercise of a nongeneral power to create a new power does or does not trigger the Delaware Tax Trap depends on whether, under the particular state's

perpetuities law, the second power "can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power." IRC § 2041(a)(3), § 2514(d). The answer to this question depends on a careful reading of the relevant state's perpetuities law, and on this even experts disagree. As Professor Lynn Foster accurately noted in her article *Fifty-One Flowers: Current Perpetuities Law in the States*, PROB. & PROP. 30, 33 (July/Aug. 2008), "there is little agreement or certainty in this area of the law." Examining perpetual-trust statutes enacted before 2002, Professors Jesse Dukeminier and James Krier concluded that trusts in Arizona, Delaware, Illinois, Maine, Maryland, Missouri, Nebraska, Ohio, Rhode Island, and Virginia were still subject to the Delaware Tax Trap, while the same year attorney Julia Fisher concluded that the Delaware Tax Trap applied to perpetual trusts only in Arizona, Colorado, Delaware, Idaho, Rhode Island, and Virginia. (For citations, see Foster at 33.) Ultimately, a careful review of each state's perpetuity law is required. That, however, is beyond the scope of these materials.

Perhaps all that can be usefully noted for present purposes is that some perpetual-trust jurisdictions have responded to the Delaware Tax Trap by enacting statutes providing that the exercise of a second nongeneral power will be measured from the creation of the original nongeneral power. See Alexander A. Bove, Jr., *Using the Power of Appointment to Protect Assets — More Power Than You Ever Imagined*, 36 ACTEC J. 333, 354 (2010) (citing Alaska Stat. §34.27.051 and Del. Code tit. 25, §504).

¶ 101 Common Uses of Powers of Appointment.

¶ 101.1 Second Look Changes.

An important use of powers of appointment is to allow changes to be made in trust provisions after the trust was created. The powerholder may be able to appoint the assets of a trust to an entirely new trust with different administrative provisions (e.g., governing law; situs; or the spendthrift or investment provisions or provisions for investment or distribution committees that advise or direct the trustee) or dispositive provisions (e.g., removing existing beneficiaries and adding new ones, or changing the terms under which income and principal may be distributed to one or more beneficiaries). Many decanting statutes do not allow trustees to change the dispositive provisions of a trust but do allow the creation of powers of appointment which the powerholder may then use to change the trust's dispositive provisions.

With the repeal or extension of the rule against perpetuities in many states, and the ability of grantors to create trusts invoking the law of those states, there has been much discussion of ever-lengthening trust terms or even so-called perpetual trusts. Perpetual charitable trusts have been allowed for hundreds of years, yet only a few last for longer than a century; so the viability of multi-century or longer trusts may be questioned. These long-term or perpetual trusts have been attacked on the ground that the number of beneficiaries will outstrip the ability of any trustee to

manage the trust and that the trust will become outdated. See, e.g., *From Here to Eternity: The Folly of Perpetual Trusts*, Univ. of Michigan Public Law Working Paper, no. 259. Working Paper by the distinguished professor and long-time leader in the trusts and estates field, Lawrence W. Waggoner of the University of Michigan; and Immortality and the Law: The Rising Power of the American Dead (Yale University Press, 2010) by Ray D. Madoff, a thoughtful professor at Boston College Law School. Powers of appointment are the answer to much of the criticism. With powers of appointment, a trust may be kept up to date—"evergreen" as it is sometimes called—at every generation. There may be other policy reasons why long-term or perpetual trusts ought be disfavored but that is outside the topic of these materials.

A. Powers to Appoint are Powers to Disappoint.

Many grantors want to give a senior generation almost, but not quite, unfettered access to trust assets (to coin a phrase, "lightly-fettered" access). For example, the grantor may want the surviving spouse as trust beneficiary to be untroubled by the complaints of the children or grandchildren that the surviving spouse's lifestyle is too expensive, yet do not want the surviving spouse to be able to divert assets to a new spouse or companion or discover a newfound love of the opera or the Little Church of the Misdirected Vision. These concerns may also extend to trusts for children when assets are to remain in trust for grandchildren. A common response to this concern is to allow the senior beneficiary to appoint the trust assets at death among the junior beneficiaries, but to be able to pick and choose among them. For example, a child is less likely to nitpick a surviving spouse when the surviving spouse could decide that the child's siblings are more desirable beneficiaries. The theory is that the trustee will prevent the spouse from doing anything "crazy," and the power of appointment will prevent the children from discussing whether mother should have a Camry or a Lexus.

A collateral concern may be for senior beneficiaries who believe that the junior generation pays positive attention to them only for the money. Thus, if the surviving spouse cannot divert the bulk of the assets away from the children and grandchildren, will the children and grandchildren visit and care for the surviving spouse? The ability of the surviving spouse to skip the children and distribute everything to the grandchildren may be a powerful inducement for the children to remind the parent of their love and affection, although such moments may be best suited for the stage. Here the balance is delicate. Regardless of good intentions and efforts by children, some parents are spiteful and, given the opportunity to "punish" children by skipping them, may do so gleefully; indeed, some couples are concerned that if a surviving spouse lives long enough, irrational behavior like this may result.

B. Powers Granted for Transfer Tax and Income Tax Purposes.

1. General Powers and Estate Tax Inclusion.

General powers are necessary to achieve certain tax results, one being a general power of appointment marital trust as described in section 2056(b)(5) and another being the qualification as a gift that would otherwise be a future interest (a gift to a Crummey trust, for example) for the annual exclusion (the right to withdraw is a presently exercisable general power of appointment).

General powers of appointment are also used to ensure that assets in trust are included in a powerholder's estate, which has the effect of preventing a generation-skipping transfer, and to achieve a new basis at the powerholder's death. The latter has become significantly more popular with the increase in the federal estate tax exclusion amount. In many situations, trust beneficiaries do not have taxable estates, hence the inclusion of assets in a beneficiary's estate by decanting or amending the trust to make the beneficiary a powerholder of a general power will generate a free basis increase.

Powers may be drafted to accomplish the tax savings with precision. For example, a power may encompass only assets that have a fair market value higher than basis, so that in a portfolio where some assets have increased and others decreased only those whose basis would be increased are subject to the general power. Further, the maximum amount subject to the power may be capped so that the powerholder is not subject to estate tax. Care must be taken to ensure that the amount subject to the power is ascertainable at the powerholder's death; in general, a cap that references the basic exclusion amount (or in appropriate cases the applicable exclusion amount) will be safer than a cap tied to whether federal estate tax is paid. The IRS's argument might be that, despite the crux of the Fifth Circuit's ruling in Clayton v. Commissioner that a QTIP election relates back to the date of death (and the same could be said about qualified disclaimers), these actions do not relate to a general power of appointment under section 2041 of the Code. The election and disclaimer do, however, affect the value of property subject to the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death. In PLR 8516011, the IRS ruled that a marital bequest conditioned on the spouse's survival of the decedent's will being admitted to probate would not be included in the spouse's estate because the spouse died prior to that event. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn required a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.

Adjustments to consider state tax regimes may also be included in the formula if desirable.

2. Non-general Powers and Incomplete Gifts.

Nongeneral powers of appointment have an important tax use in making gifts to trusts incomplete. Incomplete gifts may be helpful for many purposes but a common one is the transfer of assets to a trust that is not a grantor trust for income tax purposes. If the grantor is domiciled in a high income-tax state, and the transfer can be made to a trust that will be taxed in a lower tax state—for example, a state that does not tax assets in trusts created by non-domiciliaries—then overall income tax savings will be achieved if there is no imposition of gift tax. In order to avoid gift tax, the grantor must retain a lifetime and testamentary power of appointment and the powers of appointment must be sufficiently limited to avoid the grantor trust rules of §§ 671–677. Further discussion of this issue is beyond the scope of these materials, but private letter rulings tracing the history of the IRS position include PLR 200148028, PLR 200715005, CCA 201208026, 20131002, and 201426014.

3. Moving Jurisdictions.

Powers of appointment may also be used to move trusts from one taxing jurisdiction to another. In Linn v. Department of Revenue, 2013 WL 6662888 (Ill. App. 4 Dist.), the court held that Illinois could not tax an inter vivos trust created by an Illinois resident where the trust assets were moved via power of appointment to a Texas trust with a Texas trustee and no trust beneficiaries were in Illinois. The opinion sets forth a good statement of the law in the area:

> For a tax to comply with the due process clause, (1) a minimum connection must exist between the state and the person, property, or transaction it seeks to tax, and (2) "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State." (Internal quotation marks omitted.) Quill Corp. v. North Dakota, 504 U.S. 298, 306, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992) (quoting Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 273, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978)). In Quill Corp., 504 U.S. at 307–08, 112 S.Ct. 1904, the Supreme Court equated that analysis with the determination of whether a state has personal jurisdiction over a given entity. After analyzing the case law regarding personal jurisdiction, the Quill Corp. Court held the due process clause did not require physical presence in a state for the collection of a use tax. Quill Corp., 504 U.S. at 308, 112 S.Ct. 1904. There, the company's ongoing solicitation of business in North Dakota was more than enough to subject it to North Dakota's use tax. Quill Corp., 504 U.S. at 308, 112 S.Ct. 1904.
>
> * * *
>
> Both parties cite the Connecticut Supreme Court's decision in Chase Manhattan Bank v. Gavin, 249 Conn. 172, 733 A.2d 782 (1999),

which was decided after the United States Supreme Court's Quill Corp. decision. There, the plaintiffs asserted Connecticut's income taxation on the undistributed taxable income of four **928 *1209 testamentary trusts and one inter vivos trust was unconstitutional because it violated the due process and commerce clauses. Gavin, 733 A.2d at 785–86. Since the case before us involves an inter vivos trust, we focus on the facts and analysis related to the inter vivos trust. Under Connecticut law, a resident inter vivos trust is " 'a trust, or a portion of a trust, consisting of the property of (i) a person who was a resident of this state at the time the property was transferred to the trust if the trust was then irrevocable.' " Gavin, 733 A.2d at 789 (quoting Conn. Gen. Stat. § 12–701(a)(4)(D) (1993)). However, with an inter vivos trust, taxable income is then modifiable under a formula that takes into account whether the trust has any resident, noncontingent beneficiaries. Gavin, 733 A.2d at 790. Thus, Connecticut taxes only that portion of the inter vivo trust's undistributed income that corresponds to the number of noncontingent beneficiaries that live in Connecticut. Gavin, 733 A.2d at 790. Accordingly, in Gavin, 733 A.2d at 790, the taxability of the inter vivos trust's income was based on the facts the trust's settlor was a Connecticut resident when he established the trust and the trust's beneficiary was a Connecticut resident.

Regarding due process, the Connecticut Supreme Court found the critical link between Connecticut and the undistributed income sought to be taxed was the fact the inter vivos trust's noncontingent beneficiary was a Connecticut resident during the tax year in question. Gavin, 733 A.2d at 802. It explained that, as a Connecticut resident, the noncontingent beneficiary's rights to the eventual receipt and enjoyment of the accumulated income were protected by Connecticut law so long as the beneficiary remained a resident of the state. Gavin, 733 A.2d at 802. The Gavin court recognized the connection was "more attenuated" than in the case of a testamentary trust but still found the connection was sufficient to satisfy due process. Gavin, 733 A.2d at 802.

In support of its conclusion, the Gavin court noted the United State Supreme Court had held a state may tax the undistributed income of a trust based on the presence of the trustee in the state because it gave the trustee the protection and benefits of its laws (Greenough v. Tax Assessors, 331 U.S. 486, 496, 67 S.Ct. 1400, 91 L.Ed. 1621 (1947)), which are the same benefits and protections provided a resident, noncontingent beneficiary. Gavin, 733 A.2d at 802. The Gavin court also noted its conclusion was consistent with the California Supreme Court's decision in McCulloch v. Franchise Tax Board, 61 Cal.2d 186, 37 Cal.Rptr. 636, 390 P.2d 412 (1964). Gavin, 733 A.2d at 802. There,

> the California Supreme Court did not find a due-process violation where California taxed the undistributed income of an out-of-state testamentary trust based solely on the California residence of the trust's beneficiary. McCulloch, 37 Cal.Rptr. 636, 390 P.2d at 418. It reasoned California law provided benefit and protection to the resident beneficiary. McCulloch, 37 Cal.Rptr. 636, 390 P.2d at 418–19.

That there were no connections with Illinois was decisive for the court:

> Here, in 2006, the Autonomy Trust 3 had nothing in and sought nothing from Illinois. As plaintiff notes, all of the trust's business was conducted in Texas; the trustee, protector, and the noncontingent beneficiary resided outside Illinois; and none of the trust's property was in Illinois. Moreover, the Autonomy Trust 3 meets none of the following factors that would give Illinois personal jurisdiction over the trust in a litigation: "the provisions of the trust instrument, the residence of the trustees, the residence of its beneficiaries, the location of the trust assets, and the location where the business of the trust is to be conducted." Sullivan v. Kodsi, 359 Ill.App.3d 1005, 1011, 296 Ill.Dec. 710, 836 N.E.2d 125, 131 (2005) (citing People v. First National Bank of Chicago, 364 Ill. 262, 268, 4 N.E.2d 378, 380 (1936)). Accordingly, we find insufficient contacts exist between Illinois and the Autonomy Trust 3 to satisfy the due process clause, and thus the income tax imposed on the Autonomy Trust 3 for the tax year 2006 was unconstitutional. Thus, summary judgment should have been granted in plaintiff's favor.

4. Powers as Trustee Substitutes.

Powers of appointment may also substitute for the power of a trustee to make trust distributions, and a distribution pursuant to such exercise is generally treated in the same manner as a fiduciary directed distribution. For example, PLR 201225004 involved a trust claiming the section 642(c) deduction for income distributed to charity and the requirement that the income be distributed "pursuant to the terms of the governing instrument." The distribution was directed by a beneficiary's exercise of a lifetime special power of appointment which the IRS determined had satisfied the "pursuant to" requirement even though the governing instrument did not specify a charitable bequest. It only authorized exercise of the power in favor of charity. This situation may become more common as efforts are made to avoid the 3.8% Net Investment Income Tax.

In PLR 9821029, an individual exercised a lifetime nongeneral power of appointment over a trust to create a charitable remainder trust for a term of years with the trust as the unitrust beneficiary. The IRS allowed the trust to be the

beneficiary and allowed the charitable remainder trust to be created by the exercise of the power.

5. Upstream Sale to a Power of Appointment Trust (UPSPAT).

Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child's parent a testamentary general power of appointment over the trust assets so that the assets will be included in the parent's estate at the parent's death and receive new basis, and then the trust (which remains a grantor trust with respect to the child ever after the parent's death) uses the assets to pay off the note. The net effect is that the parent's net estate is increased by zero or a small amount yet the child receives new basis in the assets sold to the trust.

Because the contemplated transaction is not designed to remove assets from the child's estate for estate tax purposes, the section 2036 issues that require that the grantor trust be seeded would not apply. However, a sale to an unseeded trust could result in a note having a value less than its stated face value, thus causing child to make a gift. Parent's guarantee of the note could reduce that risk if the parent's assets are commensurate with the amount of the note.

Does the existence of the parent's general power cause the assets to be stepped up to full fair market value, or will the value of the note reduce the amount of the step-up? Section 2053(a)(4) provides that the value of the taxable estate will be reduced by indebtedness in respect of property included in a decedent's estate. Treas. Reg. § 20.2053-7 provides in relevant part:

A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be retuned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.

Parent's estate should be generally liable for the note, not just the trust. This may be accomplished by parent guaranteeing the obligation.

Arguably such a step is unnecessary because the regulations may be read as discretionary or optional. Further, outside the trust context, Crane v. CIR, 331 US 1 (1947) suggests

that the basis increase is based on the fair market value of the property regardless of the associated debt.

In thinking about this issue consider a QTIP or general power of appointment marital trust with $3,000,000 is non-divided paying Berkshire-Hathaway stock as assets. Suppose the trust borrows $100,000 and distributes the cash to spouse because spouse is not receiving any dividends. This might be an alternative to selling $100,000 worth of stock and incurring gain. At spouse's death the trust is worth $2,900,000: $3,000,000 less the $100,000 loan. Spouse is not personally liable for the $100,000 loan. Does the Berkshire-Hathaway stock receive a basis, in total, of $2,000,000 or $2,9000,000? On the other hand, consider the child's grantor trust. Suppose parent actually appointed the assets to the parent's estate. Now the parent's estate has the trust assets, and the trust continues to owe the debt. If the debt is severable from the assets, has child made a child when the general power springs into existence? Again, the parent's guarantee is helpful.

If the amount over which parent has a testamentary general power of appointment is limited by formula to an amount that would not increase parent's taxable estate to more than the federal estate tax applicable exclusion amount, taking into consideration parent's other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in parent's estate. The trust ought provide that it is for the benefit of the child's descendants, not the child, to avoid concerns that the one year prohibition rule of section 1014(e) apply.

Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value that would be a direct return of assets. Suppose the terms of the trust and the sale provided that no assets could be used to pay on the note beyond those required to satisfy the fair market value of the note as determined for federal gift tax purposes. The hoped for result would be that the amount of child's gift would be trapped in the trust and pass other than to a child.

Supposed child "sells" cash to the trust for a note. Section 1014(e) applied by its terms only to "appreciated property" acquired by the decedent by gift within one year prior to the decedent's death. If the cash in the grantor trust is later swapped for child's appreciated property that would not be appreciated property acquired by gift. The cash might have been acquired in part by gift – if the note were not valued at par – but not the appreciated property. Does this extra step add any value to the transaction?

Does the death of parent terminate the grantor trust status of the trust? If yes, that would cause the sale to be recognized by child as of that moment, thus undoing the benefits of the transaction. (This situation is unlike a sale to a grantor trust where grantor trust status terminates because the grantor dies; there the policy appears to be that death cannot, or ought not, cause a taxable transaction.) Treas. Reg. §1.671-2(e)(1) provides that a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer – defined as any transfer other than one for fair market value – of property to a trust. Section 678 by its terms confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving inter vivos general powers. The IRS ruling position is that an inter vivos right

to withdraw makes the powerholder a grantor under section 678 subject to the true grantor's status if the true grantor is living. What is the effect of parent's testamentary general power of appointment? Treas. Reg. §1.671-2(e)(6) contains two examples that are close but not directly on point:

> Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.
>
> Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

Note that this is the same issue which exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse. The right answer would seem to be that so long as the general power is not exercised the holder of the general power does not become the grantor. Here, that means that the child would remain as grantor even after the death of parent so long as parent did not exercise the power.

¶ 103 State Law of Powers of Appointment With Primary Reference to the Uniform Act.

¶ 103.1 Overview.

The Uniform Powers of Appointment Act (the Uniform Act) was promulgated in 2013 by the National Conference of Commissioners on Uniform State Laws (often referred to as NCCUSL), which in recent years has rebranded itself as the Uniform Law Commission ("ULC"). As of September 20, 2014, the Uniform Act has been enacted in Colorado, has been introduced in California, Mississippi, and Utah, and is being studied for enactment in many other jurisdictions. The ULC has summarized the Uniform Act as follows:

> A power of appointment is an estate planning tool that permits the owner of property to name a third party and give that person the power to direct the distribution of that property among some class of

permissible beneficiaries. It is an effective and flexible technique used in a wide variety of situations, but there is very little statutory law governing the creation and use of powers of appointment. Instead, estate planning attorneys must rely on a patchwork of state court decisions. The drafters of the Uniform Powers of Appointment Act did not set out to change the law, but rather to codify the existing common law, relying heavily on the Restatement (Third) of Property: Wills and other Donative Transfers.

The Uniform Act is divided into six articles:
Article 1: General Provisions
Article 2: Creation, Revocation, and Amendment of Power of Appointment
Article 3: Exercise of Power of Appointment
Article 4: Disclaimer or Release; Contract to Appoint or Not to Appoint
Article 5: Rights of Powerholder's Creditors in Appointive Property
Article 6: Miscellaneous Provisions

¶ 103.2 Key Elements of the Uniform Act.

A. Nonfiduciary powers.

The Uniform Act is limited to nonfiduciary powers. See §102(13). The ULC will complete a Uniform Act on Trust Decanting in the summer of 2015. That act will deal with fiduciary powers.

Suppose that a trust instrument gives a person the power to appoint the trust property as the person determines but subject to a fiduciary standard. That power is properly viewed as akin to a trustee's power to distribute trust property, not as a power of appointment. Mixing the two concepts generates confusion. For example, suppose that Paula is given the power to appoint the trust property to or among any person or entity other than herself, her creditors, her estate, and the creditors of her estate, and the trust provides that Paula is a fiduciary. A question is: to whom does Paula have a fiduciary duty? Presumably, without more, her fiduciary duty runs to the beneficiaries of the trust, hence her ability to appoint is really an ability to distribute assets among the trust beneficiaries. Might a court construe her power as a power of appointment subject to a minimal "good faith" standard? There is no authority on the subject. Drafters ought to distinguish clearly between fiduciary powers of distribution and powers of appointment.

May a trustee also be given a power of appointment? That is, a person acting as trustee is also given the power, not acting as trustee, to exercise a power of appointment. Again, the answer is unclear. Whether a trustee is always acting as a fiduciary or can separate out when she is not a fiduciary is uncertain; but the better argument would seem to be no. How might a fiduciary go about acting in the best interests of the beneficiaries all day except from noon to one, for example?

The Restatement Third §§ 17.1 to 17.5 notes various other powers that are and are not powers of appointment:

> A power to revoke or amend a trust or a power to withdraw income or principal from a trust is a power of appointment, whether the power is reserved by the transferor or conferred on another.
>
> A power to withdraw income or principal subject to an ascertainable standard is a postponed power, exercisable upon the satisfaction of the ascertainable standard.
>
> A power to direct a trustee to distribute income or principal to another is a power of appointment. In this act, a fiduciary distributive power is not a power of appointment. Fiduciary distributive powers include a trustee's power to distribute principal to or for the benefit of an income beneficiary, or for some other individual, or to pay income or principal to a designated beneficiary, or to distribute income or principal among a defined group of beneficiaries. Unlike the exercise of a power of appointment, the exercise of a fiduciary distributive power is subject to fiduciary standards. Unlike a power of appointment, a fiduciary distributive power does not lapse upon the death of the fiduciary, but survives in a successor fiduciary. Nevertheless, a fiduciary distributive power, like a power of appointment, cannot be validly exercised in favor of or for the benefit of someone who is not a permissible appointee.
>
> A power over the management of property, sometimes called an administrative power, is not a power of appointment. For example, a power of sale coupled with a power to invest the proceeds of the sale, as commonly held by a trustee of a trust, is not a power of appointment but is an administrative power. A power of sale merely authorizes the person to substitute money for the property sold but does not authorize the person to alter the beneficial interests in the substituted property.
>
> A power to designate or replace a trustee or other fiduciary is not a power of appointment. A power to designate or replace a trustee or other fiduciary involves property management and is a power to designate only the nonbeneficial holder of property.
>
> A power to create or amend a beneficiary designation, for example with respect to the proceeds of a life insurance policy or of a pension plan, is not a power of appointment. An instrument creating a power of appointment must, among other things, transfer the appointive property. (citations omitted)

B. “Powerholder”.

The Uniform Act replaces the older, confusing term “donee” with the term “powerholder”. See §102(13).

C. Terminology and categories of powers.

The black letter of the Uniform Act and the Comments to the Uniform Act explain the specialized terminology associated with powers of appointment and the categories into which powers of appointment are divided. See especially § 102.

An important distinction is between exclusionary and nonexclusionary powers. The Comment to § 102 states:

> An exclusionary power is one in which the donor has authorized the powerholder to appoint to any one or more of the permissible appointees to the exclusion of the other permissible appointees. For example, a power to appoint “to such of my descendants as the powerholder may select” is exclusionary, because the powerholder may appoint to any one or more of the donor’s descendants to the exclusion of the other descendants. In contrast, a nonexclusionary power is one in which the powerholder cannot make an appointment that excludes any permissible appointee, or one or more designated permissible appointees, from a share of the appointive property. An example of a nonexclusionary power is a power “to appoint to all and every one of my children in such shares and proportions as the powerholder shall select.” Here, the powerholder is not under a duty to exercise the power; but, if the powerholder does exercise the power, the appointment must abide by the power’s nonexclusionary nature. See Sections 301 and 305. An instrument creating a power of appointment is construed as creating an exclusionary power unless the terms of the instrument manifest a contrary intent. See Section 203. The typical power of appointment is exclusionary. And in fact, only a power of appointment whose permissible appointees are “defined and limited” can be nonexclusionary.

Comment c to § 17.5 of the Restatement Third notes a trap for the unwary if the powerholder may appoint to a large class that is poorly defined:

> An attempt by the donor to require the [powerholder] to appoint at least $X to each permissible appointee of the power is ineffective, because the permissible appointees of the power are so numerous that it would be administratively impossible to carry out the donor’s expressed intent. The donor’s expressed restriction is disregarded, and the [powerholder] may exclude any one or more of the permissible appointees in exercising the power.

Another important distinction is between general and nongeneral powers. A power will be construed to be general unless the instrument specifically limits the power. In other words, "Fred may appoint the assets of the trust as Fred determines" is a general power because there are no words of limitation. A power to revoke, amend, or withdraw from trust is a general power of appointment if it is exercisable in favor of the powerholder, the powerholder's estate, or the creditors of either.

In 1986, when the current generation skipping tax was adopted, a planning idea that arose was the grant by a trustee, or someone else, of a general power to a beneficiary to avoid the tax and include the assets of the trust in the beneficiary's estate. Some commentators wondered if the ability of a trustee, or another person, to grant a power was tantamount to the potential powerholder having the power already. Section 2041(b)(1)(C) provides that a power that is exercisable with another person will nonetheless be a general power unless the person with whom the exercise is required is the creator of the power or is adverse (discussed below). The Comment to the Uniform Act supports the view that the ability to create a general power of appointment ought not to be viewed as the equivalent of the ability to exercise the power with another. The Comment to § 102 notes that if the grantor of a trust empowers a trustee or another person to change a power of appointment from a general power into a nongeneral power, or vice versa, the power is either general or nongeneral depending on the scope of the power <u>at any particular time</u> (emphasis added). That is, if a general power can be cut back or a nongeneral power expanded, for state law purposes the power is what it is at the time it is being looked at, not what it has been or could be. Although such a state-law determination may not be determinative for federal transfer tax purposes, it does support an interpretation favorable to taxpayers.

A power that can only be exercised with the consent of an adverse party is nongeneral. See § 205. An adverse party is defined by § 205(a) as a person with a substantial beneficial interest in property which would be affected adversely by a powerholder's exercise or nonexercise of a power of appointment in favor of the powerholder, the powerholder's estate, a creditor of the powerholder, or a creditor of the powerholder's estate. The adversity must be in the trust itself, not inferred from the general circumstances (see the Comment to § 205). What is substantial depends on the circumstances. The Comment to § 205 gives these examples:

> *Example 1*. D transferred property in trust, directing the trustee "to pay the income to D's son S for life, remainder in corpus to such person or persons as S, with the joinder of X, shall appoint; in default of appointment, remainder to X." S's power is not a general power because X meets the definition of an adverse party.
>
> *Example 2*. Same facts as Example 1, except that S's power is exercisable with the joinder of Y rather than with the joinder of X. Y has no property interest that could be adversely affected by the

exercise of the power. Because Y is not an adverse party, S's power is general.

Whether the party whose consent or joinder is required is adverse or not is determined at the time in question. Consider the following example.

Example 3. Same facts as Example 2, except that, one month after D's creation of the trust, X transfers the remainder interest to Y. Before the transfer, Y is not an adverse party and S's power is general. After the transfer, Y is an adverse party and S's power is nongeneral.

D. Choice of law.

The creation, revocation, or amendment of the power is governed by the law of the donor's domicile; the exercise, release, or disclaimer of the power (or the revocation of the exercise) is governed by the law of the powerholder's domicile at the time of the exercise, release, disclaimer or revocation. See §104. The instrument creating the power may alter this default choice of law rule.

Suppose a child has a power of appointment to appoint to the child's spouse or descendants. The instrument creating the power is governed by the law of a state that does not allow same-sex marriages to be solemnized within its jurisdiction but child lives in a state that does allow same-sex marriages and indeed is married to a same-sex spouse. May child exercise the power in favor of the child's spouse? Under the Uniform Act the answer should be yes.

Traditionally, the law of the domicile of the person creating the power governed both the creation and the exercise. The Uniform Act changed that older rule to adopt the modern Restatement rule that the acts of the powerholder ought be governed by the law of the powerholder's domicile because, after all, that is the law the powerholder, and the powerholder's lawyer, is most likely to know. (For commentary on this issue, see the Restatement Third § 19.1, Comment e; Restatement Second of Conflict of Laws § 275, Comment c; Estate of McMullin, 417 A.2d 152 (Pa. 1980); White v. United States, 680 F.2d 1156 (7th Cir. 1982).)

Presumably a court that believes acknowledgment of same-sex marriages violates the strong public policy of that state might reject the modern rule. Suppose, for example, that the powerholder has children by an earlier marriage who do not want the new same-sex spouse to benefit (likely they would not want any spouse to benefit). Those children might sue the trustee, arguing that the appointment to the same-sex spouse ought not to be recognized; if the trustee is in the state of the grantor's domicile, might the court be disinclined to follow the law of the powerholder's domicile? If drafting for such a situation, specifically defining "spouse" to ensure clarity is advisable. A similar issue may arise with respect to the effect of adoption on the definition of "children" or "descendants."

E. An important exception to the presumption of unlimited authority.

The Uniform Act articulates, as a default rule of construction, that a power falls into the category giving the powerholder the maximum discretionary authority except to the extent the terms of the instrument creating the power restrict that authority. Thus, powers are presumed to be general, presently exercisable, and exclusionary unless the donor specifies otherwise. See §203.

However, to correct a recurring drafting mistake, the Uniform Act presumes that a power is nongeneral if (1) the power is exercisable only at the powerholder's death and (2) the permissible appointees are a defined and limited class excluding the powerholder's estate, the powerholder's creditors, and the creditors of the powerholder's estate. See § 204. In other words, if a parent gives a child the testamentary power to appoint among the parent's descendants, the child is presumed not to be able to appoint to the child, the child's estate, or the creditors of either. This has been the subject of litigation in state courts and private letter rulings, reaching results consistent with the Uniform Act. See, e.g., Hillman v. Hillman, 744 N.E.2d 1078 (Mass. 2001) (holding that, where the powerholder was the donor's son, a testamentary power to appoint to the donor's "issue" was a nongeneral power); PLRs 9623043, 199938024, 201006005, 201229005, 201446002.

F. Best practices when drafting the exercise of a power of appointment.

How ought powers of appointment be exercised? Unsurprisingly, the Uniform Act urges clarity and specificity rather than general exercises of "any" power of appointment that powerholder has. However, § 301 contains additional law beyond this general statement. The section provides:

> **SECTION 301. REQUISITES FOR EXERCISE OF POWER OF APPOINTMENT**. A power of appointment is exercised only:
>
> (1) if the instrument exercising the power is valid under applicable law;
>
> (2) if the terms of the instrument exercising the power:
>
> (A) manifest the powerholder's intent to exercise the power; and
>
> (B) subject to Section 304, satisfy the requirements of exercise, if any, imposed by the donor; and
>
> (3) to the extent the appointment is a permissible exercise of the power.

The first item to notice is that a power of appointment may be exercised by either a will or a revocable trust. The Comment confirms this:

Paragraph (1) states the fundamental principle that an instrument can only exercise a power of appointment if the instrument, under applicable law, is valid (or partially valid, see the next paragraph). Thus, for example, a *will* exercising a power of appointment must be valid under the law—including choice of law (see Section 103)—applicable to wills. An *inter vivos trust* exercising a power of appointment must be valid under the law—including choice of law (see Section 103)—applicable to inter vivos trusts.

Further, Paragraph (2) requires the terms of the instrument exercising the power of appointment to manifest the powerholder's intent to exercise the power. Whether a powerholder has manifested an intent to exercise a power is a question of construction, and intent may be manifested even though the powerholder does not refer to the power. The terms of the instrument exercising the power must satisfy the requirements of exercise, if any, imposed by the donor, although as discussed below the Uniform Act also contains a substantial compliance doctrine.

Language expressing an intent to exercise a power is clearest if it makes a specific reference to the creating instrument and exercises the power in unequivocal terms and with careful attention to the requirements of exercise, if any, imposed by the donor. Thus, the recommended method for exercising a power of appointment is by a specific-exercise clause, using language such as the following: "I exercise the power of appointment conferred upon me by [my father's will] as follows: I appoint [fill in details of appointment]."

Not recommended is a blanket-exercise clause, which purports to exercise "any" power of appointment the powerholder may have, using language such as the following: "I exercise any power of appointment I may have as follows: I appoint [fill in details of appointment]." Although a blanket-exercise clause does manifest an intent to exercise any power of appointment the powerholder may have, such a clause raises the often-litigated question of whether it satisfies the requirement of specific reference imposed by the donor in the instrument creating the power. § 102(3) defines a blanket-exercise clause as a clause in an instrument which exercises a power of appointment and is not a specific-exercise clause. It includes a clause that: (A) expressly uses the words "any power" in exercising any power of appointment the powerholder has; (B) expressly uses the words "any property" in appointing any property over which the powerholder has a power of appointment; or (C) disposes of all property subject to disposition by the powerholder. § 302 of the Uniform Act provides that a residuary clause is not a blanket-exercise clause and will not be deemed to manifest the intent to exercise a power of appointment except in a very few instances:

SECTION 302. INTENT TO EXERCISE: DETERMINING INTENT FROM RESIDUARY CLAUSE.

(a) In this section:

(1) “Residuary clause” does not include a residuary clause containing a blanket-exercise clause or a specific-exercise clause.

(2) “Will” includes a codicil and a testamentary instrument that revises another will.

(b) A residuary clause in a powerholder’s will, or a comparable clause in the powerholder’s revocable trust, manifests the powerholder’s intent to exercise a power of appointment only if:

(1) the terms of the instrument containing the residuary clause do not manifest a contrary intent;

(2) the power is a general power exercisable in favor of the powerholder’s estate;

(3) there is no gift-in-default clause or the clause is ineffective; and

(4) the powerholder did not release the power.

Also not recommended are blending clauses. A blending clause purports to blend the appointive property with the powerholder’s own property in a common disposition. The exercise portion of a blending clause can take the form of a specific exercise or, more commonly, a blanket exercise. For example, a clause providing “All the residue of my estate, including the property over which I have a power of appointment under my mother’s will, I devise as follows” is a blending clause with a specific exercise. A clause providing “All the residue of my estate, including any property over which I may have a power of appointment, I devise as follows” is a blending clause with a blanket exercise. The Uniform Act aims to eliminate any significance attached to the use of a blending clause. A blending clause has traditionally been regarded as significant in the application of the doctrines of “selective allocation” and “capture.” The Uniform Act eliminates the significance of such a clause under those doctrines. See §§ 308 (selective allocation) and 309 (capture). The use of a blending clause is more likely to be the product of the forms used by the powerholder’s lawyer than a deliberate decision by the powerholder to facilitate the application of the doctrines of selective allocation or capture.

Suppose a powerholder does not want to exercise a power. In general, the powerholder ought either to release the power, an action provided for in Uniform Act § 402 unless the terms of the instrument creating the power prevent the release, or to include a non-exercise clause in the powerholder’s will or revocable trust. A nonexercise clause can take the form of a specific-nonexercise clause (for example, “I do not exercise the power of appointment conferred on me by my father’s trust”) or the form of a blanket-nonexercise clause (for example, “I do not exercise any power of appointment I may have”). The property subject to the power could pass differently depending on which choice was made. That is, the takers in default of

exercise could be different if the powerholder released the power during lifetime or died with the power but did not exercise it. In effect, the way in which the power is not exercised becomes a power of appointment. Note that this inaction could have tax consequences depending on the identity of the takers in default.

G. After-Acquired Powers.

In Section 303 of the Uniform Act sets forth the general rule that a blanket-exercise clause will exercise a power granted after the instrument exercising the power was executed. Such powers are referred to as "after-acquired" powers – powers acquired before a powerholder's death. A power of appointment cannot be given to a powerholder who is deceased when the power is created. If the powerholder dies before the effective date of an instrument purporting to confer a power of appointment, the power is not created, and an attempted exercise of the power is ineffective. But note a difference between powers created in wills and in revocable trusts. The effective date of a power of appointment created in a Will is the testator's death, not when the testator executes the Will. The effective date of a power of appointment created in an inter vivos trust is the date the trust is established, even if the trust is revocable. See Restatement Third § 19.11, Comments b and c. (Of course, a power of appointment can be conferred on an unborn or unascertained powerholder, subject to any applicable rule against perpetuities. This is a postponed power that arises on the powerholder's birth or ascertainment.)

Nothing in the law prevents a powerholder from exercising a power in an instrument executed before acquiring the power. The only question is one of construction: whether the powerholder intended by the earlier instrument to exercise the after-acquired power. If the instrument of exercise specifically identifies the power to be exercised, then the question of construction is readily answered: the specific-exercise clause expresses an intent to exercise the power, whether the power is after-acquired or not. However, if the instrument of exercise uses only a blanket-exercise clause, the question of whether the powerholder intended to exercise an after-acquired power is often harder to answer. The presumptions in § 303 provide default rules of construction on the powerholder's likely intent. Unless the terms of the instrument indicate that the powerholder had a different intent, a blanket-exercise clause extends to a power of appointment acquired after the powerholder executed the instrument containing the blanket-exercise clause. General references to then-present circumstances, such as "all the powers I have" or similar expressions, are not a sufficient indication of an intent to exclude an after-acquired power. In contrast, more precise language, such as "all powers I have at the date of execution of this will," does indicate an intent to exclude an after-acquired power.

Of course, even if the terms of the instrument manifest an intent to exercise an after-acquired power, the intent may be ineffective, because, for example, the terms of the instrument creating the power manifest an intent to preclude such an exercise. In

> the absence of an indication to the contrary, however, it is inferred that the time of the execution of the powerholder's exercising instrument is immaterial to the person who created the power. Even a declaration that the property shall pass to such persons as the powerholder "shall" or "may" appoint does not suffice to indicate an intent to exclude exercise by an instrument previously executed, because these words may be construed to refer to the time when the exercising document becomes effective.

There is one exception to the general rule. Paragraph (2) of § 303 provides that if the powerholder is also the donor, a blanket-exercise clause in a preexisting instrument is rebuttably presumed not to manifest an intent to exercise a power later reserved in another donative transfer, unless the donor/powerholder did not provide for a taker in default of appointment or the gift-in-default clause is ineffective. For example, if a grantor created an incomplete-gift trust for income purposes, a blanket-exercise clause will not exercise the nongeneral powers of appointment so retained.

H. Substantial compliance with donor-imposed formal requirements.

> A tension in the law that recurs regularly is between the need for bright-line rules and the need to carry out the intent of donors and drafters. The imposition of specific requirements—wills must have a specific number of witnesses or powers of appointment must be exercised exactly as specified in the instrument of creation—create bright-line rules but often at the expense of carrying out intent. With respect to the exercise of powers of appointment, the Uniform Act adopts a substantial compliance doctrine. Section 304 provides that a powerholder's substantial compliance with a formal requirement of appointment imposed by the donor, including a requirement that the instrument exercising the power of appointment make reference or specific reference to the power, is sufficient if: (1) the powerholder knows of and intends to exercise the power; and (2) the powerholder's manner of attempted exercise of the power does not impair a material purpose of the donor in imposing the requirement.
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> Substantial compliance can only be used with respect to formal requirements imposed by the creator of the power. If the power was created by will, the formal requirements for creation of a will in the applicable state must be followed. Further, substantial compliance does not apply to substantive requirements imposed for the exercise of the power, for example that a power may be exercised only after the powerholder reaches a certain age.
>
> A straightforward example of where substantial compliance would suffice arises where the power requires exercise by will. Under the Uniform Act (see the Comment to § 304), a donor's requirement that the power of appointment be exercised "by will" may be satisfied by the powerholder's exercise in a nontestamentary instrument that is functionally similar to a will, such as the powerholder's revocable trust that remains revocable until the powerholder's death. See also Restatement Third § 19.9, Comment b ("Because a revocable trust

operates in substance as a will, a power of appointment exercisable "by will" can be exercised in a revocable-trust document, as long as the revocable trust remained revocable at the [powerholder]'s death.").

Often powers require that a powerholder must make specific reference to a power in order for it to be exercised. It is generally believed that those requirements are a holdover from 70 years ago. General powers of appointment created prior to October 21, 1942 did not cause inclusion of property in the gross estate unless exercised; thus, specific-reference clauses are thought to be a pre-1942 invention designed to prevent an inadvertent exercise of a general power. But, of course, the federal estate tax law has changed and for a general power created after October 21, 1942, estate tax consequences do not depend on whether the power is exercised. Because the original purpose of the specific-reference requirement was to prevent an inadvertent exercise of the power, it seems reasonable to presume that that this is still the purpose in most instances. Consequently, a specific-reference requirement still overrides any applicable state law that presumes that an ordinary residuary clause was intended to exercise a general power. In other words, an ordinary residuary clause may manifest the powerholder's intent to exercise but does not satisfy the requirements of exercise if the donor imposed a specific-reference requirement.

Ought a blanket-exercise clause satisfy a specific-reference requirement? If it could be shown that the powerholder had knowledge of and intended to exercise the power, the blanket-exercise clause would be sufficient to exercise the power, unless it could be shown that the donor's intent was not merely to prevent an inadvertent exercise of the power but instead that the donor had a material purpose in insisting on the specific-reference requirement. In such a case, the possibility of applying Uniform Probate Code § 2-805 or Restatement Third § 12.1 to reform the powerholder's attempted appointment to insert the required specific reference should be explored.

If a particular means of exercise is intended for some specific purpose, then it should be specified in the creation of the power as a material purpose. For example, "This power of appointment may be exercised only by specific reference to this paragraph and this requirement is material to the power."

I. Modern version of "capture doctrine".

Following the Restatement Third, the Uniform Act adopts a modern version of the "capture doctrine" concerning the disposition of property ineffectively appointed under a general power. Essentially, the gift-in-default clause controls; but, to the extent the gift-in-default clause is nonexistent or ineffective, the property passes to the powerholder or the powerholder's estate, if permissible, otherwise to the donor or the donor's transferee or successor in interest. See §309 of the Uniform Act and the Comments.

J. Authority to disclaim or release power.

The Uniform Act provides rules on the disclaimer (§401) or release (§§402-404) of a power. PLRs 9526018 and 9526019 illustrate the disclaimer of powers of appointment. Suppose that Child 1 could receive income and principal for a "specified standard" from a generation-skipping trust and also had lifetime and testamentary nongeneral powers of appointment. The child disclaimed the nongeneral powers. The child also disclaimed the right under the trust to change trustees and to serve as trustee. The IRS ruled as follows:

> Section 25.2518-3(a)(1)(iii) provides that a power of appointment with respect to property is treated as a separate interest in the property and the power of appointment with respect to all or an undivided portion of the property may be disclaimed independently from any other interests separately created by the transferor in the property, if the requirements of §2518(b) are met. Further, a disclaimer of a power of appointment with respect to property is a qualified disclaimer only if any right to direct the beneficiary enjoyment of the property that is retained by the disclaimant is limited by an ascertainable standard.
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> * * *
>
> In this case, Child 1 intends to disclaim certain rights provided in the generation skipping trust established for him at Decedent's death. Specifically, Child 1 intends to disclaim his inter vivos and testamentary power to appoint trust property, the power to change the trustee, and the right to serve as trustee either presently or in the future. Child 1 has represented that he has not accepted any of the benefits of Trust. We conclude that, if Child 1's proposed disclaimer is timely and otherwise satisfies the requirements provided in §2518, and is valid under state law, the disclaimers will be qualified disclaimers under §2518. <u>See</u>, §25.2518-3(a)(1)(iii).

If the exercise of a power of appointment requires the action of two or more individuals, each powerholder has a power of appointment. If one but not the other joint powerholder releases the power, the power survives in the hands of the nonreleasing powerholder, unless the continuation of the power is inconsistent with the donor's purpose in creating the joint power. Absent a contrary provision in the power, it may be released in part as well as entirely. A partial release is a release that narrows the freedom of choice otherwise available to the powerholder but does not eliminate the power. A partial release may relate either to the manner of exercising the power or to the persons in whose favor the power may be exercised.

K. Permissible and impermissible appointees, and fraud on exercise.

One of the most complex areas when dealing with powers of appointments is ascertaining who are permissible and impermissible appointees. Three rules are set forth in § 305.

First, a powerholder of a general power that permits appointment to the powerholder or the powerholder's estate may make any appointment, including an appointment in trust or creating a new power of appointment, that the powerholder could make in disposing of the powerholder's own property. The Comment to § 305 explains the truly broad nature of the general power stating:

> When a donor creates a general power under which an appointment can be made outright to the powerholder or the powerholder's estate, the necessary implication is that the powerholder may accomplish by an appointment to others whatever the powerholder could accomplish by first appointing to himself and then disposing of the property, including a disposition in trust or in the creation of a further power of appointment. A general power to appoint only to the powerholder (even though it says "and to no one else") does not prevent the powerholder from exercising the power in favor of others. There is no reason to require the powerholder to transform the appointive assets into owned property and then, in a second step, to dispose of the owned property. Likewise, a general power to appoint only to the powerholder's estate (even though it says "and to no one else") does not prevent an exercise of the power by will in favor of others. There is no reason to require the powerholder to transform the appointive assets into estate property and then, in a second step, to dispose of the estate property by will. Similarly, a general power to appoint to the powerholder may purport to allow only one exercise of the power, but such a restriction is ineffective and does not prevent multiple partial exercises of the power. To take another example, a general power to appoint to the powerholder or to the powerholder's estate may purport to restrict appointment to outright interests not in trust, but such a restriction is ineffective and does not prevent an appointment in trust. An additional example will drive home the point. A general power to appoint to the powerholder or to the powerholder's estate may purport to forbid the powerholder from imposing conditions on the enjoyment of the property by the appointee. Such a restriction is ineffective and does not prevent an appointment subject to such conditions.

Second, a powerholder of a general power that permits appointment only to the creditors of the powerholder or of the powerholder's estate may appoint only to those creditors. Neither the Comment to the Uniform Act nor the Restatement Third provides further guidance on the meaning of this provision. Suppose Fred has the

power to appoint the property of a trust worth $1,000,000 to his children, Tom, Dick, and Harry, and to his creditors. At a given moment, Fred owes Myrtle and Slim each $100. When listing the potential appointees of Fred's power do we say "Tom, Dick, Harry, Myrtle and Slim?" Or are Myrtle and Slim different? At the moment Fred exercises the power to appoint property to Myrtle she is a creditor, yet as soon as she receives $100 she ceases to be a creditor.

The issue also arises with a power to appoint to the creditors of the estate. Suppose that Fred may appoint $1,000,000 among his children, Tom, Dick, and Harry, and the creditors of his estate. At his death, Fred owes $100 to each of Myrtle and Slim. Suppose that Fred has exercised his power to appoint the assets among all permissible appointees to the maximum amount each may receive and equally among those who may receive any amount. Do Myrtle and Slim receive $100 each or $200,000 each (1/5th of $1,000,000). Although it is true that once Myrtle and Slim each receive $100 they cease to be creditors, it is equally true that at the moment of exercise—Fred's death—they were creditors. Put another way, ought the law of powers of appointment imply a limitation "to the extent" the appointee is a creditor?

The question is not entirely academic. The power to appoint to the creditors of the estate is commonly considered the narrowest general power that can be given. If appointment to a creditor is not limited to the amount the creditor is owed, then the power is not as narrow.

Third, with respect to nongeneral powers, unless the terms of the instrument creating a power of appointment manifest a contrary intent, the powerholder may:

(1) make an appointment in any form, including an appointment in trust, in favor of a permissible appointee;

(2) create a general power in a permissible appointee; or

(3) create a nongeneral power in any person to appoint to one or more of the permissible appointees of the original nongeneral power.

If the governing instrument allows, the holder of a nongeneral power may appoint to persons who are not among the original permissible appointees. The Comment to § 305 (c)(3) states:

> The rules of subsection (c) are default rules. The terms of the instrument creating the power may manifest a contrary intent. For example, a donor may choose to loosen the restriction in subsection (c)(3) by authorizing the powerholder of a nongeneral power to create a new nongeneral power with broader permissible appointees. Consider the following examples.

> *Example 1*. D creates a nongeneral power in D's child, P1, to appoint among D's descendants. Under the default rule of subsection (c)(3), P1 may exercise this power to create a new nongeneral power in D's child, P2. Unless the terms of D's instrument manifest a contrary intent, however, the permissible appointees of P2's nongeneral power cannot be broader than the permissible appointees of P1's nongeneral power.
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> *Example 2*. Same facts as in Example 1, except that D's instrument states: "The nongeneral power of appointment granted to P1 may be exercised to create in one or more of my descendants a new nongeneral power. This new nongeneral power may have permissible appointees as broad as P1 sees fit." On these facts, the default rule of subsection (c)(3) is overridden by the terms of D's instrument. The permissible appointees of P2's nongeneral power may be broader than the permissible appointees of P1's nongeneral power.

Any exercise of a power in favor of an impermissible appointee is ineffective. § 307(a). Further, an exercise in favor of a permissible appointee is ineffective to the extent the appointment is a fraud on the power. The concept of "fraud on the power" is explained in the Comment to § 307 as follows:

> Among the most common devices employed to commit a fraud on the power are: an appointment conditioned on the appointee conferring a benefit on an impermissible appointee; an appointment subject to a charge in favor of an impermissible appointee; an appointment upon a trust for the benefit of an impermissible appointee; an appointment in consideration of a benefit to an impermissible appointee; and an appointment primarily for the benefit of the permissible appointee's creditor if the creditor is an impermissible appointee. Each of these appointments is impermissible and ineffective.

Sections 19.15 and 19.16 of the Restatement Third of Property provide additional discussion and illustrations.

Section 19.16 discusses situations where appointments are made to permissible appointees for the benefit of impermissible appointees. That section states that:

> An appointment to a permissible appointee is ineffective to the extent that it was (i) conditioned on the appointee conferring a benefit on an impermissible appointee, (ii) subject to a charge in favor of an impermissible appointee, (iii) upon a trust for the benefit of an impermissible appointee, (iv) in consideration of a benefit conferred upon or promised to an impermissible appointee, (v) primarily for the benefit of the appointee's creditor, if that creditor is an impermissible

appointee, or (vi) motivated in any other way to be for the benefit of an impermissible appointee.

L. Contract to exercise a power.

A power of appointment is nontransferable. The powerholder may not transfer the power to another person. If the powerholder dies without exercising or releasing the power, the power lapses. If the powerholder partially releases the power and dies without exercising the remaining part, the unexercised part of the power lapses. The power does not pass through the powerholder's estate to the powerholder's successors in interest. In short, a power of appointment is not a property interest.

However, a powerholder may contract to exercise or not exercise a power of appointment in certain circumstances. The easiest case is that of a presently exercisable power of appointment because of its ownership-equivalent nature. Section 405 of the Uniform Act sets forth the rule that the powerholder may contract not to exercise the power, or to exercise it so long as the exercise does not confer a benefit upon an impermissible donee. Although a general power presently exercisable in favor of the powerholder or the powerholder's estate has no impermissible appointees, a presently exercisable nongeneral power, or a general power presently exercisable only in favor of one or more of the creditors of the powerholder or the powerholder's estate, does have impermissible appointees.

If a power is not presently exercisable, no enforceable contractual obligation with regard to the exercise or nonexercise of the power may arise except in the limited circumstance where the powerholder also created the power and reserved the power in a revocable trust. § 406. The theory behind this rule is that because the powerholder does not have the power to make a present appointment, the powerholder cannot agree to an appointment now because the creator of the power has manifested an intent that the selection of the appointees and the determination of the interests they are to receive are to be made in the light of the circumstances that exist on the date that the power becomes exercisable. Further, if something of value moves from the promisee to the powerholder in exchange for the powerholder's promise to appoint, and the powerholder or the powerholder's estate is not a permissible appointee of the power (the power is not a general power), the contract would be invalid on the independent ground that it confers a benefit on an impermissible appointee. This rule includes a promise not to revoke an existing will (or revocable trust) that exercises a power. Quite obviously, where the powerholder could revoke a revocable trust and acquire fee ownership of the property, the general rule does not apply.

In § 407, of the Uniform Act provides that a breach of contract may be remedied in appropriate circumstances by specific performance or by damages, but limited to those payable from the appointive property. The powerholder's own assets are not at risk under the Uniform Act.

M. Creditors' rights.

The Uniform Act provides rules on the rights of the powerholder's creditors in the appointive property. These rules vary depending on whether the power is a general power created by the powerholder (§501), a general power created by someone other than the powerholder (§502), or a nongeneral power (§504). There is also a provision (§503) treating a power of withdrawal from a trust as the equivalent of a presently exercisable general power for this purpose; but upon the lapse, release, or waiver of the power of withdrawal, the Uniform Act follows the Uniform Trust Code in creating an exception for property subject to a Crummey or other five and five power.

1. A general power created by the powerholder will be ineffective to shelter assets from creditors. See § 501. First, § 501(b) states the well-settled rule that the creator of a power of appointment cannot use a fraudulent transfer to avoid creditors. If a donor fraudulently transfers appointive property, retaining a power of appointment, the donor/powerholder's creditors and the creditors of the donor/powerholder's estate may reach the appointive property as provided in the law of fraudulent transfers. On the other hand, as § 501(c) states, if there is no fraudulent transfer, and the donor/powerholder has made an irrevocable appointment to a third party of the appointive property, the appointed property is beyond the reach of the donor/powerholder's creditors or the creditors of the donor/powerholder's estate. In other words, an irrevocable and nonfraudulent exercise of the general power by the donor/powerholder in favor of someone other than the powerholder or the powerholder's estate eliminates the ability of the powerholder's creditors or the creditors of the powerholder's estate to reach those assets. Finally, § 501(d) deals with the in-between situation where the donor has retained a general power of appointment but has made neither a fraudulent transfer nor an irrevocable appointment. In such a case, the following rules apply. If the donor retains a presently exercisable general power of appointment, the appointive property is subject to a claim of—and is reachable by—a creditor of the powerholder to the same extent as if the powerholder owned the appointive property. If the donor retains a general power of appointment exercisable at death, the appointive property is subject to a claim of—and is reachable by—a creditor of the donor/powerholder's estate (defined with reference to other law, but including costs of administration, expenses of the funeral and disposal of remains, and statutory allowances to the surviving spouse and children) to the extent the estate is insufficient, subject to the decedent's right to direct the source from which liabilities are paid. This same rule applies under the Uniform Trust Code, § 505(a), where a grantor may revoke a revocable trust. The application of these rules is not affected by the presence of a spendthrift provision or by whether the claim arose before or after the creation of the power of appointment.

These rules apply even if someone else nominally created the power, to the extent the powerholder contributed value to the transfer. The Comment to § 501 sets forth these examples:

> *Example 1*. D purchases Blackacre from A. Pursuant to D's request, A transfers Blackacre "to D for life, then to such person as D may by will appoint." The rule of subsection (d) applies to D's general testamentary power, though in form A created the power.
>
> *Example 2*. A by will transfers Blackacre "to D for life, then to such persons as D may by will appoint." Blackacre is subject to mortgage indebtedness in favor of X in the amount of $10,000. The value of Blackacre is $20,000. D pays the mortgage indebtedness. The rule of subsection (d) applies to half of the value of Blackacre, though in form A's will creates the general power in D.
>
> *Example 3*. D, an heir of A, contests A's will on the ground of undue influence on A by the principal beneficiary under A's will. The contest is settled by transferring part of A's estate to Trustee in trust. Under the trust, Trustee is directed "to pay the net income to D for life and, on D's death, the principal to such persons as D shall by will appoint." The rule of subsection (d) applies to the transfer in trust, though in form D did not create the general power.

These rules were applied in <u>Phillips v. Moore</u>**,** 690 S.E.3d 620 (Ga. 2010)**.** In 1996, Delmus Phillips created a trust to hold real estate for his benefit and the benefit of his family. Under the trust instrument, Phillips was entitled to receive the net income of the trust during his life. Phillips also had a testamentary power of appointment that allowed him to appoint the trust property to anyone of his choosing, including his own estate or creditors. The trust named specific beneficiaries in the event that Phillips failed to exercise the power, and also contained a spendthrift provision that protected the income and principal of the trust from claims of creditors. Phillips filed for bankruptcy in 2007, and the bankruptcy trustee moved for judgment as to whether the spendthrift provision was enforceable. The court granted the trustee's motion and held that the corpus was property of the bankruptcy estate. On appeal, the court noted the lack of controlling Georgia law and certified to the Georgia Supreme Court "whether a settlor of a trust is a sole beneficiary, such that creditors may reach the corpus of the trust, when the trust instrument gives the settlor no right to the corpus during his lifetime but provides him with a general power to appoint the trust corpus as he sees fit in his will and names specific beneficiaries to receive the corpus of the trust in the event that the settlor does not exercise his power of appointment?" The court answered in the affirmative, holding that an income right plus a general testamentary power of appointment allows

creditors to reach even the trust corpus during the settlor's life despite the presence of a spendthrift provision.

2. A general power created by someone other than the powerholder is dealt with by § 502. With an exception for property subject to Crummey withdrawal rights (§ 502(b)), appointive property subject to a general power of appointment created by a person other than the powerholder is subject to a claim of a creditor of: (1) the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable; and (2) the powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.

The theory behind section 502 is that a presently exercisable general power of appointment is equivalent to ownership. Further, upon the powerholder's death, property subject to a general power of appointment is subject to creditors' claims against the powerholder's estate (for example, administration, funeral and burial expenses, and statutory allowances to the surviving spouse and children) to the extent the estate is insufficient, subject to the decedent's right to direct the source from which liabilities are paid. In each case, whether the powerholder has or has not purported to exercise the power has no effect on this issue.

The Uniform Act follows the Restatement Third § 22.3. However, as noted by Comment c to that Restatement section, this is a new rule and is not the common law nor the rule of previous Restatements. The Comment states:

> *c. Historical note.* The common-law rule was that the [powerholder's] creditors could not reach appointive assets covered by an unexercised general power of appointment if the power had been created by a person other than the [powerholder]. The thought was that until the [powerholder] exercised the power, the [powerholder] had not accepted sufficient control over the appointive assets to give the [powerholder] the equivalent of ownership of them. Restatement Second of Property (Donative Transfers), still adhered to the common-law rule, but recognized that statutory law in a number of states had abrogated the common-law rule. . . . The Restatement Second implemented the historical rule in three sections. . Section 13.2 provided that "Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, but only to the extent provided by statute." Section 13.4 provided that "Appointive assets covered by an exercised general power to appoint by will, created by a person other than the donee, can be subjected to the payment of claims against the donee's estate." Section 13.5 provided that "Appointive assets covered by an exercised general power to appoint by deed, created by a person other than the donee, can be subjected to the payment of the claims of creditors of the donee to whatever extent they could have been thus

> subjected, under the rules relating to fraudulent conveyances, if the appointive assets had been owned by the donee and transferred to the appointee." The Restatement Third of Trusts has now diverged from the common-law rule. See Restatement Third, Trusts § 56, Comments b and c. The Restatement Third of Trusts represents the current position of the Institute, and is the rule adopted in this section . . . .

The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors' rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non*general power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a nongeneral power did not intend to benefit the powerholder.

Explaining the distinction between the exercise and non-exercise of a general power for purposes of creditor access, Univ. Nat'l Bank v. Rhoadarmer, 827 P.2d 561 (Colo. App. 1991) noted:

> When a donor gives to another the power of appointment over property, the [powerholder]... does not thereby become the owner of the property. Rather, the appointee of the power [meaning, the powerholder], in its exercise, acts as a "mere conduit or agent for the donor." The [powerholder], having received from the owner of the property instructions as to how the power may be utilized, possesses nothing but the authority to do an act which the owner might lawfully perform.

When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder's estate can reach the appointed property for the payment of their claims. See, e.g., Clapp v. Ingraham, 126 Mass. 200 (1879). The rule prevails even if this is contrary to the expressed wishes of the donor of the power. See, e.g., State Street Trust Co. v. Kissel, 19 N.E.2d 25 (Mass. 1939).

The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder's probate estate. Thus, in terms of priority, the powerholder's own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder's probate estate is insufficient.

Under the majority view at common law, the powerholder's creditors can reach the appointive assets only to the extent the powerholder's exercise was an *effective* exercise. A few states, however, follow the view that even an ineffective

exercise entitles the powerholder's creditors to reach the appointive assets. See, e.g., Estate of Breault, 211 N.E.2d 424 (Ill. App. Ct. 1965). Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes "capture" the appointive assets for the powerholder's estate, in which case the appointive assets become part of the powerholder's probate estate for all purposes, including creditors' rights.

When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder's creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a *creditor*, the powerholder's other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a "preference" in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a *volunteer* (i.e., the appointment is gratuitous), the powerholder's creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.

In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is *not* treated as the owner of the appointive property even if the power is exercised. See, e.g., St. Matthews Bank v. DeCharette, 83 S.W.2d 471 (Ky. 1935). Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A minority of states has enacted legislation that affects the rights of the powerholder's creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder's creditors and some contracts them. The following is a sampling of the legislation.

> *Michigan* legislation expands the rights of the creditors of the powerholder of an *unexercised* general power. During the powerholder's lifetime, the powerholder's creditors can subject the appointive property to the payment of their claims if the power is presently exercisable. (If the powerholder has actually made an inter vivos exercise of the power, the rules explained above with respect to inter vivos exercises presumably would be applied.) At the powerholder's death, the powerholder's creditors can subject the appointive property to the payment of their claims. In both instances, however, the appointive property is available only to the extent that the powerholder 's owned property is insufficient to meet the debts. See Mich. Comp. Laws §556.123.
>
> *New York* legislation expands the rights of the powerholder's creditors in some particulars but restricts them in others. The legislation adopts the

> same rules as the Michigan legislation, but limits their application to general powers presently exercisable. As to general testamentary powers, the powerholder's estate creditors can subject the appointive property to the payment of their claims only if the powerholder, as donor, reserved the power in himself or herself; as to general testamentary powers conferred on the powerholder by another, the powerholder's estate creditors cannot reach the appointive property even when the powerholder's will *exercises* the power. See N.Y. Est. Powers & Trusts Law §§10-7.1 et seq.

Whether a state follows the common law rule or the new Restatement rule with respect to the rights creditors have to property subject to an unexercised general power of appointment will be relevant when considering the wisdom of giving a trust beneficiary a general power for tax purposes, typically to attract new basis. If the beneficiary has a reasonable possibility of having substantial creditors at death, the risk that the trust property, which likely had no previous exposure to creditors, may be exposed.

Suppose the powerholder of a non-presently exercisable general power exercises the power to appoint the property other than to the powerholder's or the powerholder's estate's creditors. The rights of those creditors are cut-off under this section but they may still have rights under the state's fraudulent transfer law. If the exercise is to pay off one or some creditors at the expense of others there is no state law right of redress for the unpaid creditors although there may be remedies available under federal bankruptcy law (a discussion of which is beyond the scope of these materials).

Section 502(b) provides that a power of appointment created by a person other than the powerholder that is subject to an ascertainable standard relating to an individual's health, education, support, or maintenance within the meaning of section 2041(b)(1)(A) or 2514(c)(1) of the Code will be treated automatically as a nongeneral power.

3. Crummey withdrawal rights are dealt with in § 503 which provides that a current right to withdraw assets from a trust is a presently exercisable general power of appointment. However, upon the lapse, release, or waiver of such power, the power will be treated as a presently exercisable general power only to the extent that it exceeds the annual exclusion amount.

4. Property subject to the exercise of a nongeneral power of appointment is not subject to the claims of the powerholder's creditors, per § 504 of the Uniform Act, with two exceptions. If the taker in default of appointment is the powerholder or the powerholder's estate then the power is reclassified as a general power and the rights of creditors change accordingly (§ 504(c)). Further, property subject to a nongeneral power is

subject to the claim of a creditor of the powerholder or the powerholder's estate to the extent that the powerholder owned the property and transferred it in a fraudulent conveyance, reserving the nongeneral power. This is really an application of the fraudulent conveyance statutes that cause the property to be subject to the creditors, and the rule in the Uniform Act is merely to ensure that the presence of a nongeneral power does not affect that rule.

5. The special case of elective share rights of a powerholder's surviving spouse is not dealt with by the Uniform Act because elective share rights are anything but uniform. Section 23 of the Restatement Third of Property sets forth what it believes would be good policy, namely that the powerholder is treated as owning property subject to a presently exercisable general power of appointment exercisable by the powerholder immediately before death and property subject to a general testamentary power of appointment exercisable by the powerholder if the powerholder was also the creator of the power. Essentially this would treat the surviving spouse as being similar to any other creditor. The Uniform Probate Code implements this policy in UPC sec. 2-205(1)(A) and (2)(A). Numerous states have adopted some version of this section in their elective share statutes. See, for example, Florida Statute § 732.2035 and Oregon Revised Statute § 114.665.

N. Definition of "person" in the Uniform Act.

The standard definition of "person" in uniform acts is used in the Uniform Act, in § 102(12):

> "Person" means an individual, estate, trust, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

This definition matters because powerholders are persons, appointees are persons, and donors—those who create powers—are persons. In short, in the Uniform Act one does not have to be an individual to create a power, have a power, exercise a power, or be the beneficiary of an exercise of a power. Note that the Uniform Trust Code contains a similar definition of "person" and allows trusts to be created by persons.

Consider a trust that gives a limited liability company a power of appointment. The ownership of the LLC could be transferred, thus changing who could control the exercise of the power. Undoubtedly for federal tax purposes the LLC would be looked through and the power treated as held by the owners of the LLC. Consider also a trust that allowed a powerholder to appoint assets to a particular LLC. Because the ownership of the LLC could change, the beneficiaries of the power could change as well, and the exercise of the power could be bought and sold. Rights of withdrawal are presently exercisable general powers of appointment; might there

be circumstances where those powers would be better held by an LLC than by individuals?

To date, the only regular use of this expanded definition has been outside the area of powers of appointment. The Uniform Trust Code allows the settlor of a charitable trust to enforce its terms. If a charitably minded individual transfers assets to an LLC and the LLC creates the charitable trust, the LLC is the settlor of the trust for state law purposes, and in a UTC state that has not altered the uniform provisions the LLC may enforce the charitable trust. The LLC need not terminate when the individual who originally created it dies. We can expect additional uses to develop as the Uniform Act becomes widespread.

¶ 104 Recent Cases Dealing With Powers of Appointment.

¶ 104.1 Cessac v. Stevens, 127 So.3d 675 (Fla. 1st DCA, November 20, 2013) Failure to make specific reference to powers of appointment was fatal to their exercise.

A. The decedent had powers of appointment over three trusts each of which allowed her to appoint assets by Will "making specific reference to the power herein granted". The decedent's Will only referred to the trusts and the powers by stating the following: "Included in my estate assets are the STANTON P. KETTLER TRUST, FBO, SALLY CHRISTIANSEN, under will dated July 30, 1970, currently held at Morgan Stanley Trust offices in Scottsdale, Arizona and two (2) currently being held at Northern Trust of Florida in Miami, Florida."

B. The court held that the "mere reference" to one of the trusts and the location of the property of the other two trusts was insufficient to substantially comply with the specific reference requirement. Section 732.607 of the Florida Statutes provides that a will making a disposition of "all of the testator's property" will not exercise a power of appointment without specific reference to the power or other indication of intent.

C. The court noted that the result, while seemingly harsh, really is not because compliance with the specific reference is easy. Here, the attorney who drafted the decedent's will testified that "he made no effort to ensure that the will complied with the trusts' requirements" even though he had a copy of at least one of the trusts.

D. While not addressed in the decision, it is worth noting that Florida did not adopt Section 304 dealing with substantial compliance. See, Chapter 709, Florida Statutes.

¶ 104.2 Sefton v. Sefton, et al., 206 Cal. App. 4th 875 (Cal. App 4 Dist., 2012). Validity of exercise of testamentary power of appointment determined under law in effect when grantor of power died and not when power exercised.

A. In a case of first impression in California, the California Court of Appeals was asked to determine the effect that a California statute, enacted after the creation of a power appointment, had on the permissible appointees of the power.

B. At his death, J.W. Sefton, Jr., owned a highly valuable controlling interest in San Diego Trust & Savings Bank. J.W. executed a will in 1955 and died in 1966. Under his will, J.W. gave his son, Thomas, a life estate in certain property. J.W. also gave Thomas testamentary limited power of appointment over 75 percent of J.W.'s estate that could be exercised in favor of Thomas's then living issue. Thomas' children were identified in J.W.'s will as Thomas Sefton Jr., Laurie Sefton, and Harley Sefton. Thomas died in 2006 and under his will he exercised his power of appointment in favor of Laurie and Harley, but he excluded Thomas Jr. Thomas Jr. challenged his father's exercise of the power of appointment, arguing that his father exceeded the scope of the power of appointment.

C. Under the common law existing at the time that J.W. executed his will and at the time of his death, J.W.'s will would be interpreted as giving Thomas a "non-exclusive power of appointment" that required that each of the grandchildren receive a "substantial" part of the trust. In 1970, prior to Thomas's death but after J.W.'s death, California changed its common law by implementing a statute that presumed that a power of appointment was "exclusive" so that one or more persons in a defined class of appointees could be excluded unless the grantor of the power specified otherwise.

D. The trial court dismissed Thomas Jr.'s petition, applying the law in effect at the time of Thomas's death (and therefore the time of the exercise of the power).

E. On appeal, California Court of Appeals reversed the trial court on the grounds that: (1) the California statute that changed the law on powers of appointment did not apply to powers of appointment that were created prior to July 1, 1970; (2) the court presumed that J.W. and the attorney that prepared his will were aware of the prevailing law at the time the will was created, as well as the time of J.W.'s death, and further presumed that J.W. intended to benefit all of the grandchildren; (3) had the 1970 change in law been retroactive, it would change the intent of donors and substantive parts of wills and would likely be unconstitutional; and (4) Thomas Jr. was entitled to a "substantial" share of J.W.'s trust and remanded the matter for further determination as to what would constitute a substantial share.

¶104.3 Taylor v. Feinberg, 919 N.E. 2d 888 (Illinois Supreme Court, Sept. 24, 2009). The Illinois Supreme Court upheld the validity of an exercise of a power of appointment to direct trust distributions to grandchildren conditioned on marrying within the Jewish faith.

A. Max Feinberg died in 1986, leaving a pour-over will and a revocable trust. Under his trust, he established Trust A and Trust B for the lifetime benefit of his wife, Erla Feinberg. He also granted his wife lifetime and testamentary limited powers of appointment over the trust assets.

B. To the extent his wife did not exercise her powers of appointment, he directed the distribution of the trust assets to his descendants, but subject to what the court called a "beneficiary restriction clause." The beneficiary restriction clause directed that 50% of the trust assets be held in separate trusts for his grandchildren, but provided that any descendant who married outside the Jewish faith or whose non-Jewish spouse did not convert to Judaism within one year of marriage, would be deemed deceased and lose their share of the trust, with any forfeited share paid to Mr. Feinberg's children.

C. Mrs. Feinberg exercised her lifetime power of appointment to direct the distribution at her death of $250,000 outright and free of trust to each child and grandchild who would not be deemed deceased under Mr. Feinberg's beneficiary restriction clause. At the time of Mrs. Feinberg's death in 2003, all five grandchildren had been married for more than one year, but only one met the conditions of the beneficiary restriction clause and was entitled to receive $250,000. One of the disinherited grandchildren sued Mr. Feinberg's children (including her father) as co-executors challenging the validity of the beneficiary restriction clause.

D. The trial court invalidated the beneficiary restriction clause on public policy grounds for interfering with the right to marry a person of one's own choosing, and the court of appeals affirmed relying on prior decisions of the Illinois Supreme Court and the Restatement (Third) of Trusts. The Illinois Supreme Court granted an appeal, and received amicus curiae briefs from Agudath Israel of America, the National Council of Young Israel, and the Union of Orthodox Jewish Congregations of America.

E. The Illinois Supreme Court refused to consider whether Mr. Feinberg's original disposition under his will violated public policy and dismissed arguments that related to the continuing trusts provided for under the will. Because Mrs. Feinberg exercised her power of appointment to provide outright distributions, the Illinois Supreme Court only considered whether her exercise of the power of appointment violated public policy by disqualifying any descendent who married outside the Jewish faith from receiving a $250,000 distribution. The court held that determinations of public policy are conclusions of law, and reviewed the decisions of the trial court and the court of appeals de novo.

F. The Illinois Supreme Court reviewed the state's public policy in support of broad testamentary freedom, observing that state law only placed

two limits on a testator's freedom to leave property as he or she desired – the spouse's ability to renounce and protections for pretermitted heirs. The court noted that there is no forced heirship for descendants.

G. In support of this policy, the court noted the broad purposes for trusts under state trust statutes, the repeal of the common law rule against perpetuities and the Rule in Shelley's Case, and the focus in case law on determining the intent of the testator. The factual record indicated Mr. Feinberg's intent to benefit those of his descendants who furthered his commitment to Judaism by marrying with the faith and his concern with the dilution of the Jewish people by intermarriage. The court observed that Mr. Feinberg would be free during his lifetime to attempt to influence his grandchildren to marry within the faith, even by financial incentives.

H. The court acknowledged the long-standing rule that trust provisions that encourage divorce violate public policy. However, the court distinguished its prior decisions on the grounds that (1) because of Mrs. Feinberg's power of appointment, the grandchildren never received a vested interest in the trust upon Mr. Feinberg's death; (2) because they had no vested interest that could be divested by noncompliance with the condition precedent, the grandchildren were not entitled to notice of the existence of the beneficiary restriction clause; and (3) the grandchildren, since they were not heirs at law, had at most a mere expectancy that failed to materialize.

I. The court refused to consider whether to adopt the rule of the Restatement (Third) of Trusts on the basis that exercise of the power of appointment was not in trust and was in the manner of a testamentary disposition. The court held that Mrs. Feinberg's distribution scheme did not operate prospectively to encourage the grandchildren to make choices about marriage, since the condition precedent (marriage within the faith) was either met or not met at the moment of Mrs. Feinberg's death, and observed the distinction between conditions precedent (which might be effective even if a complete restraint on marriage) and conditions subsequent (which may not). The court observed that because there were no continuing trusts under Mrs. Feinberg's distribution scheme, there was no "dead hand control" or attempt to control the future conduct of the beneficiaries, and therefore no violation of public policy. Accordingly, the court reversed the court of appeals and the trial court.

J. The Illinois Supreme Court rejected the grandchild's other arguments, including her claim that the beneficiary restriction clause violated the constitutional right to marry because the absence of a governmental actor. The court summarized its holding as follows: "Although those plans might be offensive to individual family members or to outside observers, Max and Erla were free to distribute their bounty as they saw fit, and to favor grandchildren of whose life choices they approved over other grandchildren

who made choices of which they disapproved, so long as they did not convey a vested interest that was subject to divestment by a condition subsequent that tended to unreasonably restrict marriage or encourage divorce.

¶ 104.4 Midwest Trust Company et al. v. Reed Brinton, 2014 Kan. App. Unpub. LEXIS 680 (Kan. Ct. App., August 15, 2014). Trust beneficiary's exercise of testamentary general power of appointment was not valid because it did not strictly comply with the condition precedent of approval by the trust protector.

A. Decedent, Reed Byers, created a revocable trust agreement for the benefit of his daughter, Wendy, and her two sons, David and Reed Brinton. Under the terms of the trust, Wendy was granted a general power of appointment over the trust assets. If her power was not exercised, a small portion of the trust assets were set aside for her husband, Bill, and the remaining assets were divided equally between David and Reed. The trust also provided that Wendy's exercise of her power of appointment had to be approved prior to her death by the Trust Protector. The trust named Thomas McKittrick as the initial Trust Protector and Thomas Van Dyke as successor, if the initial Protector was unable or unwilling to serve. McKittrick was Byers' long time CPA and Van Dyke was Byers' attorney.

B. Wendy amended her revocable trust to disinherit her son, Reed, and also executed a second codicil to her Will in which she exercised her general power of appointment to appoint the assets in the Byers trust to her revocable trust. Van Dyke approved the codicil as a valid exercise of her power.

C. Wendy died in 2009 and Bill died in January 2011. In September 2011, Reed filed a claim against Bill's estate stating that Wendy's exercise of the general power of appointment was invalid and any assets distributed from the Byers Trust for the benefit of Bill should be paid back to the trust.

D. Both sides moved for summary judgment. The lower court determined that the exercise was invalid as not approved by the Trust Protector because (1) the approval did not come from McKittrick and (2) the facts presented did not show that McKittrick was either unwilling or unable to serve as Trust Protector. The trustees of Wendy's Trust and the estate planning attorneys for Wendy and Byers appealed the summary judgment.

E. On appeal, the Court of appeals affirmed the lower court on the grounds that: (1) the language in the trust was clear and unambiguous, McKittrick was the initial Trust Protector, and absent facts that show he was unable or unwilling to serve, the power of appointment required his approval before it could be validly exercised; (2) substantial compliance was not available because Kansas has never recognized substantial compliance for the exercise of a power of appointment; and (3) even if under the Uniform

Trust Code it could recognize substantial compliance, the issue at hand was not whether Wendy's exercise of the power substantially complied to the terms of the trust, but whether the condition precedent to her exercising the power was met, and it was not.

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