

The Power to Appoint and Disappoint

Anatomy of Powers of Appointment

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2025 Estate Planning and Community Property Law Journal CLE & EXPO
February 21, 2025
Lubbock, Texas

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The Garden Keeper Parable



What is a power of appointment? (II.A.1)

- The right and power to change the beneficiary enjoyment of property.
- The change is effected on property the powerholder does not own.
- The change can affect not only who enjoys the property but how he or she enjoys it.
- We will focus on powers held in a non-fiduciary capacity.

Example

Ward and June Cleaver have two children, Wally and Theodore (“Beaver”). Wally is a doctor, has one child (and wanting more), and is married to a woman that Ward and June adore. While Beaver talks about marrying his long-time girlfriend, he has difficulty making commitments. With Ward and June uncertain about the future of the estate tax, they want to act now to take advantage of the high exemption (\$13.99 million) before it disappears. Ward and June want to set up trusts for their current and potential descendants. They also want to make sure their descendants control their financial destiny—that is, Ward and June don’t want to be “the hand from the grave.” They have read-up on powers of appointment and ask, “How can we use powers of appointment to let our kids be in control of trust assets, while protecting those assets from in-laws, outlaws, creditors, and predators.”

Powers of appointment allow for flexibility

- Accommodating the unexpected and unplanned for events of life, such as drafting errors, needs, changes in behavior, illnesses, deaths, divorces, lawsuits, bankruptcies, liabilities, and legislative changes while providing protections from in-laws, outlaws, creditors, and predators.
- Breaking away from the hand from the grave.
- Keeping kids honest.
- Tax efficacy.

But, like everything, they can create problems such as an opportunity for bad actors to act.

The Texas definition (II.A.1)

Texas Property Code §181.001(2) defines a power as the authority to:

- appoint or designate the recipient of property,
- invade or consume property,
- alter, amend, or revoke an instrument under which an estate or trust is created or held,
- terminate a right or interest under an estate or trust, and
- any authority remaining after a partial release of a power.

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Terminology (II.A.2)

- **Appointive Property** – The property or interest subject to a power.
- **Donor** – The person who creates or reserves a power.
- **Donee or Powerholder** – The person who holds the power.
- **Appointee** – A person in whose favor a power is exercised.
- **Permissible Appointee** – A person in whose favor a power may be exercised.
- **Impermissible Appointee** – Anyone who is not a permissible appointee.

Terminology (II.A.2)

- **Taker-in-Default** – The person who takes the appointive property if the power is not effectively exercised.
- **Gift-in-Default** – A clause that identifies the taker-in-default.
- **Release** – The renunciation, relinquishment, surrender, refusal to accept, extinguishment, release, or covenant not to exercise all or part of a power of appointment.

Terminology (II.A.3.a)

- **General Power**

- A power that grants to the donee the authority to confer on himself or herself the full benefit of the appointive property to the exclusion of others.
- Generally, a power will be a general power unless the language prohibits its exercise in favor of the donee, the donee's estate, and the creditors of either.
- This can be done by exclusion ("to any person or persons other than the donee, the donee's estate, and the creditors of either") or by inclusion ("only to my descendants").

- **Nongeneral Power**

- A power that is not a general power.
- Sometimes referred to as a "limited" or "special" power.

Terminology (II.A.3.b)

- **Presently Exercisable Power** – A power that can be exercised at anytime “by deed” or “by deed or will.”
- **Testamentary Power** – A power that is exercisable only “by will” and is not presently exercisable.
- **Postponed Power** – A power not exercisable until the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified period of time.

Terminology (II.A.3.c)

- **Exclusionary**

- A power in which the donor has authorized the donee to appoint to any one or more permissible appointees, to the exclusion of others.
- To “any one or more” of the permissible appointees, to “such of” the permissible appointees as the donee selects, or to “such person or persons” as the donee selects.
- Ambiguous language is construed in favor of creating an exclusionary power.

- **Nonexclusionary**

- A power in which the donor intended to require each appointee to receive a reasonable benefit (i.e., no illusory appointments).
- To “all and every one” or to “each and every one” of the permissible appointees.

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Granting powers (II.B)

- Requirements
 - Must have (i) a donor, (ii) a donee, (iii) one or more permissible appointees, (iv) appointive property, and (v) a properly executed instrument that clearly expresses the donor's intent to create a power of appointment.
 - The donor must (i) sign the instrument creating the power with the formalities required to execute that type of instrument, (ii) possess capacity, and (iii) be free from undue influence and other wrongdoing.
- A power of appointment is created when the document purporting to create it becomes effective.

Exercising powers (II.C.1)

- Requirements:
 - The donee's intent to exercise the power must be clear;
 - The donee must have sufficient capacity to exercise the power;
 - The donee must exercise the power by an instrument that satisfies the formal requirements of exercise imposed by the donor and by applicable law; and
 - The donee's appointment must constitute a permissible exercise of the power.

Exercising powers (II.C.2)

- Exercise clause types
 - **Specific exercise clause** makes specific reference to the creating instrument (I exercise the power of appointment conferred upon me by my mother's will as follows: I appoint . . .").
 - **Blanket exercise clause** purports to exercise any power of appointment granted to the donee ("I exercise any power of appointment I may have as follows: I appoint . . .").
 - **Blending clause** purports to blend the appointive property with the donee's own property in a common disposition ("All the rest, residue, and remainder of my estate, including the property over which I have a power of appointment under my mother's will, I give, devise, and bequeath as follows . . .").
 - **Nonexercise clause** is a definitive statement by a donee to assure nonexercise of a power of appointment ("I do not exercise the power of appointment conferred on me by my mother's trust." or "I do not exercise any power of appointment I might have.")

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Client Concerns

- Who holds the power?
- When can the power be exercised (i.e., presently exercisable, testamentary, or postponed?)
- Who are the permissible appointees?
- Is the power exclusionary or nonexclusionary?
- Are there limits on how an appointee enjoys the property?
- Who are the takers-in-default?

Our Concerns

- Understanding and addressing our client's concerns.
- Understanding, explaining, and addressing:
 - The rights of the donee's in-laws, outlaws, creditors, and predators.
 - The gift, estate, and GST tax implications.
 - The income tax implications.
- Can we get a basis adjustment under IRC §1014(b)(9)?
- Do we have a potential problem under the rule against perpetuities?
- Deciding whether we idiot proof the granting instrument or draft it to provide maximum flexibility, understanding that "with great power comes great responsibility."

Most of “our concerns” depend on whether the power is general or nongeneral.

The rights of the donee's in-laws, outlaws, creditors, and predators (II.C.3.f)

Protection is afforded by

- A nongeneral power of appointment.
- An exercised power that would otherwise be a general power but for the fact it is
 - limited by an ascertainable standard (e.g., HEMS), or
 - exercisable only with the consent or joinder of an adverse party.
- A postponed general power. (II.A.3.b.iii)

The rights of the donee's in-laws, outlaws, creditors, and predators (II.C.3.f)

Protection is afforded by

- Under common law and the Restatement (Second) Property (i.e., Texas law [see Texas Property Code §112.035(f-1) relating to unexercised testamentary general powers]), an unexercised general power does NOT subject the appointive property to creditors' claims, subject to creditors' claims in bankruptcy. (II.C.3.f.i)
- Under the Restatement (Third) Property and the Uniform Powers of Appointment Act (e.g., New Mexico law), an unexercised general power subjects the appointive property to creditors' claims. (II.C.3.f.i)

The gift, estate, and GST tax implications (III.A & B)

- The regulations provide that a power of appointment “includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations.”
- For tax purposes, a power is a general power if it is exercisable in favor of the donee, the donee’s estate, or the creditors of either, unless the power is
 - limited by an ascertainable standard (e.g., HEMS), or
 - exercisable only with the consent or joinder of (i) **the donor**, or (ii) an adverse party.

The gift, estate, and GST tax implications (III.A & B)

- The donee is the transferor for gift tax purposes when he or she exercises or releases a general power of appointment.
- Estate tax inclusion results when a donee possesses a general power of appointment at death (whether the power is exercised or not) or releases it before death but is subject to inclusion under IRC §2035 death.
- GST tax follows gift or estate taxation, as appropriate.

Getting a basis adjustment under IRC §1014(b)(9) (III.A)

- Possessing a general power of appointment (whether the power is exercised or not) generates a basis adjustment under IRC §1014(b)(9).
- Consider granting a general power by formula or independent third-party grant, such as a trust protector or independent trustee. *See* PLR 202206008 (Feb. 11, 2022).
- Consider springing the Delaware Tax Trap on the donee's death if the donee only possesses a nongeneral power of appointment.

The income tax implications (III.B)

When a donee who holds both a nongeneral power of appointment over trust assets and a lifetime income interest in that trust exercises that power over trust corpus, the IRS takes the position that the donee has made a gift equal to the present value of his or her income interest attributable to the appointed property. *See Estate of Regester v. Commissioner.*

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- Releases and disclaimers. (II.D & III.A.3)
 - While likely not applicable, be mindful of the double inclusion issues raised in *Estate of Powell v. Comm’r*, 148 T.C. 392, 423 (2017) and *Estate of Moore v. Comm’r*, TC Memo 2020-40 (where the Tax Court, *sua sponte*, raised double inclusion under IRC §2043).
- Texas Property Code §113.029. (III.A.4.c)
- Judicial reformation but be mindful of *Comm’r v. Estate of Bosch*; but see Rev. Rul. 73-142 (III.A.4.c)

Takeaways

- Powers of appointment are a useful tool to keep in our toolbox, providing a lot of flexibility.
- Careful drafting is required in both granting powers and exercising powers.
- General powers generally cause estate tax inclusion in the donee's estate and may be reachable by the donee's creditors, especially in bankruptcy.
- Nongeneral powers do not result in estate tax inclusion in the donee's estate and prevent the donee's creditors from reaching the assets.
- Exercising a presently exercisable nongeneral power over a trust where the donee has an income interest may result in a deemed gift by the donee.
- Some problems with powers may be fixed by release or disclaimer, Texas Property Code §113.029, or judicial reformation.



Questions

I know of no safe depository of the ultimate powers of the society but the people themselves; and if we think them not enlightened enough to exercise their control with a wholesome discretion, the remedy is not to take it from them but to inform their discretion.

– Thomas Jefferson