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I. INTRODUCTION

The proper way to tax transfers of property pursuant to the exercise or lapse of a power of appointment[1] has been the subject of much debate since the enactment of the first federal estate tax in 1916.[2] The debate has been triggered by the ambiguous status of the holder of a power of appointment. On the one hand, the powerholder does not own the property subject to the power in the traditional property-law sense of ownership, because the holder does not have legal title to it.[3] On the other hand, the powerholder often possesses sufficient rights of disposition over the property to give the holder considerable control over its beneficial enjoyment. The federal estate tax provisions dealing with such transfers were amended substantially three times: in 1918,[4] 1942,[5] and 1951.[6] In the Powers of Appointment Act of 1951,[7] which enacted what are now sections 2041 and 2514 of the Internal Revenue Code of 1954 (Code),[8] Congress resolved the issue of the extent to which the federal estate and gift taxes should apply to transfers of property over which the decedent or donor possessed a power of appointment largely by eliminating the tax on such property except in situations in which the powerholder has unfettered discretion to consume the property. Section 678, enacted for the first time

1. For a discussion of the definitions of power of appointment, see text accompanying notes 18-26 *infra*.
2. Revenue Act of 1916, ch. 463, §§ 200-212, 39 Stat. 756, 777-80.
3. L. SIMES, Law of Future Interests § 55 (2d ed. 1966); Restatement of Property § 318, comment b (1940).
4. Revenue Act of 1918, ch. 18, § 402(e); 40 Stat. 1057, 1097.
5. Revenue Act of 1942, ch. 619, § 403; 56 Stat. 798, 942-44.
6. Powers of Appointment Act of 1951, ch. 165, 65 Stat. 91 (codified at 26 U.S.C. §§ 2041 & 2514 (1982)).
7. *Id.*
8. *Id.* [hereinafter sections of the Code that were in force as of March 1, 1985, will be referred by section number in text and cited as I.R.C. § in footnotes. Earlier versions of Code sections will be referred to as Former I.R.C. §].

as part of the new codification in 1954,[9] provides a similar, although not identical, result with respect to the taxation of income generated by property subject to a power of appointment.

Dissatisfaction with the pattern of taxing property subject to such powers continued after the legislation of the early 1950's. It became increasingly clear that lesser, nontaxable powers provide estate owners with a means to grant family members considerable control over the disposition of family wealth while eliminating transfer tax on these dispositions. Indeed, it is highly unlikely that a grantor would give anyone a taxable power of appointment unless that grantor intended deliberately to attract a transfer tax upon the exercise or lapse of the power in order to obtain an exclusion from tax on the creation of the power.[10] Many tax theorists agreed that this pattern of taxation permitted the holder of a nongeneral power to make changes in the interests of other beneficiaries that were tantamount to "transfers" and should be taxed as such.[11] This consensus provided part of the impetus for enactment of an additional transfer tax that culminated in the adoption of the generation-skipping transfer tax in 1976.[12]

The generation-skipping transfer tax seems to provide the more appropriate framework in which to tax transfers of property

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9. Internal Revenue Code of 1954, ch. 736, § 678 (1954); 68A Stat. 3, 231.

10. For example, a married person might write his will to give his spouse a life estate coupled with a general testamentary power of appointment over all or a portion of his estate in order to secure for his estate the benefit of the federal estate tax marital deduction under I.R.C. § 2056(b)(5). The property would escape tax at his death and would be subject to tax under I.R.C. § 2041 only at the death of the spouse, thus giving the family the benefit of a substantial tax deferral. On the other hand, it is unlikely that the property owner would give his spouse a taxable power of disposition to achieve goals unrelated to tax, for example, to provide her access to the property for her support, or to allow her to decide at some later date to whom the property ought to pass following her death. If his will is drafted properly, he can give his spouse both of those powers without subjecting the property to a transfer tax at the spouse's death. *See* I.R.C. §§ 2041(b) & 2041(b)(1)(A). Property subject to such a power will be taxed at the property owner's death because the disposition does not qualify for the marital deduction.

A common estate plan divides the assets into two trusts, both for the primary benefit of the property owner's surviving spouse, one of which will qualify for the marital deduction and one of which will not. The only difference in the dispositive provisions of the trusts is that the surviving spouse has a general power to appoint by will the property in the marital deduction trust, and powers to consume property for her support in the non-marital trust and to appoint what is left over at her death to anyone other than herself, her creditors or her estate. *See, e.g.*, J. FARR & J. WRIGHT, AN ESTATE PLANNER'S HANDBOOK 486 (4th ed. 1979).

11. *See* note 305 *infra*.

12. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006 (1976), 80 Stat. 1520, 1879- 90, (enacting I.R.C. §§ 2601-2622).

over which the decedent or donor possessed a power of appointment. The taxable event in the generation-skipping transfer tax is the shift of interests in a trust fund from one beneficiary to another, each of whom may have substantially less than outright ownership of the fund both before and after the shift.[13] Furthermore, the tax is payable out of the trust fund rather than out of the estate of the person away from whom the property has been shifted. However, the current generation-skipping transfer tax is itself hopelessly complex and in need of substantial revision. Recent proposals of the Treasury Department address a number of the problems presented by the tax as enacted in 1976.[14] However, these new proposals will also require fairly substantial revision prior to enactment.

In addition, the pattern of taxation to the powerholder of income generated by property subject to a general power does not conform to the pattern of transfer taxation under either the generation-skipping transfer tax or the estate and gift taxes. In general, it exempts from income tax liability an even broader class of powerholders than are exempt from estate and gift tax. It also fails to deal clearly with the income tax consequences of several types of powers that are explicitly excepted from the estate and gift tax provisions. The American Law Institute (ALI) adopted a proposal to revise completely the provisions of the Code dealing with the income taxation of estates and trusts at its May, 1984 Annual Meeting.[15] The Treasury Department has recently proposed a revision in the pattern of income taxation of trusts and

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13. Thus, for example, a transfer in trust to pay income to A for life, and then to C, a child of A, for life, with the remainder to be distributed to C's living children at C's death, will attract a generation-skipping transfer tax at the death of A and again at the death of C, because each of these events is the termination of the interest of a person who is assigned to a generation within the family that is a higher generation than any other beneficiary of the trust. I.R.C. §§ 2601, 2611(a)-(c), 2613(b).

14. U.S. DEPT. OF THE TREAS., II REPORT TO THE PRESIDENT: TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (November, 1984), [hereinafter cited as TREASURY DEPARTMENT 1984 PROPOSALS]. After this article was completed, the President responded to the Treasury Department 1984 Proposals by promulgating The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (May, 1985). The President's proposals contain no suggestion for change in the estate, gift, and generation-skipping transfer taxes. They do include suggested modifications of the provisions of the Code governing the income taxation of trusts which are similar to, although not identical with, the Treasury Proposals concerning those provisions. The differences between the President's Proposals and those of the Treasury do not appear in provisions which deal specifically with the income taxation of powerholders.

15. *See generally* 61 A.L.I. PROC. (1984) (adopting Federal Income Tax Project, Subchapter J, Tentative Draft No. 12 (1984) [hereinafter cited as ALI Subchapter J Project].

estates that is similar to, though not identical with, the ALI proposal.[16] A Task Force of the American College of Probate Counsel (ACPC) has also responded to the ALI suggestions with a proposal of its own.[17] Each of these proposals includes solutions to some but not all of the problems of the income taxation of powerholders.

Some of the problems observed in the taxation of holders of powers of appointment relate to more fundamental problems in the taxation of grantors who retain powers over property the legal title to which they have transferred to others. Others appear to be the result of hurried passage of incompetely thought through statutes dealing with powers of appointment, or with unfortunate extensions of a statute by interpretative regulations or court decisions.

This article will review the current taxation of nongeneral powers of appointment under the federal estate, gift and generation-skipping transfer taxes and the income tax. It will then evaluate the leading proposals for the amendment of the provisions and suggest statutory changes.

II. DEFINITIONS

The term "power of appointment" is defined differently for purposes of the federal tax laws than it is in traditional property law. The tax definition is considerably broader.

Section 318 of the Restatement of Property defines power of appointment as "a power created or reserved by a person (the donor) having property subject to his disposition enabling the donee of the power to designate, within such limits as the donor may prescribe, the transferees of the property or the shares in which it will be received." Section 318 specifically excludes from the definition of power of appointment the power to invade principal for the benefit of the income beneficiary, whether it is exercised directly by a holder or by a trustee; the power to revoke a trust; and the power to allocate income among a class of beneficiaries, whether it is exercised in a fiduciary or an individual capacity.[18] The Regulations under sections 2041 and 2514 of the Code state that, for tax purposes, the term "power of appointment" includes both the power of invasion and the power of reallocation the power to alter, amend or revoke the instrument creating the property

16. *See* TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 96-106.

17. Pennell, *Income Taxation of Trusts, Estates, Grantors and Beneficiaries: Proposals to Improve Subchapter J*, 10 ACPC PROBATE NOTES 239-253 (1984) [hereinafter cited as ACPC Proposals].

18. RESTATEMENT OF PROPERTY § 318(2), & comments i, j, & l (1940).

interests (other than a power to amend only administrative provisions), and the power to remove a trustee and appoint oneself trustee, if the trustee has any of these powers.[19] Since property law is concerned primarily with the relative rights of various individuals to use or control an asset, it seems useful to distinguish between these powers for property law purposes. The law of transfer taxation, on the other hand, is concerned primarily with whether any particular individual has the right to make the type of transfer of the asset that should attract the tax.[20] Clearly the power to invade the principal of a trust for the benefit of the income beneficiary, or to make allocations of income or principal among beneficiaries, is as much a right to transfer property as is a traditional power of appointment. Therefore, it is conceptually correct to treat all such rights identically for federal transfer tax purposes.

The Restatement uses the term "general power" to refer to a power which the donee may exercise wholly in favor of himself or his estate;[21] it uses the term "special power" to refer to a power under which the donee's choice of appointees is limited to a group defined by the donor and not including the donee of the power, provided that the group is "not unreasonably large."[22] A power of appointment that is not general because it cannot be exercised in favor of the powerholder, but is not special because the class is unreasonably large, is a hybrid power.[23]

Sections 2041 and 2514 of the Code define a general power of appointment as one which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, with certain exceptions.[24] Any power that does not meet this definition is sim-

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19. Treas. Reg. §§ 20.2041-1(b)(1) & 25.2514-1(b)(1) (1981); (hereinafter, Treasury Regulations in force as of March 1, 1985, will be cited without a date).

20. The estate tax has been defined as "an excise imposed upon the transfer of or shifting in relationships to property at death." United States Trust Co. of N.Y. v. Helvering, 307 U.S. 57, 60 (1939).

21. RESTATEMENT OF PROPERTY § 320(1) (1940).

22. *Id.* at § 320(2).

23. *Id.* at § 320, comment a.

24. I.R.C. §§ 2041(b) & 2514(c). The exceptions are (1) a power that is circumscribed by an ascertainable standard relating to the health, education, support, or maintenance of the powerholder, I.R.C. §§ 2041(b)(1)(A) & 2514(c)(1); (2) a power created on or before October 21, 1942, that may only be exercised jointly, I.R.C. §§ 2041(b)(1)(B) & 2514(c)(2); and (3) a power created after October 21, 1942, that may only be exercised jointly with the grantor of the power or with someone who possesses a substantial interest in the property that is adverse to the exercise of the power, I.R.C. §§ 2041(b)(1)(C) & 2514(c)(3). These exceptions will be the focus of much of the analysis and criticism in part IV of this article.

I.R.C. § 2041(a)(3) requires that property subject to a nongeneral power of appointment be included in the estate of the powerholder if the powerholder exercises the power to create another power "which under the applicable local ply not a general power of appointment.[25] The distinction between special and hybrid powers is largely irrelevant for tax purposes because only a power of appointment that meets the tax definition of a general power can have estate or gift tax consequences to the powerholder.[26] Therefore, tax practitioners usually refer to any power that does not have transfer tax consequences as special, limited, or nongeneral.

In this article the tax nomenclature will be used. The term "power of appointment" will include all powers to affect the beneficial enjoyment of the appointive property within the meaning of the estate and gift tax regulations. The term "general power of appointment" will refer to a power of appointment that permits the powerholder to use the property for his own benefit. All other powers of appointment will be referred to as nongeneral powers. In order to avoid confusion between those who are given a power of appointment and those who are given ownership of property, the former will be referred to as powerholders instead of as donees.

III. Estate Tax

A. Historical Development

Federal estate and gift taxes are excise taxes upon the right

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law can be validly exercised so as to postpone the vesting of any estate or interest in such property, 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." In most states, it is impossible to exercise the power so as to achieve such a deferral because such an exercise will violate the rule against perpetuities. The transfer tax consequences to the first powerholder under I.R.C. § 2041(a)(3), & I.R.C. § 2514(d), its gift tax counterpart, will not be discussed in this article. For an excellent analysis of these sections, see Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 ALBANY L. REV. 261 (1980).

25. Neither the Code nor the regulations use the terms "special" or "limited" power.

26. One early commentary advised against the use of the broadest type of nongeneral power of appointment, that is, one that is exercisable explicitly in favor of all the world except the powerholder, his estate, his creditors, or the creditors of his estate, because its status was uncertain under traditional property law. Thus, the powerholder might be held to own the property absolutely under state law, or his creditors might be able to reach it. Furthermore, if these results did obtain under state property law, the powerholder might be held to have a taxable general power for federal estate tax purposes. McCoid, *The Non-General Power of Appointment—a Creature of the Power of Appointments Act of 1951*, 7 VAND. L. REV. 53 (1953). However, the author has been unable to find any case decided since 1951 which refused to enforce the exercise of such a power, or which held that an instrument that repeated exactly the language of the Code

to transfer property.[27] The estate tax is imposed upon transfers made at death, and the gift tax is imposed upon inter vivos transfers. Furthermore, it is traditional to construe federal transfer tax statutes strictly to apply only to those transfers Congress has enumerated explicity.[28] Therefore, to include an interest in property in the transfer tax base, one must identify a taxable event, that is, a taxable transfer, to which the property is subject.

As originally enacted in 1916, the first federal estate tax did not mention powers of appointment specifically.[29] The only section under which property subject to such a power could have been taxed was the predecessor of present section 2033, which taxed all property in which the decedent had an interest if it were subject to the payment of charges against his estate and the expenses of its administration and if it were distributable as part of his estate.[30] In *United States v. Field*,[31] the Supreme Court held that property subject to a general power of appointment exercised by the decedent in her will was not such property and therefore was not subject to federal estate tax. Under the property law of Illinois, the state of Mrs. Field's domicile at her death, the property subject to the power was not distributed as part of her estate.

In 1918, Congress amended the federal estate tax to provide specifically for powers of appointment.[32] Section 402 of the Revenue Act of 1918 included within the estate tax base property subject to a general power of appointment that was exercised by will or by a transfer in contemplation of death or by a transfer taking effect at death. The Act did not define the term "general power of appointment." However, the Regulations defined a general power as one exercisable in favor of anyone, including the powerholder.[33] In 1940, the Supreme Court held that this definition was supported by the legislative history of the 1918 Act.[34] The Court also held that the term was to be defined uniformly for federal estate tax purposes and was to include any power exercisable in favor of the powerholder, or his estate or his creditors, re-

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to create a power created any interest other than a nongeneral power of appointment.

27. *See generally* United States Trust Co. of N.Y. v. Helvering, 307 U.S. 57, 60 (1939).

28. *See generally* Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 58 (1942).

29. *See* Revenue Act of 1916 §§ 200-212.

30. *Id.* at § 202.

31. 255 U.S. 257 (1921).

32. *See* Revenue Act of 1918 § 402(e).

33. *E.g.*, Treas. Reg. 80, art. 24 (1934), *reprinted in* 139 INTERNAL REVENUE ACTS OF THE UNITED STATES, 1909-1950, LEGISLATIVE HISTORIES, LAW, AND ADMINISTRATIVE DOCUMENTS 47 (1979).

34. Morgan v. Commissioner, 309 U.S. 78, 81 (1940).

gardless of whether the particular power was classified as a general power of appointment under applicable state property law.[35]

The estate tax statutes concerning powers of appointment remained the same from 1918 until 1942.[36] During this period, the Supreme Court had a number of opportunities to construe these statutes. By and large, the decisions continued to interpret the tax statute based upon property law concepts. For example, in *Helvering v. Grinnell*,[37] the Court held that property subject to a general power of appointment which was exercised by the decedent in her will was nonetheless not taxable to her estate because the same persons would have taken the property in default of the exercise of the power of appointment. The power had been exercised validly by will; however, the takers in default had renounced the powerholder's will and had taken under the default clause in the will creating the power. Therefore, the Court reasoned, the instrument that effected the transfer was the will creating the power and designating the alternate takers, rather than the powerholder's will. On the other hand, several years later in *Rogers v. Commissioner*,[38] the Supreme Court held that property subject to a general power of appointment exercised validly in favor of a taker in default was subject to estate tax in the powerholder's estate because the interest appointed was smaller than the interest that would have been taken by the same beneficiary in default of appointment.

In *Helvering v. Safe Deposit & Trust Co.*,[39] the Supreme Court held that property subject to an unexercised general power of appointment was not subject to estate tax in the powerholder's estate. This decision is hardly surprising insofar as the section of the estate tax statute dealing with powers of appointment is concerned, because the applicable statute referred explicitly to exercised general powers of appointment.[40] The far more significant holding was the Court's disposition of the government's alternate grounds for including the appointive property in the powerholder's estate. In addition to his general powers of appointment in several trusts, the decedent in *Safe Deposit & Trust Co.* had the right to income from the trusts and would have received the principal of one trust outright had he lived to the age of twenty-eight. The government argued that property in which a decedent had

35. *Id.* at 80.

36. C. LOWNDES, R. KRAMER & J. MCCORD, FEDERAL ESTATE AND GIFT TAXES § 12.2 (3d ed., 1974) [hereinafter cited as LOWNDES].

37. 294 U.S. 153 (1935).

38. 320 U.S. 410 (1943).

39. 316 U.S. 56 (1942).

40. Revenue Act of 1926, ch. 27 § 302(f), 44 Stat. 9, 70, (the same as Revenue Act of 1918 § 402(e)).

all of these interests should be taxed to his estate under the predecessor to section 2033[41] because these interests together constituted the substantial equivalent of fee simple ownership. This argument was essentially a plea for application to the general estate tax section of the same analysis applied to the predecessor of income tax section 61 in *Helvering v. Clifford*,[42] decided just two years earlier. In rejecting the "substantial equivalent" test in *Safe Deposit & Trust Co.*, the Court held that the legislative history of the estate tax provisions, unlike that of the income tax provisions, indicated clearly that they were to be construed narrowly.[43] Although this decision is not without support in the legislative history, it was unfortunate in that it set the stage for many of the problems that have plagued drafters and enforcers of the federal transfer tax statutes in the forty years since *Safe Deposit & Trust Co.* was decided.[44]

For several years prior to the decision in *Safe Deposit & Trust Co.*, commentators had become increasingly critical of the pattern of estate taxation applicable to powers of appointment.[45] Their arguments tended to cluster around the same issues argued by the Commissioner of Internal Revenue (Commissioner) in *Safe Deposit & Trust Co.* First, they pointed out that there was no reason to distinguish between exercised and unexercised powers for transfer tax purposes because the failure to exercise the power was really a transfer of the subject property to the takers in default. Second, a growing number of commentators believed that there were a variety of powers that, while they could not be exercised in favor of the powerholder, gave the powerholder sufficient control over others' enjoyment of the property to justify subjecting the property to transfer tax upon the exercise or lapse of the power. Proponents of this argument pointed principally to the need for vertical equity. They argued that a transferor could afford to exclude only a very wealthy powerholder from the class of beneficiaries to whom the powerholder might appoint the property. Thus the very people who could most easily bear the tax burden were in the best position to escape taxation. Congress was persuaded that the first argument was correct and provided in the

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41. *Id.* at § 302(a).
42. 309 U.S. 331 (1940).
43. 316 U.S. at 58, n. 1.
44. For a recent article arguing for use of the substantial ownership test as a unifying principle in reform of our federal transfer taxes, see, Dodge, *Substantial Ownership and Substance Versus Form: Proposals for the Unification of Federal Estate and Gift Taxes and for the Taxation of Generation-Skipping Transfers*, 1976 U. ILL. L.F. 657 (1976).
45. *E.g.*, Griswold, *Powers of Appointment and the Federal Estate Tax*, 52 HARV. L. REV. 929 (1939) [hereinafter cited as Griswold].

Revenue Act of 1942 for taxation in the estate of the powerholder of property subject to certain powers of appointment, whether exercised or not.[46]

The question of which powers were sufficiently similar to outright ownership to justify transfer taxation of the powerholder upon their exercise or lapse proved more difficult to answer. Some commentators, led by Louis Eisenstein[47] and Erwin Griswold,[48] believed that property subject to any power of disposition, except a power held by a "disinterested" fiduciary, that is, one who had no beneficial interest in the property, should be subject to transfer tax. Dean Griswold added that the tax should come from the fund subject to the power, rather than other property of the powerholder.[49] The principal reason given by these commentators for their point of view was that a truly equitable transfer tax must reach all property that the taxpayer has power to dispose of, whether or not he can consume the property himself. Another group of commentators, led by Barton Leach, believed that the taxation of the exercise or lapse of nongeneral powers was less equitable than excluding them from the transfer tax base.[50] Proponents of this point of view believed that such a tax would force property owners into unnecessarily rigid estate plans, since the bequest of income to a child for life with remainder to the child's children would not attract a transfer tax at the child's death, while a bequest of income to a child for life, with remainder to those of the child's children as the child might appoint would be subject to tax at the child's death.

There are a number of responses to Professor Leach's assertion, including, of course, the proposal that the death of the child with only a life estate ought to be a taxable event. Not surprisingly, many of the adherents to Dean Griswold's position were also early proponents of the generation-skipping transfer tax.[51] Indeed, as will be noted below,[52] the pattern of taxation advocated for generation-skipping transfers may also be the most effective way of taxing transfers pursuant to the exercise or lapse of a

46. Revenue Act of 1942 § 403(a) (enacting I.R.C. § 811(f)(1) (1939)). Powers created prior to October 21, 1942 were excepted from the Act. Revenue Act of 1942 § 403(d)(3). This distinction is preserved in current law. I.R.C. § 2041(a)(1). *See*, note 61 *infra* for grandfather provisions applicable to pre-1942 powers.

47. Eisenstein, *Powers of Appointment and Estate Taxes*: I, 52 YALE L. J. 296 (1943) & II, 52 YALE L. J. 494 (1943) [hereinafter cited as Eisenstein].

48. Griswold, *supra* note 45.

49. *Id.*

50. Leach, *Powers of Appointment and the Federal Estate Tax—A Dissent*, 52 HARV. L. REV. 961 (1939) [hereinafter cited as Leach].

51. *See, e.g.*, Eisenstein, *supra* note 47.

52. *See* text accompanying notes 310-322 *infra*.

power of disposition. However, in order to advocate transfer taxation of property upon the termination of the interest of a beneficiary who has no power to determine the next owner of the property, one must believe that a mere shift in beneficial interest in the property predetermined by the last grantor should be a taxable transfer. Such a drastic change in the scope of our federal transfer taxes was not to be considered seriously by Congress until thirty years later.

Nevertheless, within the context of our traditional estate and gift taxes, proponents of Dean Griswold's view distinguished between the child with only a life estate and the one with both a life estate and a limited power of disposition. The child who possesses the nongeneral power of appointment has the right to determine whether any given member of the potential appointive class will receive any property and, if so, how much. The family should pay a transfer tax for the additional flexibility gained by using this power to transfer. Indeed, one could have argued that a person with no life interest but only a limited power of disposition over the property had a sufficient interest so that the lapse of that power at his death should be taxed. However, there seems to have been general agreement that one who possessed power to allocate property among members of a class, without having any beneficial interest in the property, was indistinguishable from a trustee, for this purpose, and that neither the powerholder nor the trustee should be subject to transfer tax upon the exercise or lapse of the power. The taxation of property subject to powers of disposition in the early 1940's was still discussed in the context of whether the powerholder was to be treated as an "owner" of the property, rather than whether the exercise or lapse of the power caused a shift in interest between two beneficiaries neither of whom was the powerholder.

Although the Revenue Act of 1942 embodied a compromise on the subject of nongeneral powers, it substantially expanded the class of powers that rendered the appointive property subject to estate tax upon the death of the powerholder. A decedent's gross estate included property subject to any power of appointment whether or not it was exercised and, with two exceptions, whether or not it was general.[53] The two exempted powers were those that limited the class of appointees to members of the donee's immediate family or that of the donor or to a charity and powers that could be exercised only by a disinterested fiduciary (that is, one who did not possess a beneficial interest in the property) in favor of a restricted class of persons.

53. Revenue Act of 1942 § 403.

The powers of appointment provisions of the Revenue Act of 1942 were subject to extensive criticism. Not only were Professor Leach's criticisms renewed, but the exception for special powers to appoint in favor of the lineal descendants of the grantor or the powerholder was further criticized as establishing an arbitrary line between taxable and nontaxable powers.[54] Indeed, the exception for powers to appoint to lineal descendants had been suggested as a solution to Professor Leach's concerns about the unnecessary distinction between a life estate with remainder to one's children and a life estate with special power to appoint to one's children. Although Professor Leach had admitted that such an exception would solve his problem, he also noted that it would probably except from federal estate tax ninety-nine percent of the powers that were granted. He therefore suggested that the Act specifically enumerate those powers that were to be taxed, rather than including an exception that would swallow the rule.[55]

Some of the criticisms leveled at these provisions of the Revenue Act are well taken. For example, there is no reason to distinguish between a nongeneral power to appoint to lineal descendants and a nongeneral power to appoint to collaterals exercisable by someone who has no lineal descendants. Furthermore, it was never clear whether the term "restricted class" meant only those potential appointees who would also have been in the excepted special power class or any group, so long as its members were identified specifically.

However, it is not clearly unreasonable to tax the exercise or lapse of a nongeneral power to appoint among a class of persons that does not include the powerholder. This is particularly true if the tax is to come out of the fund subject to the power, rather than out of other assets of the powerholder's estate.[56] Under such a pattern of taxation, the tax reduces only the amount of appointive property received by the powerholder's designees or the takers in default. It cannot affect the amount of other property transferred by the powerholder from other sources.

During the late 1940's, a number of professional legal groups, including the American Bar Association (ABA), took the position that only powers exercisable in favor of the powerholder, his es-

54. *See, e.g.*, Buck, Craven, & Shackelford, *Treatment of Powers of Appointment For Estate and Gift Tax Purposes*, 34 VA. L. REV. 255 (1948).

55. *See* Leach, *supra* note 50, at 966.

56. *Cf.* Griswold, *supra* note 45, at 950. I.R.C. § 2207, which was originally enacted as I.R.C. § 826(d) (1939) in the Revenue Act of 1942 § 403(c), permits a deceased powerholder's executor to recover from the recipient of the property the portion of the estate tax attributable to the inclusion in the estate of the appointive property, unless the powerholder's will provides otherwise.

tate, or his creditors should be taxed to his estate.[57] Among the ABA's reasons for its position was that only such a power is the equivalent of outright ownership and that no property should be taxed to a decedent's estate unless he has enjoyed the equivalent of outright ownership of it.

Ultimately, Congress accepted the ABA's position in enacting the Powers of Appointment Act of 1951.[58] Its stated purpose in choosing this position was to draft a statute that was easy to understand and comply with; Congress recognized that the amount of revenue produced by compliance would be negligible.[59]

The Powers of Appointment Act of 1951 was made effective retroactively to October 21, 1942, and applied to the estates of decedents dying on or after that date.[60] Since these are the effective dates of the 1942 Act, the 1951 Act eliminates the 1942 provisions as though they had never been passed.

To preserve the status of powers created before the enactment of the 1942 legislation, the 1951 Act also provides explicitly that property subject to a general power of appointment created before October 21, 1942, and exercised at the death of the decedent will be includible in his gross estate, but that the nonexercise or release of such a power will not result in inclusion.[61]

There has been no substantial amendment to the federal estate taxation of property subject to a power of appointment since 1951. Thus, under current law, only property that the decedent could have appointed to himself, his estate, his creditors, or the creditors of his estate is subject to federal estate tax at his death.[62] Courts have held consistently and correctly that it should not matter that the powerholder acts in a fiduciary capacity rather than

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57. Craven, *Powers of Appointment Act of 1951*, 65 HARV. L. REV. 55, 61-64 (1951) [hereinafter cited as Craven].

58. Powers of Appointment Act of 1951 § 2(a), enacting I.R.C. § 811(f)(3), presently codified at I.R.C. § 2041(b).

59. S. REP. No. 382, 82d Cong., 1st Sess. (1951), *reprinted in* 1951 U.S. CODE CONG. & AD. SERV. 1530 [hereinafter cited as S. REP. on 1951 Act].

60. The Powers of Appointment Act of 1951 § 2(c).

61. *Id.* at § 2(a), enacting I.R.C. § 811(f)(1) (1939), presently codified at I.R.C. § 2041(a)(1). The Act also contained several other grandfather provisions, including one that treated as a pre-October 21, 1942, power any power created in a will dated before that date, provided the testator had died before July 1, 1949, without republishing the will after October 21, 1942, and one providing a grace period for the tax-free partial release of a pre-1942 power before November 1, 1951. Such a release was not subject to gift tax, nor is the exercise or lapse of the limited power subject to estate or gift tax.

Unless otherwise noted, this article will deal exclusively with powers created after the effective date of the Powers of Appointment Act of 1951.

62. I.R.C. § 2041(b)(1).

an individual capacity, so long as he may appoint the property to one of the four classes of beneficiaries listed in the statute.[63]

B. Current Law

By and large, Congress succeeded in its goal of making the statute "simple and definite enough to be understood and applied by the average lawyer,"[64] insofar as taxable general powers of appointment are concerned. However, section 2041(b) contains exceptions to the definition of general power of appointment that are in conflict with this goal. Their purpose, apparently, is to exempt from transfer tax certain types of commonly used general powers. The legislative history of the section is unclear, but this seems to be another instance in which Congress was persuaded to except a class of common transfers from the burden of taxation on the ground that the taxpayer was entitled to eliminate, or at least reduce, the tax burden on his beneficiaries, provided he used the most common estate plans.[65] Only "unusual" transfers are to be taxed. The wisdom of this reasoning is obviously questionable. But section 2041(b) is subject to additional criticism: not only is it overly generous to those who comply with its terms, but it is highly technical. Those who wish to take advantage of it must have the wit to hire skilled tax counsel.

Thus, a statute drafted to prevent trapping the unwary has itself proven a trap for the unwary.

1. Power to Consume Subject to an Ascertainable Standard

Section 2041(b)(1)(A) excepts from the definition of general power of appointment a power to consume, invade, or appropriate property for the powerholder's benefit that is limited by an ascertainable standard relating to the powerholder's health, education, support, or maintenance. The legislative history of the 1951

63. *See, e.g.*, Maytag v. United States, 493 F.2d 995 (10th Cir. 1974); Miller v. United States, 387 F.2d 866 (3d Cir. 1968); Estate of Lanigan v. Commissioner, 45 T.C. 247 (1965).

64. S. REP. on 1951 Act, *supra* note 59, at 1531.

65. *Id.* at 1535-36. The policy of subjecting only unusual transactions to tax seems to be peculiar to transfer taxation, where it is quite common. For a more recent example, see H.R. REP. 94-1380, 94th Cong., 2d Sess. 53 (1976) [hereinafter cited as H.R. REP. on 1976 Act]. The practice has frequently and justly been the subject of criticism. *See, e.g.*, Verbit, *Annals of Tax Reform: The Generation-Skipping Transfer*, 25 UCLA L. REV. 700 (1978); Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

Powers of Appointment Act contains no guidance as to the meaning of the phrase "relating to." The regulations, however, make it clear that it is not necessary to use the words "health, education, support, or maintenance" in order to exclude the property subject to the power from the decedent's gross estate. For example, the regulations state that the following are properly limited powers: "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed standard of living." However, the regulations also state that a power to appropriate property for "the comfort, welfare, or happiness of the holder" is not a properly limited power.[66] It is unfortunate that the Treasury Department did not simply define the words health, education, maintenance, and support, rather than adding terms that the courts must test against the statutory standard. Not surprisingly, substantial litigation has been generated as taxpayers and the Commissioner have attempted to determine which standards qualify under section 2041(b)(1)(A) and which leave the decedent with a general power taxable in his or her estate.[67]

This exception can be criticized from two standpoints. First, the standard is difficult for courts to deal with because its application requires a determination of whether the particular words used in the governing instrument constitute an ascertainable standard under the applicable state law, and because it is similar to but not identical with a judicial exception to sections 2036 and 2038, provisions dealing with inclusion of certain previously transferred property in the estate of the transferor. Second, it is difficult to understand why property subject to such a power of invasion should not be included in the powerholder's gross estate.

Sections 2041(b)(1)(A) and 2514(c)(1) are unique in the wealth transfer tax law in that they contain an explicit exception for powers subject to ascertainable standards. The ascertainable standards exception began as a judicial exception to the rules concerning the estate tax charitable deduction[68] and was extended to exclude certain transfers that would otherwise have been taxable to the estate of the grantor by virtue of retention of certain powers.[69]

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66. Treas. Reg. § 20.2041-1(c)(2).

67. A recent article cites over thirty cases and rulings in which the issue was whether language purporting to limit the scope of a power of invasion constituted an ascertainable standard. Randall and Schmidt, *The Comforts of the Ascertainable Standard Exception*, 59 TAXES 242 (1981).

68. Ithaca Trust Co. v. United States, 279 U.S. 151 (1929).

69. *See, e.g.*, Bittker, *Transfers Subject to Retained Right to Receive the Income or Designate the Income Beneficiary*, 34 RUTGERS L. REV. 668, 685-88 (1982); Pedrick, *Grantor Powers and Estate Taxation: The Ties that Bind*, 54 NW. U.L. REV. 527 (1959); Note, *The Doctrine of External Standards Under Sections 2036(a)(2) and 2038*, 52 MINN. L. REV. 1071 (1968).

The judicial exception is justified as follows: Any standard that is "ascertainable," that is, readily capable of precise definition by a state court in a proceeding to construe the governing instrument, gives the other beneficiaries of the transfer an enforceable right against the grantor or charitable beneficiary whose interest is subject to the standard. The person whose interest is limited by such a standard may consume the property only for the defined purposes; and because his interest is thus circumscribed, he does not have the type of control that the statute was intended to tax.[70]

In the case of section 2041, the ABA argued and Congress apparently agreed that the right to use the property only for one or more of the enumerated purposes should not result in taxation to the estate of a powerholder because it would not result in taxation as a retained interest in the estate of a grantor.[71] The practical difficulties caused by section 2041(b)(1)(A) are that it is not the same as the judicial exception to sections 2036 and 2038, and that, like the judicial exception, it requires an inquiry into the applicable state law to determine whether the limiting language in each instrument of transfer creates a standard that falls within the exception.[72] The judicial exception to sections 2036 and 2038 excludes from taxation property subject to *any* ascertainable standard. Therefore, under those sections the courts must deter-

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70. With respect to the federal estate tax charitable deduction, the exception for interests subject to ascertainable standards is a rule of valuation. It developed before the Tax Reform Act of 1969 (Pub. L. No. 91-172, § 201(d) (1969), 83 Stat. 487, 560) was enacted, adding the more stringent standards that taxpayers must now meet under I.R.C. § 2055(e) to receive the federal estate tax charitable deduction for a charitable remainder interest. Prior to 1969, it was possible to create a qualifying charitable remainder by using the same terms of transfer as could be used to create any other remainder. The principal requirement for deductibility was that the remainder be "presently ascertainable, and hence severable from the noncharitable interest." Treas. Reg. § 20.2055-2(a). If the principal of the charitable remainder trust could be invaded for the benefit of the income beneficiary, it was uncertain that any of the property would pass to charity; hence, the deduction was denied. In *Ithaca Trust Co.*, 279 U.S. at 154-55, the Supreme Court held that the language of the trust instrument created a power to invade only to maintain the income beneficiary at her accustomed standard of living. Such a power was ascertainable, that is, subject to valuation. And, since the income of the trust was sufficient to maintain her at that level, it was virtually certain that the principal would never be diverted from charity. Therefore, the Court held that the remainder interest was deductible under the predecessor of I.R.C. § 2055.

Dissatisfaction with the subsequent development of the ascertainable standards exception was one of the factors that led Congress to enact the more stringent rules of the Tax Reform Act of 1969. *See generally*, LOWNDES, *supra* note 36, at §§ 16.7-16.9.

71. Craven, *supra* note 57, 64, 72.

72. *See generally* Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

mine only whether the standard is capable of definition under state law; under section 2041, they must also decide whether the state law definition limits exercise of the power exclusively to invasion for the health, education, maintenance or support of the powerholder.

The determination of which powers are properly limited under section 2041(b)(1)(A) should not be difficult. Clearly, a power that is limited explicitly solely to use for health, education, support, or maintenance is a power limited by the appropriate standard. It should not matter whether the exact four words of the statute are used, so long as the terms chosen are synonymous, under state law, with some or all of the words in the statute. Conversely, a power which permits the decedent to invade for purposes other than the four listed in the statute should be considered a general power, even though the words of the statute are also used. For the most part, the courts have no trouble finding that a power to invade for both permissible and impermissible purposes is a general power and not one subject to the appropriate ascertainable standard. Thus, a power to invade for "support, maintenance, comfort and welfare"[73] or "not only for her support and maintenance but also for her comfort and pleasure"[74] or "for her comfort, maintenance and support"[75] or "for his care, comfort or enjoyment"[76] have been found to grant the powerholder a general power of appointment rather than one limited by an ascertainable standard. In one recent case, however, the Seventh Circuit has found that a power to use property for the powerholder's "maintenance, comfort and happiness" was a power limited by an ascertainable standard under Massachusetts law. *Brantingham v. United States*[77] holds that under Massachusetts law the right of a legal life tenant to invade corpus under the language quoted above is a nongeneral power under section 2041(b)(1)(A). Although the court does not state specifically that the standard is one relating to health, education, maintenance, and support, the opinion relies heavily on the opinion of the Massachusetts Supreme Judicial Court in *Dana v. Gring*,[78] which states that under Massachusetts law a power to invade for the powerholder's "reasonable welfare and happiness" is limited by an ascertainable standard relating to the health, education, maintenance, and support of the powerholder.[79]

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73. Lehman v. United States, 448 F.2d 1318, 1320 (5th Cir. 1971).
74. Estate of Schlotterer v. United States, 421 F. Supp. 85, 87 (W.D. Pa. 1976)(emphasis omitted).
75. Doyle v. United States, 358 F. Supp. 300, 302 (E.D. Pa. 1973).
76. Stafford v. United States, 236 F. Supp. 132, 133 (E.D. Wis. 1964).
77. 631 F.2d 542 (7th Cir. 1980).
78. 374 Mass. 109, 371 N.E.2d 755 (1977).

The Internal Revenue Service (Service) has issued a ruling stating that it will not follow *Brantingham.*[80] The Ruling is somewhat disappointing because the Service does not base its nonacquiescence upon the obvious ground that the language used in the instrument is proscribed explicitly by the regulations[81] and therefore does not raise a question of state law,[82] nor does it argue that the Supreme Judicial Court of Massachusetts misconstrued the governing instrument in the *Dana* case. Rather, the Service takes the position that, even if *Dana v. Gring* is correctly decided, it is inapplicable in the *Brantingham* situation. The powerholder in *Dana* was also a co-trustee and thus her right to exercise the power would have been limited to the purposes of health, education, maintenance, and support by her fiduciary obligations under Massachusetts law.[83] In *Brantingham*, on the other hand, the powerholder was a legal life tenant whose power to invade the corpus of the subject property was not so limited. This reasoning avoids the issue; the key here is construction of the governing instrument. Clearly one can be both a general powerholder and a trustee under the same instrument, and it is as reasonable to say that the explicitly granted right to invade for one's happiness abrogates one's fiduciary obligations as it is to say that the implied duty limits the power.

The courts, and occasionally the Service, have been less successful in analyzing words which appear to set an ascertainable

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79. The taxpayers in *Dana v. Gring* were the executors of the estate of a deceased powerholder. Apparently, they pursued their state suit to the Supreme Judicial Court in order to preclude the federal court's hearing their suit for refund of estate taxes from making an independent determination of Massachusetts law, pursuant to Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). The action in *Dana* was commenced 3 1/2 months after the executors received notification that the agent auditing the federal estate tax return of the deceased powerholder had determined that the power was general and that the property subject to it was taxable in the powerholder's estate. 374 Mass. at 112-13, 371 N.E.2d at 757. The executors also paid the deficiency assessed and filed a protest and a claim for refund. They gave notice of the state court action to the Internal Revenue Service, but it declined to appear in the lower court proceedings. 374 Mass. at 110, 371 N.E.2d at 756. The executors requested and received leave to appeal directly to the Supreme Judicial Court. The United States eventually filed an *amicus curiae* brief in the Supreme Judicial Court.

80. Rev. Rul. 82-63, 1982-1 C.B. 135.

81. Treas. Regs. § 20.2041-1(c)(2).

82. Apparently, the Service did argue this unsuccessfully in Dana v. Gring, 374 Mass. at 110-11, 371 N.E.2d at 756.

83. The Service lost a similar battle recently in Finlay v. United States, 752 F.2d 246 (6th Cir. 1985). The Sixth Circuit held in *Finlay* that a power held by a sole trustee to invade the principal of a trust for her own benefit "if she desires" was a nongeneral power under I.R.C. § 2041(b)(1)(A) because, under applicable state law, a trustee owes a fiduciary duty to the remainderpersons of the trust to limit invasions to items of maintenance and support.

standard under state law but which do not use the terms of the statute or the regulations. Among the powers that seem to give the greatest difficulty are those limited to maintenance of the powerholder's standard of living and those limited by such words of financial exigency as "emergencies," "requirements," or "needs" of the powerholder. The regulations state that a section 2041(b)(1)(A) power is one exercisable only for items necessary to sustain the powerholder, that is, food, clothing, shelter, medical care, and education.[84] However, sustenance need not be subsistence; the powerholder who may use the property to satisfy his needs at the level to which he has generally been accustomed has a nongeneral power. This is clearly consistent with the language of the statute. However, it is equally clear that a power to invade to pay for items that are part of the powerholder's accustomed standard of living but that are not related to health, education, maintenance, and support cannot be a section 2041(b)(1)(A) power.[85]

Similarly, a power to invade for "emergencies" or "needs" is a general power. Although it is subject to an ascertainable standard, it is not an ascertainable standard that limits the invasion solely to the purposes of health, education, maintenance, or support. In 1978, the Service ruled that the power to invade corpus for "emergency or illness" was a general power, noting that the word "emergency" does not ordinarily refer to any particular type of need but rather to the immediacy of the need.[86] Clearly, this is the correct result. Recently, however, the Tenth Circuit reached the opposite result. In *Estate of Sowell v. Commissioner*[87], the decedent had the power, as trustee of a trust under her husband's will, to invade the corpus of the trust for her own benefit "in cases of emergency or illness." The court began by stating, correctly, that it must first decide whether the standard was "ascertainable," that is, one which is "capable of being readily interpreted and applied by a court of law," and, second, whether the standard is "related to" the types of needs listed in section 2041(b)(1)(A), that is, measurable in terms of the decedent's health, education, maintenance, and support. The court attempted to resolve the first question by stating that the power was not a general power because the word "emergency" is synonymous with the word "need;" *i.e.*, the court merely substituted one undefined term for another.

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84. Treas. Reg. § 20.2041-1(c)(2).

85. Rev. Rul. 77-60, 1977-1 C.B. 282 (power to invade "to continue the donee's accustomed standard of living" is a general power). *But see*, Ltr. Rul. 7914036 (power to invade "to maintain standard of living to which he or she was accustomed" is a § 2041(b)(1)(A) power).

86. Ltr. Rul. 7841006.

87. 708 F.2d 1564 (10th Cir. 1983).

The court did not assert that the power to invade was limited to those needs or emergencies related to health, education, maintenance, and support. In support of its reasoning, the Tenth Circuit cited two inapposite cases. In *Pittsfield National Bank v. United States*,[88] the court simply applied the same faulty reasoning as did the court in *Sowell* to the issue of whether the word "need" constitutes an ascertainable standard relating to health, education, maintenance, and support under section 2041(b)(1)(A). *Funk v. Commissioner*,[89] was an income tax case. As will be discussed below,[90] section 678, dealing with the treatment of a powerholder as owner of trust property for income tax purposes, contains no limitation similar to that in section 2041(b)(1)(A). The *Sowell* court simply failed to apply the test it articulated in determining whether a power to invade for emergencies is to be treated as a general power under section 2041(b)(1)(A).

Ironically, the power to invade for emergencies may have been the only power Congress intended to except from the definition of a general power under section 2041(b)(1)(A). The legislative history of the 1951 Act notes that one of the sources of dissatisfaction with the scope of the 1942 Act was that it might be construed to extend to "emergency powers to invade principal ... powers which had theretofore not been regarded as powers of appointment."[91] Congress may have intended to limit exemption to those powers that closely resemble powers subject to a contingency beyond the powerholder's control.[92] However, the statute as drafted is not so restricted.

An additional anomaly is the triggering of a tax under section 2041[93] by a lapse at death of a power to use property for the support or maintenance of a person (other than the powerholder) whom the powerholder is legally obligated to support. Similarly, section 2036 includes in a grantor's gross estate property which he retained the right to use for the support of one whom he was

88. 181 F. Supp. 851 (D. Mass. 1960).

89. 185 F.2d 127 (3d Cir. 1950).

90. *See* text accompanying notes 200-28, *infra.*

91. S. REP. on 1951 Act, *supra* note 59, at 1531.

92. *Cf.* Treas. Reg. § 20.2038-1(b) (property over which a grantor retained such power is not includible in the grantor's gross estate under I.R.C. § 2038); Jennings v. Smith, 161 F.2d 74 (2d Cir. 1947) (power of grantor-trustee to invade principal for "prolonged illness or financial misfortune" did not render trust property includible in grantor's estate under the predecessors of I.R.C. §§ 2036 or 2038, I.R.C. §§ 811(c) and 811(d)(2) (1939)); *but cf.* Treas. Reg. § 20.2036- 1(b)(3) (property over which a grantor retained power subject to a contingency which was beyond the grantor's control and which did not occur before his or her death is includible in the grantor's gross estate under I.R.C. § 2036).

93. Treas. Reg. § 20.2041-1(c).

legally obligated to support.[94] Thus, sections 2036 and 2041 tax a decedent who had power to use property for the benefit of another, but do not tax a decedent who could use it in the same manner for his own benefit.

Furthermore, in a majority of states, a power to invade for the health, education, maintenance or support of the powerholder may be exercised without regard to the actual financial resources of the powerholder, unless the creating instrument provides otherwise.[95] Indeed, the regulations under section 2041 state that it is immaterial for federal estate tax purposes whether the beneficiary is required to exhaust his other income before the power can be exercised.[96] In the case of a wealthy powerholder, the question becomes which pocket support expenses will be paid out of. A powerholder who plans to leave his property to the same individuals as will ultimately receive the property subject to the power, or who has a nongeneral testamentary power to appoint the property to them, can enjoy considerable tax savings by paying living expenses out of his own resources and depleting them first, since the property subject to the power will not be subject to estate taxation at the death of the powerholder while property that he owns outright will.

The ultimate question, of course, is whether the distinction between a general power of appointment and a section 2041(b)(1)(A) power is meaningful for transfer tax purposes. One who has a section 2041(b)(1)(A) power obviously does not have the unfettered right to use the property for any purpose. He does, however, have the unfettered right to decide, without regard to his other assets, whether he will use the property for certain purposes for his own benefit or permit it to pass to others. It is difficult to find a meaningful difference between the extent of the powerholder's control over the transfer to the ultimate beneficiaries, whether he is given a general power of appointment or a section 2041(b)(1)(A) power. Initially, it might appear that the best solution to this problem is to repeal sections 2041(b)(1)(A) and 2514(c)(1). Unfortunately, that would simply encourage grantors to give the same power to invade for the beneficiary's benefit to a friendly trustee, that is, one who could be relied upon to exercise it as the beneficiary wished. The permissible recipient of a trustee's discretionary invasions of principal for health, education, maintenance, and support is not subject to estate tax on the subject property, regardless of the identity of the trustee. There is no federal estate tax provision that treats the beneficiary's death as a transfer. Even if sections

94. Treas. Reg. § 20.2036-1(b)(2).
95. SCOTT, THE LAW OF TRUSTS § 128 (3d ed. 1967).
96. Treas. Reg. § 20.2041-1(c)(2).

2041(b)(1)(A) and 2514(c)(1) were repealed and the judicial exception to sections 2036 and 2038 were overruled legislatively, such a beneficiary would not be subject to estate tax unless he could remove the trustee and appoint himself as trustee. As long as we are willing to exclude property subject to such a fiduciary power from the beneficiary's estate and gift tax base, including property subject to a limited power of appointment will be no more than a trap for those who fail to obtain good legal advice prior to planning for the disposition of their estates.

The foregoing is not intended to suggest that our pattern of transfer taxation should exclude from the beneficiary's estate property subject to such a discretionary power of invasion. Indeed, the belief that such property should be subject to transfer tax on the death of the beneficiary has always been one of the major reasons cited for enactment of the generation-skipping transfer tax. The decision not to include property subject to fiduciary powers of invasion in the beneficiary's estate and gift tax base is due largely to administrative, rather than policy, considerations. It is a relatively simple matter to draft a statute requiring inclusion of the trust principal in the estate of the beneficiary when the trust has a single beneficiary for whom principal may be invaded. However, most discretionary trusts have more than one beneficiary. Indeed, such trusts are usually created precisely because the grantor wishes to give the trustee flexibility to make unequal distributions among a number of beneficiaries whose individual future needs cannot be predicted accurately and are likely to fluctuate over time. Therefore, any statute that requires inclusion of property subject to such powers in the estate of the beneficiary must include rules to deal with trusts that have multiple discretionary beneficiaries. The statute must address such issues as whether to treat each exercise in favor of one beneficiary as a gift made by the others, and what proportion of the property should be included in the estate of each beneficiary.[97] Even if such rules can be drafted, they will likely achieve relatively minor increases in revenue and equity, while requiring executors and trustees to engage repeatedly in complex and time-consuming valuation of fractional interests.

Because the generation-skipping transfer tax is assessed on the entire trust fund once per generation, it eliminates the need to deal with many of these administrative issues. At the death of the last beneficiary who was a member of the next generation

97. *See*, Dodge, *Substantial Ownership and Substance Versus Form: Proposals for the Unification of Federal Estate and Gift Taxes and for the Taxation of Generation-Skipping Transfers*, 176 U.ILL.L.F. 657 (1976).

younger than the grantor, the trust principal is valued, and a tax calculated. The tax is payable out of the trust fund.[98]

The Treasury Department has proposed recently that the problem created by sections 2041(b)(1)(A) and 2514(c)(1) be eliminated by treating as general powers of appointment only those powers that permit the powerholder unlimited discretion to vest property in himself or herself.[99] The stated purpose of this suggestion[100] is to make the estate and gift tax provisions more like the income tax provision.[101] The Treasury Department also points out that estate or gift taxation of property subject to powers of appointment would be unnecessary if the generation-skipping transfer tax were always imposed at the powerholder's generation.[102] In light of the foregoing discussion of the administrative complexities of taxing discretionary trusts, it seems clearly preferable to impose the generation-skipping transfer tax rather than the estate or gift tax on property subject to such powers.

Such a change will reduce substantially the incidence of transfer taxation on property subject to powers of appointment. Under the current generation-skipping transfer tax[103] and the Treasury Department proposal,[104] property subject to the powerholder's right of invasion would not be taxed until the death of the last member of his generation who has a present interest. Therefore, there is considerable opportunity for tax deferral. Secondly, under the Treasury Department proposals, generation-skipping transfers are not taxed until they exceed one million dollars per grantor, regardless of the size of the estates of the members of the skipped generation.[105] However, if the proposal is otherwise sound, this criticism can be answered by reducing the per grantor exclusion. It is more significant that the lapse of such a power to

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98. The generation-skipping pattern of taxation is discussed in detail in section VI(B)(1) *infra*.

99. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 384. The Proposals are written in narrative form; they do not contain suggested statutory language. Apparently, the proposal concerning estate and gift taxation of powers of appointment contemplates the redrafting of the definition sentences of I.R.C. §§ 2041(b) & 2514(c) and deletion of the exceptions.

100. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 385.

101. For a discussion of the income tax consequences of having a power of appointment, see section V *infra*.

102. For a discussion of the generation-skipping transfer tax provisions dealing with the exercise or lapse of powers of appointment, see section VI(B)(2) *infra*.

103. I.R.C. § 2613(b)(2)(A).

104. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 389-93; *see* text accompanying notes 355-360 *infra*.

105. *Id.* at 390.

consume at the powerholder's death, or the exercise of it in favor of a third person during life or at death, will not attract any transfer tax under the Treasury Department proposals if the next transferee of the property is a member of the powerholder's generation or of an older generation, or if the powerholder was a member of the generation of the transferor who created the power or of an older generation.[106] Apparently, this reduction in the incidence of taxation is intentional. The Treasury Department now takes the position that wealth should not be subject to estate tax more often than once per generation. To implement this policy, the Proposals include an amendment to section 2013 to give an estate full credit against its estate tax liability for any estate tax paid upon the transfer of property includible in the estate from a member of the decedent's generation or a lower generation.[107] Therefore, only the appreciation in value during the powerholder's life of property subject to a taxable power would be taxed to his estate if he received the property from a member of his own generation or a younger generation. If the powerholder received the power from a member of an older generation, the property would be fully taxable to his estate, but, if the transferee were a member of the powerholder's generation or an older generation, the estate of the transferee would receive a full credit for the tax paid. In other words, if the Treasury Department 1984 Proposals are passed, eliminating the estate and gift tax on property subject to certain powers of appointment will reduce the incidence of taxation of such property relative to the current taxation of property owned outright. However, it will be consistent with the new taxation of property owned outright. In view of the difficulty of drawing the line under the current estate and gift taxes between powers that are equivalent to ownership (taxable) and those that are merely a (nontaxable) beneficial interest, taxation of all wealth transmission once per generation seems to be the simplest and most equitable solution.

2. Jointly Exercisable Powers

In 1933, the Supreme Court held that a power of appointment exercisable only with the consent of another, even a disinterested trustee, was not a general power of appointment.[108] Therefore,

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106. I.R.C. §§ 2611(a), 2613(a)(1), and 2613(b)(1); *see* text accompanying notes 315-17 and 323-25 *infra*. The TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, will not change these provisions.

107. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 394. No similar credit is suggested with respect to the gift tax.

108. Reinecke v. Smith, 289 U.S. 172 (1933).

property subject to such a power would not have been subject to estate tax at the death of the powerholder. The Revenue Act of 1942 broadened the tax base to include property subject to nongeneral powers of appointment and included explicitly within its definition of taxable powers of appointment those exercisable alone or in conjunction with any person,[109] thus overruling legislatively the prior case law.

The drafters of the 1951 legislation were concerned with the obvious possibilities for tax avoidance under the pre-1942 case law.[110] A grantor could render an otherwise general, and therefore taxable, power of appointment nontaxable simply by requiring the powerholder to obtain the consent to exercise the power of someone who had no interest in the property and, therefore, no reason to withhold consent. But critics of the 1942 legislation argued that the new legislation should include in the transfer tax base only property over which the powerholder had control equivalent to outright ownership.[111] They argued that one who had to obtain consent of an individual who also had an interest in the property did not have such control. Again, the arguments of the critics carried the day.

The 1951 legislation contains provisions substantially limiting the taxation of jointly exercisable powers. First of all, no power created prior to October 21, 1942, that requires consent of any person for exercise is a general power.[112] Second, a power created after that date is not a general power, even if the powerholder may exercise it in favor of himself, if he must obtain the consent of the creator of the power,[113] or of a person having a substantial interest in the appointive property that is adverse to the exercise of the power.[114]

The exception for powers exercisable only with the consent of the creator was enacted to coordinate the new powers of appointment section with existing provisions for the taxation to the grantor of transfers with retained interests or powers.[115] Property subject to such a power is includible in the estate of the grantor under sections 2036(a)(2) and 2038(a)(1). Apparently, Congress believed that such property should not also be subject to tax in the estate of the powerholder if he predeceased the grantor.

Under the Treasury Department Proposals, the estate of the

109. Revenue Act of 1942, § 403(a) (enacting I.R.C. § 811(f)(2) (1939)).
110. Craven, *supra* note 57, at 72.
111. *Id.*
112. I.R.C. § 2041(b)(1)(B).
113. I.R.C. § 2041(b)(1)(c)(i).
114. I.R.C. § 2041(b)(1)(C)(ii).
115. S. REP. on 1951 Act, *supra* note 59, 1951 U.S. CODE CONG. AND AD. SERV. 1530, 1533.

grantor would no longer include property that the grantor retained a power to dispose of if he could not exercise the power in favor of himself and he retained no beneficial interest in the property.[116] Instead, the grantor will be subject to gift tax on the full value of the property at the time of the transfer. If this proposal is enacted, there is no reason to treat a power exercisable jointly with the grantor differently from any other joint power. If the distinction between adverse and nonadverse parties is to be retained, then property subject to a power held jointly with a nonadverse grantor should be taxable in the powerholder's estate. Such a change in the law might be criticized on the grounds that it encourages tax avoidance. The grantor will grant such a power of appointment to someone with an estate of his own that is too small to be subject to estate tax. This will permit the grantor to transfer the property subject to the power at the cost of a transfer tax calculated on the date of gift value, while retaining control of the property. Subsequent appreciation will escape taxation in the estates of both the grantor and the powerholder. This criticism has merit; however, the possibility of tax avoidance is inherent in the proposed changes in the transfer taxation of grantors who retain powers of disposition. The best solution to the problem of transfer taxation of property subject to jointly exercisable powers of appointment seems to lie in excluding it from the estate and gift tax base and subjecting it only to the generation-skipping transfer tax. To understand the justification for this suggestion, it is necessary to consider the taxation of powers exercisable jointly with someone other than the grantor.

The exception for powers subject to the consent of a person other than the grantor who has a substantial interest that is adverse to the exercise of the power was justified by the drafters of the 1951 Act on the grounds that the powerholder did not have sufficient control to be treated as an outright owner.[117] The statute itself provides no guidance concerning the meaning of "substantial" and "adverse" other than to say that one who would possess a power of appointment exercisable in favor of himself over the same property following the death of the first powerholder has an interest that is adverse to the exercise of the power. The Committee Reports indicate that the terms are to have the same meaning as they do for gift and income tax purposes.[118]

The doctrine of substantial adversity is not part of the gift tax provisions of the Code, but is found in the regulations dealing with

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116. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 379.
117. *See* Craven, *supra* note 57.
118. S. REP. on 1951 Act, *supra* note 59, at 1534.

the concept of completeness.[119] Historically, our pattern of transfer taxes has delayed imposition of the tax until the transferor has relinquished the last of his rights in the property. We do not tax a gift until it is "complete," a concept that the gift tax regulations define in some detail as that point at which the grantor has relinquished all dominion and control over who may possess or enjoy the property or the income it generates. The regulations state that a gift is complete if the donor may revoke or modify it only with the consent of a person who has a substantial adverse interest in the disposition of the property or the income therefrom. The regulations also state that a trustee does not have such an interest, but do not define "substantial" and "adverse." The decisions interpreting these regulations define adverse interest as a direct pecuniary interest that would be reduced if the grantor exercised his right.[120] Consistent with the principle that the gift is complete at the time of the transfer, and therefore taxable to the grantor, the beneficiary who possesses the adverse interest is treated as the owner of the transferred property. When he gives his consent to the grantor's exercise of his retained power, he, and not the grantor, makes a taxable gift.[121] Similarly, if the beneficiary dies prior to the grantor, the property is includible in his estate.[122]

The estate tax regulations under section 2041 are generally consistent with the gift tax definition of substantial adverse interest as a direct pecuniary interest in the property that will be reduced by the exercise of the power. A taker in default of the exercise of the power does have a substantial adverse interest, but a mere co-holder of the power does not, unless the co-holder possesses a general power of appointment over the property following the other powerholder's death.[123]

The exception for such powers exercisable by a grantor has been criticized frequently, principally because the grantor chooses the person whose consent is required.[124] Obviously, he will choose someone likely to accede to his requests to exercise the power. Indeed, property subject to such a jointly exercisable power is includible in the grantor's estate if he predeceases the adverse party.[125] The Treasury Department apparently advocates elimi-

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119. Treas. Reg. § 25.2511-2(e).

120. Commissioner v. Prouty, 115 F.2d 331, 333 (1st Cir. 1940).

121. Cerf v. Commissioner, 141 F.2d 564, 567 (3d Cir. 1944).

122. I.R.C. § 2033.

123. Treas. Reg. § 20.2041-3(c)(2).

124. *Prouty*, 115 F.2d at 335, Lowndes, *Tax Consequences of Limitations Upon the Exercise of Powers*, 1966 DUKE L. J. 959, 974 (1966) [hereinafter cited as Lowndes, *Tax Consequences*].

125. I.R.C. §§ 2036(a) & 2038(a).

nating the distinction for gift tax purposes between powers that are exercisable unilaterally by the grantor and those that are exercisable only with the consent of an adverse party.[126] Although the explanation of the proposal is unclear, it seems that the Treasury Department would tax all such powers as though they were exercisable unilaterally.

While the grantor, rather than the donee, of a power of appointment chooses the person whose consent the powerholder must obtain, it is equally likely that the grantor will choose someone likely to accede to the powerholder's wishes. If he did not wish to grant the powerholder the broadest latitude in exercising the power that would not attract a tax, he would vest the power to make discretionary distributions in a trustee. Therefore, it may be surprising that the Treasury Department's Proposals suggest that sections 2041(b) and 2514(c) be amended so that all jointly exercisable powers are nontaxable.[127] In other words, they advocate a return to the pre-1942 treatment of joint powers. However, this appears to be the best solution; the reason lies again in the transfer taxation of discretionary trusts. A trustee does not have a substantial interest that is adverse to the powerholder's exercise of the power.[128] Therefore, a powerholder who can exercise an otherwise general power only with the consent of the trustee still has a general power. However, no well-advised grantor will ever grant a beneficiary a taxable general power of appointment subject to consent by a trustee. Substantially more favorable tax treatment can be achieved by modifying slightly the procedure by which the powerholder may obtain use of the property.

A common estate planning technique is to place property in trust for the benefit of one's children or other members of one's family and to grant to the trustee the right to make distributions of corpus to such members of the family for such reasons as making a down payment on a house, paying the cost of a wedding, or beginning a new business.[129] A beneficiary who can invade the corpus of a trust unilaterally for his own benefit for such purposes possesses a general power of appointment because the enumerated purposes are not limited by an ascertainable standard relating to health, education, maintenance, and support as required by section 2041(b)(1)(A).[130] Therefore, the property over which he has such a power is includible in his estate for federal estate tax purposes. Furthermore, since the trustee is not an adverse party,

126. Treasury Department 1984 Proposals, *supra* note 14, at 378.
127. *Id.* at 384.
128. Treas Reg. § 25.2511-2(e).
129. *See, e.g.*, 1 HARRIS, FAMILY ESTATE PLANNING GUIDE § 46 (3d ed. 1982).
130. *See* text accompanying notes 66-107 *supra*.

the requirements that the trustee consent to such an invasion will not change this result. However, a permissible recipient of the trustee's discretionary distributions does not possess a general power of appointment unless he is the trustee or he can remove the trustee and appoint himself at will. The beneficiary who may obtain property for reasons similar to those listed above by setting forth those reasons in a letter to the trustee does not have a taxable general power of appointment, as long as the trustee has discretion not to make a requested distribution. As is the case with powers subject to an ascertainable standard, the problem with taxing jointly held powers to the estate of the beneficiary is that such a practice simply creates a trap for the unwary. Well-advised taxpayers will place the power in the hands of a trustee and eliminate the estate tax at the beneficiary's death.

The grantor cannot avoid the generation-skipping transfer tax as easily. For purposes of assessing the generation-skipping transfer tax, it is only necessary to identify a beneficiary and to assign the beneficiary to a generation. Clearly, the permissible recipient of discretionary distributions from a trust has a beneficial interest, whether the power to distribute is exercisable by a trustee unilaterally or by the potential recipient unilaterally or jointly with another. If the permissible recipient is the only member of his generation and his generation is a younger generation than the grantor's, the generation-skipping transfer tax will be assessed at the death of the permissible recipient on the property subject to the power, regardless of who holds the power. If there are other beneficiaries assigned to the same generation, the tax will be assessed at the death of the last survivor. As was pointed out in the discussion of powers subject to an ascertainable standard, eliminating the estate and gift tax consequences of joint powers will reduce substantially the incidence of taxation of such powers.[131] However, if the Treasury Department 1984 Proposals were adopted by Congress in their entirety, this would simply be part of a more general shift toward the taxation only once per generation of the gratuitous transfer of wealth.

3. Five or Five Powers

The last of the exceptions to the definition of general power of appointment is the exception for lapses of powers of appointment over property the fair market value of which is less than the greater of $5,000 or 5% of the total principal on the date of the lapse.[132] The general rule is that the lapse of a power of ap-

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131. *See* text accompanying notes 103-07 *supra.*
132. I.R.C. § 2041(c)(2).

pointment created after October 21, 1942, is treated as a release of that power.[133] In other words, the lapse of the power during the powerholder's life is a taxable gift under section 2514;[134] the lapse of the power at the death of the powerholder renders the property subject to estate tax. In addition, to achieve consistent treatment of general powerholders and outright owners, section 2041(a)(2) subjects to estate tax property over which the decedent had a general power which he released during life, if he retained an interest in the property that would require inclusion of the property in his estate had he been a grantor. Under this provision, a beneficiary who possessed, for example, a general power of appointment over the principal of a trust of which he was also the income beneficiary, and who released only the power, would be subject to estate tax on the trust property, because a grantor would be subject to estate tax on such property under section 2036(a)(1). Because a lapse is treated as a release, the same result obtains if the beneficiary simply permits the power to lapse by the terms of the agreement. For example, a common estate planning technique permits a beneficiary to terminate a trust and take the principal upon reaching a certain age. If he fails to exercise the right within a stated period, the right lapses and the property continues in trust for his benefit until his death. The trust principal will be includible under section 2041(a)(2) in the estate of a beneficiary who dies after having permitted such a power to lapse.

Prior to 1942, it had become fairly common to grant one or more beneficiaries the right to withdraw a fixed small amount annually from the principal of a trust.[135] The withdrawal right lapsed at the end of each year. This is clearly a useful addition to a family trust, particularly one for a number of beneficiaries or for beneficiaries who are not financially sophisticated. It gives such beneficiaries access to an additional source of funds, while, at the same time, allowing for professional management of the larger fund. Clearly such a power is a general power of appointment as to the specific sum that the beneficiary may withdraw each year.

Under the law prior to 1942, the lapse of a general power of appointment was not considered the exercise of that power,[136] and only exercised powers were subject to estate and gift tax.[137] Therefore, the lapse of a general power of appointment had no transfer tax consequences.

The estate tax provision of the Revenue Act of 1942 applied

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133. *Id.*
134. I.R.C. §§ 2514(b) & (e).
135. S. REP. on 1951 Act, *supra* note 59, at 1531.
136. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 (1942).
137. Revenue Act of 1918 § 402(e).

explicitly to all property over which the decedent possessed a taxable power of appointment, whether he exercised it or not,[138] and the gift tax provision stated that the inter vivos exercise or release of a power of appointment was a taxable event for gift tax purposes.[139] The regulations under the gift tax provision stated that the failure to exercise a power of appointment within a specified time was a taxable release of the power if it caused the termination of the power.[140] Therefore, the annual lapse of a power of withdrawal was a taxable gift from the powerholder to the remainder beneficiaries of the trust.

While Congress was considering the Powers of Appointment Act of 1951, the Treasury Department stated that it would take the position that the annual lapse of powers of withdrawal were taxable gifts under the new statute,[141] and that an income beneficiary who possessed such a power and permitted it to lapse made a transfer with a retained life estate. Therefore, the fair market value at the date of the income beneficiary's death of all property that had ever been subject to such a power of withdrawal would be includible in the income beneficiary's estate under the predecessor to section 2036(a)(1).[142] Congress believed that the ability of grantors to give financially unsophisticated beneficiaries access annually to small amounts of property without transfer tax consequences to the beneficiary was so desirable that the new legislation should preclude the Treasury Department from taking that position. Therefore, the Senate Finance Committee added what are now sections 2514(e) and 2041(b)(2).[143]

Under section 2514(e) the annual lapse of the right to withdraw the greater of $5,000 or 5% of the corpus of a trust is not a taxable gift. Furthermore, even if the powerholder has another interest in the trust, such as the right to income, the annual lapses will not subject the property to estate tax at his death because the lapse is neither an exercise nor a release for purposes of section 2041(a)(2).

The exemption applies to the first $5,000 or 5% that may be withdrawn, even if the powerholder may withdraw more than these amounts.[144] For example, the holder of a power to withdraw $15,000 a year from the principal of a trust will make a taxable gift of $5,000 to the remainder beneficiaries of the trust if he per-

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138. Revenue Act of 1942 § 403(a).
139. *Id.* at § 452(a).
140. Treas Reg. 108, § 86.2(b) (1943).
141. Craven, *supra* note 57, at 76.
142. I.R.C. § 811(f)(1)(1939).
143. *See* Craven, *supra* note 57, at 77.
144. Treas. Reg. §§ 20.2041-3(d)-3 & 25.2514-3(c)-4; S. REP. on 1951 Act, *supra* note 59, at 1536.

mits the withdrawal power to lapse when the principal of the trust is worth $200,000. If the principal were worth $300,000 when the power lapsed, there would be no taxable gift, because $15,000 is 5% of $300,000. If the powerholder had another interest in the trust, such as the right to income, only those portions of the property subject to the lapsed withdrawal powers that constituted a taxable gift at the time of the lapse would be includible in the powerholder's estate under section 2041(a)(2).[145] In order to account for fluctuation in the value of the fund, the total amount includible in the powerholder's estate is determined by multiplying the fair market value of the principal of the trust on the date of the powerholder's death by a fraction equal to the sum of the fractions of the principal that the taxable portions represented on the dates of the lapses.[146] Of course, the full amount that the beneficiary may withdraw in the year of death is includible in his gross estate under section 2041, because he has a general power of appointment over that portion of the principal at his death.

The five or five power has attracted considerable attention as an estate planning tool since the case of *Crummey v. Commissioner*[147] was decided by the Ninth Circuit seventeen years ago. Most wealthy donors wish to take maximum advantage of the present interest exclusion from the gift tax.[148] However, until the *Crummey* decision the two ways to obtain the annual exclusion for the full value of the donated property were to give the property outright or, if the beneficiary were a minor, to transfer it to a trust complying with the provisions of section 2503(c). Many donors found these alternatives unacceptable for two reasons. First, section 2503(c) requires that the property be distributed to the beneficiary upon his or her attaining the age of 21. Many donors

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145. Treas. Reg. § 20.2041-3(d)-4.

146. *Id.*

147. 397 F.2d 82 (9th Cir. 1968).

148. I.R.C. § 2503(b) excludes from the gift tax base the first $10,000 of gifts "other than gifts of future interests" given by a donor to each donee each year. Treas. Reg. § 25.2503-3(b) defines present interest as "[a]n unrestricted right to the immediate use, possession or enjoyment of property or the income from property . . . ." This regulation has been the subject of considerable litigation. *See* S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION, 652-84 (2d ed. 1982).

Part of a gift may be an excludible present interest while the rest of it will be a taxable future interest. Fondren v. Commissioner, 324 U.S. 18, 21 (1945). For example, a gift in trust directing the trustee to pay income to the beneficiary annually until he reaches a stated age and then to distribute the principal to him, is treated as a gift of two interests: an excludible present interest to the extent of the present value of the right to receive income for a term of years and a taxable future interest of the present value of the right to receive the principal after the expiration of the term.

wished to have the property managed by a trustee beyond that age. Second, many donors wished to limit the interest of the beneficiary in such a way as to eliminate the estate tax on the property at the death of the beneficiary. This made both outright transfer and a section 2503(c) transfer undesirable. In the *Crummey* decision, the Ninth Circuit approved a plan that allowed the donor to accomplish all of these goals. The taxpayers in *Crummey* had set up trusts for the benefit of their four children, three of whom were minors. Each trust agreement provided that the income of the trust was to be paid out or accumulated for a child, in the discretion of the trustee, for the child's life. Upon the death of the child, the principal of his or her trust was to be distributed pursuant to the exercise by the child of a testamentary special power of appointment, or, in default of exercise, to the child's issue. Each child was granted the right to withdraw additions to the trust annually, up to $4,000, but the right to withdraw lapsed on December 31 of the year in which the addition was made. The Ninth Circuit held that the right of withdrawal rendered each addition a "present interest" for purposes of section 2503(b), even though no guardian was appointed for the three minor beneficiaries[149] and, in at least one year, the addition to the trusts was made only two weeks before the end of the year.[150]

When *Crummey* was decided, the gift tax annual exclusion was $3,000.[151] Therefore, the five or five exclusion effectively eliminated the estate and gift tax consequences to the beneficiary of a withdrawal power sufficient to obtain for the donor the full annual exclusion. In 1981, the gift tax annual exclusion was increased to $10,000.[152] Since then, commentators have devoted considerable attention to the adverse transfer tax consequences of granting a withdrawal power in excess of $5,000 or 5% of the trust fund per year,[153] and to devising means to avoid these consequences.[154] In addition, some authors have advocated increasing

149. Crummey v. Commissioner, 397 F.2d 82, 87-88 (9th Cir. 1968).

150. *Id.*

151. Former I.R.C. § 2503(b) (1970).

152. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 442(a)(3)(B), 95 Stat. 320 (1981).

153. *E.g.*, Adams & Bieber, *Making "5 and 5 Equal 20: Crummey Powers after ERTA*, 122 TR. & EST. 22 (1983) [hereinafter cited as Adams & Bieber]; Covey, POWERS OF WITHDRAWAL, 1982 Prac. Drafting 58, 77-80, (1982) [hereinafter cited as Covey]; Natbony, *The Crummey Trust and "Five and Five" Powers After ERTA*, 60 TAXES 497 (1982) [hereinafter cited as Natbony].

154. One of the more ingenious ways of coping with the discrepancy between the annual exclusion and the excludible withdrawal power is the "hanging" power described in Covey, *supra* note 153, and in Adams & Bieber, *supra* note 153. The hanging power is a power to withdraw all of each annual addition to a trust, regardless of the amount, which lapses at the end of each successive

to $10,000 the amount excepted by sections 2041(b)(2) and 2514(e).[155] Although these commentaries are technically precise and quite creative, it seems unwise as a matter of tax policy to continue to tolerate the devices they advocate. Indeed, rather than demonstrating the advisability of increasing the amount excepted from transfer tax under sections 2041(b)(2) and 2514(e), these devices point to the need to reconsider the advisability of the present interest exclusion, especially as it applies to transfers in trust.

The five or five exception is, of course, a de minimis rule designed to permit granting the beneficiary the right to withdraw a small amount of principal annually without requiring complex computations to determine gift tax consequences on the annual lapse of the power, or estate tax consequences on the beneficiary's death. Obviously, the beneficiary has the right of an owner as to the amount withdrawable during the year; there is no reason why the death of a beneficiary who possesses such a power should not be treated as a transfer of the property to the remainder beneficiaries for estate tax purposes. Sections 2041(b)(2) and 2514(e) are simply an obvious example of the propensity of Congress to draft transfer tax statutes that exclude from taxation the most common forms of wealth transmission and tax only the unusual ones.

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calendar year to the extent of $5,000 or 5% of the value of the trust principal on the last day of the year. This device permits each donor of the trust to obtain the full benefit of the $10,000 annual exclusion, or a $20,000 split gift annual exclusion, if the donor's spouse consents in accordance with I.R.C. § 2513, while eliminating or substantially reducing the transfer taxes due from the beneficiary or his estate. For example, if a grantor transfers $20,000 into a trust one of the beneficiaries of which is granted a hanging power in the trust instrument, and the grantor's spouse consents to treat the transfer as a split gift, the full $20,000 will qualify for the gift tax annual exclusion. If the beneficiary does not exercise the power, $5,000 of the power of withdrawal lapses at the end of the first calendar year. There is no gift tax due on the lapse because of I.R.C. § 2514(e). The remaining $15,000 power of withdrawal continues into the second year and, if the grantor makes no further additions to the trust, another $5,000 lapses at the end of that year. If the grantor adds an additional $20,000 in the second year so that the principal of the trust (assuming no appreciation in the first $20,000 addition) is $40,000 at the end of the second year, then the full amount of the contribution qualifies for the gift tax annual exclusion, assuming the spouse consents once again to splitting the gift. The beneficiary's withdrawal power will still lapse only to the extent of $5,000 if he does not exercise the power, but $30,000 of withdrawal rights will carry over into the third year. There is estate tax exposure to the beneficiary's estate should he die before all of the power lapses, since the unlapsed power is a general power of appointment over the corpus of the trust under I.R.C. § 2041(a)(2). However, the successive lapses do not require inclusion in the beneficiary's estate under that section, even if the beneficiary has another interest in the trust, because the lapses are not releases. I.R.C. § 2041(b)(2).

155. *See, e.g.*, Natbony, *supra* note 153.

The Treasury Department 1984 Proposals advocate eliminating estate and gift tax on property subject to all powers except those that do not lapse by the terms of the creating instrument prior to the death of the powerholders.[156] Interestingly, this was the position advocated by the ABA during the drafting of the Powers of Appointment Act of 1951.[157] It was rejected by the Treasury Department on the grounds that it would emasculate the statute because the grantor could simply provide that the power lapsed if the beneficiary had not exercised it by the time he attained a certain age.[158] If the beneficiary survived the stated birthday without having exercised the power, there would be no transfer tax consequences. Apparently, the Treasury Department now advocates the position it once rejected because the lapse described above will usually be taxable under the generation-skipping transfer tax.[159]

If the Treasury Department 1984 Proposals are enacted, no annually lapsing power, regardless of the amount of property it covers, will have gift or estate tax consequences to the powerholder. Furthermore, it is relatively unlikely that powers to withdraw small amounts will have generation-skipping transfer tax consequences either, unless the tax is applied at the powerholder's death to the aggregate amounts that he could have withdrawn during his lifetime.[160]

If the Treasury Department is prepared to eliminate the estate and gift tax on powers that lapse before death, it is not clear why the Treasury Department does not advocate elimination of the estate and gift tax upon all property subject to a power of appointment. There is no more reason to tax the lapse of a general power at the death of the powerholder than to tax the lapse of such a power on the powerholder's thirty-fifth birthday. The Treasury Department 1984 Proposals do not state the reason for the distinction. Last year, an ALI Study Group advocated repeal of sections 2041 and 2514 as part of a proposal for the integration of the estate, gift and generation-skipping transfer taxes.[161] Because one must understand the pattern of taxation of the gen-

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156. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 385.

157. Craven, *supra* note 57, at 64.

158. *Id.* at 76.

159. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 384. The generation-skipping transfer tax consequences of the lapse of a power of appointment under the current generation-skipping transfer tax and under the various proposals for amending it are discussed in part VI of this article.

160. *See* text accompanying note 351 *infra.*

161. FEDERAL ESTATE AND GIFT TAX PROJECT: STUDY ON GENERATION-SKIPPING TRANSFERS UNDER THE FEDERAL ESTATE TAX, A.L.I. DISCUSSION DRAFT No. 1 (1984); *see* text accompanying notes 362-366 *infra.*

eration-skipping transfer tax in order to understand fully the ALI Study Group's proposal, consideration of the proposal is included in part VI of this article. Unfortunately the proposal does not go far enough to eliminate the opportunity for transfer tax avoidance it is designed to thwart. It may be impossible to devise a statute that will provide the perfect remedy. However, if a general powerholder whose power does not lapse before the powerholder's death continues to be treated as an owner for transfer tax purposes, a general powerholder whose power lapses during life must be so treated as well.

IV. Gift Tax

A. Historical Development

The gift tax statutes contained no provision dealing explicitly with powers of appointment until the Revenue Act of 1942. The few courts that considered the question were divided on whether the inter vivos exercise or release of a general power of appointment was subject to the gift tax.[162] Apparently, there was general agreement that the inter vivos exercise or release of a nongeneral power was not a taxable gift.[163]

The Revenue Act of 1942 contained a provision that made a taxable event for gift tax purposes the inter vivos exercise or release of any power of appointment that would have rendered the appointive property taxable to the estate of the powerholder had he held the power at his death.[164]

Since 1942, the estate and gift taxation of transfers of property pursuant to the exercise, release, or lapse of a power of appointment have been parallel. Section 2514, the predecessor of which was enacted in the Powers of Appointment Act of 1951 as the companion to the predecessor of section 2041,[165] parallels section 2041 exactly and contains the same exceptions to the definition of the term "general power" of appointment.[166] The regulations under the two sections are also parallel.

162. *Compare, e.g.*, Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945) (trustee's payments of income to named beneficiaries of trust he had power to terminate in favor of himself held exercise of power of appointment and taxed), *with* Commissioner v. Walston, 168 F.2d 211 (4th Cir. 1948) (exercise not taxed) *and* Edith E. Clark, 47 B.T.A. 865 (1942) (release not taxed).

163. *Lowndes, supra* note 36, at § 27.6.

164. Revenue Act of 1942 § 452 (amending I.R.C. § 1000(c)(1939)).

165. Powers of Appointment Act of 1951 § 3 (amending I.R.C. § 1000(c)(1939), which was reenacted without change as I.R.C. § 2514).

166. *Compare* I.R.C. § 2041(b) (estate tax provision) *with* I.R.C. § 2514(c)-(e) (gift tax provision).

B. Current Law

The exercise, release, or lapse of any general power of appointment during the lifetime of the powerholder is a taxable gift under section 2514, while the exercise, release, or lapse of a nongeneral power is not. Therefore, one who has a power to consume limited by an ascertainable standard relating to health, education, maintenance, or support and a power to appoint the subject property to any person other than himself, his creditors, his estate, and the creditors of his estate is not subject to gift tax upon the exercise of the power in favor of another. It seems obvious that the exercise of the right to decide whether to consume the property or to give it away ought to attract a transfer tax. The transfer is exempt from gift tax, however, because of the ascertainable standards exception, and the criticisms of estate tax exception are equally applicable to the gift tax.[167] Similarly, the exercise of a power exercisable jointly either with the grantor or with one who has a substantial interest in the property that is adverse to the exercise of the power is not a gift taxable to the powerholder. The Treasury Department advocates making the same changes in section 2514 as in section 2041.[168] Section 2514(e) excepts from the general rule annual lapses of powers over not more than the greater of $5,000 or 5% of the principal of the fund subject to the power. This provision parallels estate tax section 2041(b)(2). The reasons for eliminating this rule are stated above, in section III. B. 3. The strongest reason for eliminating this exception is that it permits tax avoidance of the type permitted by the *Crummey* decision.[169] If the exception were eliminated, there would be relatively few cases in which the lapse of the power would attract a gift tax. In most cases, the powerholder will have another interest in the trust that will reduce, if not eliminate, the portion of the withdrawable property subject to gift tax upon the lapse of the power. For example, if the powerholder is also a life income beneficiary, the taxable gift will be the value of the remainder interest only. Using the current ten percent valuation tables, the value of the remainder will be less than fifty percent of the amount subject to the lapsed withdrawal power if the powerholder is less than seventy seven years old.[170] Furthermore, if the powerholder also has a right to obtain principal for his own health, education, maintenance, or support, or if the trustee has discretion to invade

167. *See* text accompanying notes 93-106 *supra*.

168. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 384-85.

169. Crummey, 397 F.2d 82, discussed in text accompanying notes 147-155 *supra*.

170. Treas. Reg. § 25.2512-5(f), Table A.

principal for the benefit of the powerholder, the gift might well be valueless.[171] In such cases, were it not for the exception of section 2041(b)(2), the aggregate of property subject to the lapsed annual withdrawal powers would be subject to estate tax at the powerholder's death.[172] While both exceptions need to be eliminated, the elimination of the estate tax exception will produce the greatest result with the least change in our pattern of transfer taxation.

The partial release of a general power with retention of a nongeneral power is not a taxable gift because the gift is not complete.[173] However, if the powerholder retains the nongeneral power until death, the property subject to the power will be included in his estate, if the retained power is one that would have resulted in inclusion under sections 2035 through 2038 had it been retained by an outright owner.[174] Similarly, if the powerholder exercises or releases the nongeneral power during his life to transfer the appointive property to another person, then the transfer constitutes a taxable gift.[175]

There is one rather common situation in which the inter vivos exercise of a nongeneral power of appointment may have gift tax consequences. A common estate plan grants the income beneficiary of a trust a nongeneral power of appointment over the trust principal. When the beneficiary exercises the power, clearly he makes a nontaxable transfer of the principal. Equally clearly, the value of his income interest is subject to gift tax. The regulations[176] and a recent revenue ruling[177] so state; however, there is disgreement among the courts concerning the validity of the regulation.[178] The beneficiary in this situation has two interests: he is the holder of a nongeneral power of appointment over the principal and he is the owner of the life income. While section 2514 permits him to transfer the principal without incurring a tax, his

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171. Treas. Reg. § 25.2511-2(c).
172. I.R.C. § 2041(a)(2).
173. Treas. Reg. § 25.2514(c)(1).
174. I.R.C. § 2041(a)(2).
175. Treas. Reg. § 25.2514(c)(3).
176. Treas. Reg. § 25.2514-1(b)(2).
177. Rev. Rul. 79-327, 1979-2 C.B. 342.
178. *Compare* Regester v. Commissioner, 83 T.C. 1 (1984) (value of income interest taxed) *with* Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956) (value of income interest not taxed; powerholder mere agent of grantor). *See also*, Monroe v. United States, 301 F. Supp. 762 (D.C. Wash. 1969) *aff'd per curiam* 454 F.2d 1169 (9th Cir. 1972) (legal life tenant with pre-1942 power to consume underlying property "for her comfort, enjoyment, support, maintenance or expenditure in such manner as will cause the remainder of her life to be most useful," who released the power to invade prior to 1951, made a taxable gift of her income interest when she released her right to it in 1963).

concurrent transfer of the life income interest is taxable under section 2511, as would be any gratuitous assignment of income. Obviously, the addition of a power over principal cannot render the transfer of the income interest exempt from transfer tax. Section 2514 applies only to the transfer of the present value of the remainder interest.

There are substantially fewer cases and revenue rulings concerning section 2514 than concerning section 2041. Perhaps this is because relatively few powerholders release their powers completely during life or exercise them during life in favor of another. Therefore, the question of taxability of property subject to the power does not arise until the powerholder's death. As is the case with the estate tax provision, the focus of such controversy as does arise under section 2514 is on the exceptions to the definition of general power of appointment.[179]

V. INCOME TAX

A. *Historical Development of the Grantor Trust Provisions*

Section 678, the provision dealing with the income tax consequences of a power to vest in oneself property held in trust, is part of a series of sections referred to colloquially as "the grantor trust provisions."[180] These provisions are exceptions to the general pattern of income taxation of trusts.[181] However, in order to evaluate section 678, it is necessary to view it in the context of the general pattern of taxation. Therefore, it will be helpful first to outline briefly the method by which trusts and their beneficiaries are taxed.[182]

Since the Revenue Act of 1916, a trust has been treated as a separate taxpayer for income tax purposes.[183] The gross income of the trust is computed in a manner that is not very different from the manner in which the gross income of an individual is computed and the trust is allowed similar deductions.[184] However, income received from a trust by a beneficiary is taxable to the

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179. *E.g.*, Rev. Rul. 79-327, 1979-2 C.B. 342; Rev. Rul. 76-547, 1976-2 C.B. 302.

180. I.R.C. §§ 671-79.

181. I.R.C. §§ 641-92.

182. For more detailed descriptions, see A. MICHAELSON & J. BLATTMACHR, INCOME TAXATION OF ESTATES AND TRUSTS (11th ed., 1980) [hereinafter cited as Michaelson]; M. FERGUSON, J. FREELAND & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES (1970 and Supp. 1984).

183. Revenue Act of 1916 § 2(b) (currently I.R.C. § 641(a)).

184. I.R.C. §§ 641(b) & 642.

beneficiary.[185] In order to prevent double taxation of trust income, the Code provides for a modified conduit pattern of taxation. The trust is allowed a deduction for amounts distributed or distributable to beneficiaries,[186] and the beneficiaries must include in in-

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185. I.R.C. §§ 102(b), 652(a), & 662(a).

186. I.R.C. §§ 651 & 661. The income taxation of trusts is complicated by the fact that the concept of income is not the same for federal taxation purposes as for state law fiduciary accounting purposes. For example, some receipts, such as tax-exempt interest, are clearly income under the state laws governing trust accounting, but are not subject to federal income tax. Conversely, some receipts and disbursements that affect the computation of taxable income are allocable to principal under the trust accounting laws of most states. Capital gains and losses and trustees' principal commissions are common examples of this second type. *See, e.g.* TENN. CODE ANN §§ 35-6-104 & -113 (1984 Repl. Vol.); UNIFORM PRINCIPAL AND INCOME ACT §§ 3 & 12. Finally, the law of fiduciary accounting differs from state to state. Congress created the concept of distributable net income ("DNI") in 1954 to coordinate these different concepts of income and to prevent over- or under-inclusion of trust income in the taxable income of beneficiaries. DNI, which is defined in § 643, is essentially the taxable income of the trust computed as it would be for an individual, excluding capital gains and losses, but including tax-exempt ordinary income. Thus, deductions permitted to an individual are deducted in arriving at DNI even if they are paid from principal under state fiduciary accounting rules. The word "income" standing alone is defined as state law fiduciary accounting income for purposes of I.R.C. §§ 641 through 669. I.R.C. § 643(b).

The Code divides trusts into two categories, those which are required to distribute all of their income currently and do not set aside any amount for charity nor make any distributions during the taxable year of any amount that is not current income and all other trusts. The former compute their distributions deductions and beneficiaries' inclusions under I.R.C. §§ 651-52; the latter under I.R.C. §§ 661-64. The regulations, and tax practitioners generally, refer to the former as simple trusts and the latter as complex trusts, Treas. Reg. § 1.651(a)-(1). They will be referred to in that manner throughout this article.

The distributions deduction for the trust and the total amount all beneficiaries must include in their income is limited to the lesser of DNI or the total amounts required by the trust instrument to be distributed currently to a beneficiary. I.R.C. §§ 651(a), 652(a), 661(a)-62(a). In other words, the lesser of DNI or fiduciary accounting income is taxed to the beneficiaries of a simple trust whether or not it is distributed. If the trustee of a complex trust has discretion to accumulate income, only the income actually distributed is taxed to the beneficiaries; accumulated income is taxed initially to the trust. I.R.C. § 661(a). However, it may ultimately be taxed as an accumulation distribution under the 'throwback' rules, I.R.C. §§ 665-68, *see* text accompanying notes 267-69 *infra*, if it is distributed to a beneficiary in a later year. Furthermore, if a complex trust distributes principal and accumulates income in the same year, the principal distribution may be deemed to 'carry out' DNI so that the principal distributee, rather than the trust, will be liable for tax on the trust's income for that year. This is to prevent a trustee from making a tax-free distribution of trust property to a beneficiary who is in a higher income tax bracket than the trust.

A rather complex series of rules known as the 'tier' system governs which of the various principal and income beneficiaries of a complex trust will be taxable upon the various items of income realized by the trust. I.R.C. § 662(a); Treas. Reg. §§ 1.662(a)-2, 1.662(a)-3 & 1.662(b)-1. Essentially, these rules provide that come their respective shares of the income distributed or distributable to them.[187] The trust pays income tax on the income it retains pursuant to a rate schedule that is slightly higher than that applicable to unmarried individuals.[188]

The taxation of trust income either to the trust or to the beneficiaries can result in substantial income tax savings to a family group. The family members in higher income tax brackets create trusts to accumulate income or distribute it to lower income tax bracket family members. So long as the trust has some economic reality separate from the grantor, this reduction in the overall family tax burden is justifiable because the income is being taxed to those who control or enjoy its economic benefits. However, when the trust agreement is drafted so that the trustees are simply agents of the grantor and all economic benefits of the fund are subject to the grantor's control, the establishment of the trust becomes a subterfuge for the assignment of income that should be taxed to the grantor.

The rule that the grantor of a trust is taxable on the income of the trust if he has the power to revest the trust corpus in himself or the right to receive the income (whether or not he actually receives income or corpus in a particular year), has also been part of the law of the income taxation of trusts since the Revenue Act of 1916,[189] and was embodied in the 1939 Code in sections 166 and 167. Those sections recognized the trust as a separate entity but simply taxed the income to the grantor to the extent he possessed the aforementioned powers, whether or not he actually received the income. A series of decisions such as *Douglas v. Willcuts*[190] and

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beneficiaries to whom income is required to be distributed currently (first tier beneficiaries) are taxable first, and then, if there is any excess DNI, any beneficiaries who receive mandatory distributions of principal or discretionary distributions of income or principal (second tier beneficiaries) are taxable on the remaining DNI in proportion to the amounts they receive.

Income retains the character in the hands of the beneficiary that it had when received by the trust. I.R.C. §§ 652(a) & 662(a). Thus, the income beneficiary of a trust that received rent and tax exempt interest during a given taxable year will be deemed to have received his proportionate shares of rent and tax exempt interest from the trust.

Since capital gains and losses are not taken into account in computing DNI, they will generally be taxed to, or deductible by, the trust itself. This is true even if the trust makes a distribution of principal. Treas. Reg. § 1.643(a)-3. Indeed, a principal distribution may carry out DNI, so that the distributee will be taxed on ordinary income items while the capital gain is taxed to the trust.

187. I.R.C. §§ 652(a) & 662(a).

188. I.R.C. § 1(e).

189. *See* note 2 *supra.*

190. 296 U.S. 1 (1935) (income of alimony trust held taxable to grantor because establishment of the trust relieved him of the legal obligation to support his wife).

Helvering v. Clifford[191] that extended the principle of these sections to situations that technically were not covered by them prompted the Treasury Department to issue a more detailed series of rules in this area in 1942. These regulations, promulgated under section 22, the general section of the 1939 Code defining gross income, and referred to by practitioners as the "Clifford regulations," required the grantor of a trust to include in his gross income the gross income of a trust over which he retained sufficient economic control to be considered the owner.[192] The regulations contained a detailed series of examples of powers and conditions that would cause the grantor to be so treated, including, for example, the power to revoke the trust, the power to determine who might receive income or principal and the retention of a reversion after a period of less than ten years. The trust was disregarded as a separate entity; the income, including principal items, such as capital gain, if the power was exercisable over corpus, was taxed to the grantor as though he or she owned the property outright.

The possibility that a person other than the grantor of the trust might be treated as the owner of trust income or corpus was first considered in the case of *Mallinckrodt v. Nunan.*[193] In *Mallinckrodt* the court was called upon to determine who was taxable upon trust income that could be distributed to a beneficiary if he requested it but was to be added to principal if he did not. The Eighth Circuit acknowledged that this income was not taxable to the beneficiary as income required "to be distributed currently" under the predecessor of sections 651(a) and 661(a),[194] but held that the income that could have been distributed to the beneficiary was taxable to him under section 22, whether or not it was distributed, because his right to receive it upon request "could be regarded as the equivalent of the ownership of the income for purposes of taxation."[195] Following the *Mallinckrodt* decision, the Treasury Department issued additional regulations under section 22 providing that a person other than the grantor of a trust who had "a power exercisable solely by himself to vest the corpus or the income . . . in himself, . . ." was taxable on the income as an owner.[196]

When Congress enacted the 1954 Code, it added sections 671 through 678, dealing with controlled trusts, to Subchapter J, the

191. 309 U.S. 331 (1940) (income of irrevocable five-year trust for the benefit of the grantor's wife held taxable to the grantor because he retained powers over trust property and income tantamount to ownership).

192. Treas. Regs. 118, § 39.22(a)-21.

193. 146 F.2d 1 (8th Cir. 1945).

194. I.R.C. § 162(b) (1939).

195. 146 F.2d at 5.

196. Treas. Reg. 118, § 39.22(a)-22.

portion of the new Code dealing with the income taxation of estates and trusts. These grantor trust provisions, follow and elaborate upon the principles set forth in the Treasury's *Clifford* and *Mallinckrodt* regulations. They state that the grantor or a nongrantor will be treated as the owner of those portions of the income or corpus of a trust over which he or she possesses certain enumerated powers or retained interests.[197] The grantor trust rules supersede the general rules of subchapter J whenever both are applicable.[198] In addition, section 671 states that neither a grantor nor a nongrantor can be taxed on the income from a trust under section 61 solely on the ground of his or her dominion and control of the income or corpus other than in accordance with the terms of sections 671 through 679.[199]

B. Current Taxation of Powerholders—Section 678

1. The Scope of Section 678(a)(1)

In contrast to detailed provisions relating to grantors, section 678(a)(1) provides simply that a powerholder will be treated as the owner of that portion of a trust over which he "has a power exercisable solely by himself to vest the corpus or the income therefrom in himself." This language is taken verbatim from the *Mallinckrodt* regulations under the 1939 Code.[200]

The income tax consequences of a power of appointment do not turn upon the classification of the power as "general," as that

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197. Among the powers and interests that will cause the grantor to be treated as owner are the power to revest the principal in himself (I.R.C. § 676), to receive the income of the trust or have it accumulated for the grantor's benefit or the benefit of his or her spouse (I.R.C. § 677), and the right to receive the principal back in less than ten years (I.R.C. § 673). For a detailed analysis of the grantor trust rules, see Michaelson, *supra* note 182, at 107-55; Peschel, *The Impact of Fiduciary Standards on Federal Taxation of Grantor Trusts: Illusions and Inconsistency*, 1979 *Duke L.J.* 709 (1979); Lowndes, *Tax Consequences*, *supra* note 124.

198. I.R.C. § 671.

199. Treas. Reg. § 1.671-1(c) makes it clear that this rule does not apply if the grantor would be treated as the taxpayer under a theory other than dominion and control of the trust principal, for example, under the assignment of income doctrine, or the family partnership rules. Apparently the purpose of this sentence of I.R.C. § 671 was to make clear that the grantor trust rules superseded all case law in the line of cases of which *Clifford* was a part, but was not intended to preclude application of other doctrines to determine the appropriate taxpayer. See S. REP. NO. 1622, 83rd Cong., 2d Sess. 1954, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 5006 [hereinafter cited as S. REP. on 1954 Code], H. R. REP. NO. 1337, 83rd Cong., 2d Sess. 1954 *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4352 [hereinafter cited as H.R. REP. on 1954 Code].

200. Treas. Reg. 118, § 39.22(a)-22.

term is defined for purposes of federal estate and gift taxes. Obviously, one who has a nongeneral power of appointment for federal estate and gift tax purposes will never be treated as the owner of the property for purposes of section 678(a)(1). If he does not exercise the power, it will have no income tax consequences at all; the trust will be taxed under the general provisions of subchapter J. If he does exercise the power, the amounts distributed will be "other amounts required to be distributed" under section 662(a)(2). Therefore, a portion of the distributable net income (DNI) of the trust might be taxed to the appointees.[201] However, the powerholder would not be subject to tax on any of the income so distributed.[202]

Conversely, it is equally clear that the holder of a general power will be treated as the owner of that portion of the trust subject to his power. The holder of such a power over principal is treated as the owner of both the income and the principal for every year in which the power is exercisable, whether or not he exercises it.[203]

It is unclear from the language of section 678 whether the holder of a general power over trust income only would be treated as the owner only of items of taxable income that are also fiduciary accounting income,[204] or whether he would also be treated as the owner of items of taxable income and deduction, such as capital gains and losses, that are allocable to trust principal. However, the regulations under section 671 state that the powerholder whose power extends only to income is treated as the owner of the trust income only.[205] This seems correct because it is consistent with the taxation of an income beneficiary under the general rules of Subchapter J.

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201. For a definition of DNI, see note 188 *supra.*

202. The tax consequences to a grantor who reserves a similar right to affect the distribution of income or corpus of a trust to persons other than himself are quite different. Under I.R.C. §§ 674 & 676, the grantor is generally treated as owner of the portion of the trust over which he has retained the power; all income generated by that portion of the trust is taxable to him whether or not he exercises his power.

203. Treas. Reg. § 1.671-3(b)(3); Oppenheimer v. Commissioner, 16 T.C. 515 (1951) (decided under the *Mallinckrodt* regulations of the 1939 Code).

204. It is unclear whether the word "income" as used in the grantor trust provisions means fiduciary accounting income or all items includible in gross income for income tax purposes. The unmodified word "income" is defined as fiduciary accounting income in I.R.C. § 643(b). That definition is applicable only to I.R.C. §§ 641 to 669. Nonetheless, the term appears to be used to mean fiduciary account income in I.R.C. § 678(a)(1) as well, since the clause also contains a reference to corpus.

205. Treas. Reg. § 1.671-3(b)(1). A grantor who retains such a power is treated similarly.

Section 678 changes the powerholder's tax liability significantly only as to items he is not otherwise entitled to receive and does not receive. Income that is required to be distributed currently to the powerholder by the governing instrument will be taxed annually to him to the extent of DNI under the general rules of Subchapter J, whether or not it is distributed.[206] Similarly, discretionary distributions of income or principal made by a trustee to the powerholder will carry out DNI to the powerholder as a beneficiary unless there is another mandatory income beneficiary.[207] However, there are two common instances in which section 678 will and clearly should make a difference in the tax liability of the powerholder: those in which the powerholder is a mandatory income beneficiary, but the power extends to principal; and those in which income distributions are discretionary with the trustee or are required to be made to someone other than the powerholder, whether the power extends only to income or only to principal, or to both.

In the first instance, the trust will be disregarded entirely for income tax purposes to the extent of principal subject to the power, and the principal items, as well as income items, will be taxed to the powerholder as owner.[208] In the second instance, the trust will be disregarded as to that portion over which the power is held.[209] If it is exercisable only with respect to income, the powerholder will be taxable on all of the income of the trust even if it is distributed to someone else or accumulated in the trust. Neither the actual distributee nor the trust, if the income is accumulated, will be taxable on the income because the grantor trust rules supersede the general rules of Subchapter J.[210] However, principal items, such as capital gains, will be taxed to the trust. If the power extends to all or a portion of principal, the trust will be disregarded entirely as to that portion and all items of income and deduction, including principal items, will be taxable to the powerholder. These results are clearly correct because the power to vest principal or income of the trust in oneself gives one a veto power over the dispositive provisions of the trust agreement.

A powerholder is taxable under section 678 regardless of his legal capacity to exercise the power, so long as there is no limitation on his exercise of it in the trust instrument. Thus, a minor who had power to demand principal of a trust or to terminate the trust at any time was held to be owner of the trust principal even

206. I.R.C. § 652(a).
207. I.R.C. § 662(a)(2).
208. Treas. Reg. § 1.671-3(b)(3).
209. Treas. Reg. § 1.671-3(b)(1).
210. I.R.C. § 671.

though she could not exercise the power without the appointment of a legal guardian.[211] This construction of the word "exercisable" in section 678 is consistent with its construction under section 2041 of the estate tax.[212]

Similarly, one who has unlimited power to use trust property for his own benefit should be taxable under section 678 as the owner of the trust property even though he is also the trustee. The Second Circuit held that a trustee with power to revoke a trust was taxable on its income prior to the enactment of section 678.[213] Furthermore, it is clear that Congress contemplated that one person might be both a powerholder and a trustee when it drafted the income tax provision. Section 678(c), discussed below,[214] contains an exception to the general rule of section 678(a)(1) for the holder of a power exercisable "as trustee or co-trustee" to satisfy his own obligations of support. Clearly, if a power exercisable in a fiduciary capacity were not covered by section 678(a) there would be no need for such language in section 678(c).

Unfortunately, the phrase "exercisable solely by himself" in section 678(a) has been construed so narrowly by the courts and the Treasury Department that it affects few powerholders. Indeed it seems likely that there are only two groups of grantors who create powers to which section 678 is applicable: those who intend to take advantage of the powerholder's lower income tax bracket and those who fail to obtain sound tax advice.

Section 678(a)(1) has been held not to apply to a number of types of powers that are taxed as general powers of appointment under sections 2041 and 2514. Thus, one whose power of appointment or invasion is circumscribed in any way, even if it is limited by language that does not meet the requirements of sections 2041(b)(1)(A) and 2514(c)(1), is not the owner for income tax purposes of the portion of the trust over which he possesses that power. For example, in *United States v. DeBonchamps*,[215] the Ninth Circuit held nontaxable under section 678 both the power to "consume . . . for [the powerholder's] needs, maintenance and comfort during her

211. Trust No. 3 v. Commissioner, 285 F.2d 102 (7th Cir. 1960); Rev. Rul. 81-6, 1981, 1 C.B. 385.

212. Estate of Rosenblatt v. Commissioner, 633 F.2d 176 (10th Cir. 1980). A similar rule applies to adult powerholders who have been adjudicated mentally incompetent. Boeving v. United States, 650 F.2d 493 (8th Cir. 1981); Estate of Gilchrist v. Commissioner, 630 F.2d 340 (5th Cir. 1980); Estate of Alperstein v. Commissioner, 613 F.2d 1213 (2d Cir. 1979); Pennsylvania Bank & Trust Co. v. United States, 597 F.2d 382 (3d Cir. 1979).

213. Commissioner v. Newman, 159 F.2d 848 (2d Cir.), *cert. denied*, 331 U.S. 859 (1947).

214. *See* text accompanying notes 222-28, *infra*.

215. 278 F.2d 127 (9th Cir. 1962).

life without any restriction . . ." and the right "to invade and use the corpus for [the powerholder's] own needs, maintenance and comfort as well as those of [her] daughter's . . . . It is [the testator's] wish and intention to have [his] wife enjoy the free use of said corpus and income . . . ."[216] The relatively small number of courts that have had the opportunity to consider this question have held consistently that any limitation upon the power is sufficient to exclude it from the scope of section 678(a).[217] Even if one whose power is limited is not to be treated as the owner of trust property under section 678, it is difficult to see how the words "needs" and "comfort" create a meaningful limitation. Furthermore, the language in the *DeBonchamps* wills allowing the powerholders sole discretion in deciding how to use the property would seem to negate any possible limitation.

In *Hirschmann v. United States*,[218] the Second Circuit held that the holder of a legal life estate with power to invade principal under a German will was the owner of the property and, therefore, taxable upon the capital gains generated by the property under section 22 of the 1939 Code, as construed in *Mallinckrodt*. The will granted the beneficiary the "lifelong usufruct ... [and] the unrestricted possession and enjoyment of the entire property of both of us and shall in no way be restricted in disposing *inter vivos* also

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216. *Id.* at 133. The decedents in *DeBonchamps* had not created trusts explicitly; they had each transferred property to their wives for life, giving each wife the power to consume the property in accordance with the standards set out in the text, with remainder to the couple's children at each wife's death. The entities to which Subchapter J is applicable are listed in I.R.C. § 641(a); the legal life estate-remainder arrangement is not included. The court first found that the life tenants were not taxable on income allocable to principal whether or not Subchapter J applied because both I.R.C. § 678 and the case law under I.R.C. § 61 following the *Clifford* decision required that the power be unlimited in order for tax liability to be imposed. A majority of the court then held that Subchapter J applied because, under applicable state law, the life tenants had a fiduciary responsibility to preserve the property for the remainderpersons. Therefore, the arrangement was taxable as though it were a trust, and the entities, not the remainderpersons, were liable for the tax on capital gains.

217. *See, e.g.*, Koffman v. United States, 300 F.2d 176 (6th Cir. 1962) ("personal support and maintenance, the reasonableness thereof to be determined by her"); Security-First National Bank v. United States, 181 F. Supp. 911 (S.D. Cal. 1960) ("Support, comfort, health and service"); *accord*, Funk v. Commissioner, 185 F.2d 127 (3d Cir. 1950) ("needs"); Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952) ("support, maintenance, comfort and enjoyment"); and Eva V. Townsend, 5 T.C. 1380 (1945) ("as she deems necessary for her own support" decided under I.R.C. § 22 of the 1939 Code as construed by the *Mallinckrodt* decision). *But see*, Ltr. Rul. 8211057, in which the Service ruled that a trustee-beneficiary who could invade principal in her "sole discretion to provide for [her] support, welfare and maintenance" had an I.R.C. § 678(a) power.

218. 309 F.2d 104 (2d Cir. 1962).

of its substance . . ."[219] It is difficult to see how the power in *DeBonchamps* was more limited than that in *Hirschmann.* The Second Circuit accepted the district court's holding that the life tenant in *Hirschmann* did not have any fiduciary duty to the remaindermen. Presumably, therefore, unlike the Ninth Circuit, the Second Circuit would have found Subchapter J, including section 678, inapplicable to the arrangement if the 1954 Code had applied to the tax years in question.[220] However, regardless of the Code section under which the tax is imposed, there is no reason to treat the powerholder differently for income tax purposes depending upon whether the property subject to the power is held in trust. Taxpayers who possess extremely broad powers of invasion should be treated as owners even when the power is exercisable over trust property, because they have the power to vest the property in themselves within the meaning of section 678.

Furthermore, it is not clear that Congress intended section 678(a) to be inapplicable to powers limited expressly by a recognized ascertainable standard such as support or education. As was noted earlier,[221] the wording of section 678(a) is taken from the decision in *Mallinckrodt,* a case that involved an unlimited power. Section 678(c) excludes from section 678(a) powers to satisfy legal obligations to support dependents out of trust property.[222] Since such a power is limited by an ascertainable standard, there would be no need for section 678(c) if section 678(a) applied only to unlimited powers.

The regulations repeat that the power must be "exercisable solely by [the powerholder]" without elaboration.[223] Apparently, the phrase is to be read literally so that one who must act jointly with another cannot be the owner of trust property under section 678(a).[224] Thus, a joint power that is taxable under sections 2041(b)(1)(C) and 2514(c)(3) because the interest of the person who must consent is not adverse[225] does not render the powerholder an owner under section 678. It is not entirely clear that Congress intended section 678 to be so interpreted. As has been noted previously, section 678(c) creates an exception for one who has the

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219. The Surrogate's Court of New York County had construed this provision as creating a legal life estate with power of invasion. 309 F.2d at 104 (Moore, J., concurring).

220. *See* note 215 *supra.*

221. *See* text accompanying notes 193-200 *supra.*

222. For a discussion of I.R.C. § 678(c), see text accompanying notes 262-90 *infra.*

223. Treas. Reg. § 1.678(a)-1(b).

224. Ltr. Rul. 8213140; Ltr. Rul. 7923074; *accord,* 6 MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 37.51 (1983); *supra* note 182, at 155.

225. *See* text accompanying notes 114-23 *supra.*

power to use property to support his own dependents exercisable in his capacity as trustee or co-trustee. Clearly, if merely having the power exercisable jointly with another trustee were not sufficient to make the powerholder an owner for purposes of section 678(a)(1) there would be no reason for the reference to a co-trustee. However, unless there is a change in the entire pattern of taxation under Subchapter J, confining section 678 to powers exercisable unilaterally is correct for the same reasons that confining sections 2041 and 2514 to powers exercisable unilaterally is correct. One who may receive income or principal in the discretion of a trustee is not taxable on trust income unless a distribution is made.[226] It does not make sense to tax as owner someone who must get the permission of another to exercise his power if we do not tax as owner someone who need only ask a friendly trustee.

Apparently, one who has a general power of appointment exercisable only by will is not the owner of the portion of the trust subject to the power. Such a power does not permit the powerholder to vest the property in himself.[227] A testamentary general power of appointment is a taxable power under current sections 2041 and 2514, since they define a general power of appointment disjunctively as one exercisable in favor of the powerholder, his creditors, his estate, *or* the creditors of his estate. In contrast, a grantor who retains a power to dispose of trust property following his death is taxable under section 673 as owner of principal items during his life.[228]

2. Release or Modification of a Taxable Power: Section 678(a)(2)

Section 678(a)(2) provides that the powerholder continues to be treated as the owner of any portion of the trust over which he had a power previously that he has "partially released or otherwise modified," if, following such a release or modification, the powerholder has such control over trust property as would cause a grantor to be treated as an owner of the property previously subject to the power. The reader will recall that a powerholder who releases a general power of appointment will still remain subject to estate tax on the appointive property if he retains until his death any interest or power in the property that would expose a grantor to estate tax under sections 2035 through 2038.[229] Sim-

226. I.R.C. §§ 661(a) & 662(a).
227. Ltr. Rul. 5805204610A; Ltr. Rul. 5702284610A.
228. Treas. Reg. §§ 1.671-3 & 1.674(b)-1(b)(3). However, the grantor would not be taxable during life on items allocable to fiduciary accounting income, unless such items can be accumulated during his lifetime. I.R.C. § 674(b)(3).
229. I.R.C. § 2041(a)(2).

ilarly, the inter vivos exercise or further release of the "cut down" power will be a taxable gift, if a grantor would be subject to gift tax upon the exercise or release of the same retained power.[230] Therefore, it appears that in the usual case the income tax consequences of partially releasing a general power of appointment will be roughly equivalent to the transfer tax consequences.[231] So, for example, the holder of a general power over the principal of a trust who releases the power to appoint to anyone other than his lineal descendants will continue to be treated as the owner of all items of income and deduction of the trust.[232]

Unfortunately, the income tax provision fails to track the estate and gift tax provisions in two significant respects. First, section 2041(a)(2) of the estate tax requires inclusion of trust property in the powerholder's estate in any case in which the powerholder releases the power in a *transfer* that would cause the property to be included in a grantor's estate under section 2035 through 2038. Section 678(a)(2) requires the powerholder to be treated as the

230. Treas. Reg. § 25.2514-3(c)(3).

231. The results will not be identical in all cases, however, because the grantor trust income tax provisions do not parallel exactly estate tax §§ 2035-2038. The estate tax provisions are broader.

Perhaps the most important differences are the exceptions embodied in I.R.C. §§ 674(b)(5)(B) & 674(b)(6) and the rules governing jointly exercisable powers. Thus, for example, the grantor will not be treated as the owner of trust property for income tax purposes merely because he can distribute principal to an income beneficiary, if the distributions are chargeable against the principal held in trust for the payment of income to that beneficiary. I.R.C. § 674(b)(5)(B). Apparently, this applies to items allocable to principal for fiduciary accounting purposes as well as those allocable to income. *Compare* Treas. Reg. § 1.674(b)(5), Ex. 2 *with* Treas. Reg. § 1.674(b)-(1)(b)(3). *Accord*, Costello, *Capital Gains Realized by Trusts: Taxation to Persons Other Than the Trustee*, 22 TAX LAW. 495, 512 (1969). Nor will the grantor be treated as the owner of any part of a trust merely because he may distribute principal to anyone he wishes, if he must first obtain the consent of an adverse party, as that term is defined by I.R.C. §§ 672(a) & 674(a) (by implication). However, the trust property subject to either of these powers is includible in the grantor's gross estate under I.R.C. §§ 2036(a)(2) & 2038(a)(1).

Similarly, a powerholder who partially releases his unlimited power and retains only the powers just described will no longer be treated as the owner of trust property for income tax purposes under I.R.C. § 678(a). However, the property will still be includible in his gross estate under I.R.C. § 2041(a)(2) if he dies without having released the retained powers, and exercise of the retained powers will constitute a taxable gift under I.R.C. § 2514. Treas. Reg. § 25.2514-3(c)(3).

This clearly seems incorrect; both the grantor and the powerholder should continue to be treated as owners for income tax purposes following such transfers. The solution, however, lies in amending I.R.C. § 674, rather than I.R.C. § 678(a)(2). For a thorough review and criticism of these rules, see Lowndes, *Tax Consequences*, *supra* note 124; Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance*, 60 COLUM. L. REV. 326 (1960).

232. I.R.C. § 674(a).

owner of the trust property for income tax purposes if, after the release of the power, he retains such *control* as would require a grantor to be treated as owner under sections 671 through 677. Therefore, it is unclear whether a former powerholder who has a beneficial interest in the trust after he releases his power, but no powers over trust property, continues to be an owner of trust property under section 678(a)(2). The word "control" appears to limit application of the section to taxpayers who retain powers but not interests. In contrast, it is clear that the trust property will be includible in the former powerholder's estate if he retains only a beneficial interest in the trust, since the estate of a grantor will include trust property that he transfers if he retains a beneficial interest in it.[233]

Second, permitting a power to lapse unexercised constitutes the release of the power for estate[234] and gift[235] tax purposes. The income tax statute contains no such rule. Therefore, it is unclear whether a powerholder who has another interest or power in the trust that would expose a grantor to income tax liability as an owner under sections 671 through 677, and who permits his power to lapse unexercised, continues to be the owner for income tax purposes of the portion of the trust formerly subject to the power.

The legislative history is adequate to resolve either of these questions. As to the effect of the word "control," the statute codifies a sentence of the *Mallinckrodt* regulations,[236] and the Committee Reports merely repeat the language of the statute without explanation.[237] However, the general purpose of the *Mallinckrodt* regulations and section 678 is to define those situations in which someone has been given so much control over trust property that he should be treated for income tax purposes as though he owned it outright. If he has had that control at any time, he should be treated as a grantor whenever he modifies that control. It is inconsistent to treat one who reduces his general power of appointment to a limited power as a grantor would be treated under section 674, but not to treat one who releases the power entirely while retaining a discretionary beneficial interest in the trust as a grantor would be treated under section 677.[238]

The second question is relevant to the income tax consequences of powers that lapse at a stated time under the terms of

233. I.R.C. §§ 2036 & 2037.

234. I.R.C. § 2041(b)(2); *see* text accompanying notes 132-34 *supra*.

235. I.R.C. § 2514(e).

236. Treas. Reg. 118, § 39.22(a)-22 (second sentence).

237. S. REP. on the 1954 Code, *supra* note 199, at 4719; H.R. REP. on the 1954 Code, *supra* note 199, at 4089.

238. *Accord*, Westfall, *Lapsed Powers of Withdrawal and the Income Tax*, 39 TAX L. REV. 63 (1983) [hereinafter cited as Westfall].

the granting instrument. The two most common such powers are the "window" power and the annually expiring five or five power. The window power permits a beneficiary to withdraw all or a substantial portion of trust principal during a short period of time, after which the entire power lapses. The estate and gift tax consequences of this power and its estate planning uses have been discussed previously.[239] Often the holder of a window power will have another interest in the trust that would cause a grantor to be treated as an owner under sections 671 through 677, for example, an income interest or a nongeneral power to appoint the principal. It seems clear that such a powerholder who permits the window power to lapse ought to be treated as having released it for purposes of section 678(a)(2). One who was at one point the absolute owner of the property and chose to permit it to continue in trust for the benefit of himself and others ought not to be treated differently for income tax purposes from one who owned the property and transferred it to a trust for the benefit of himself and others. Therefore, he should be considered the owner thereafter under section 678(a)(1) of that portion of the trust that he could have withdrawn. In most cases, since he will have had the temporary power to withdraw the entire principal, under this interpretation of section 678(a)(2) the powerholder will be taxed on all ordinary trust income for all subsequent years in which income may be distributed to him,[240] and on income items allocable to principal to the extent that principal may be distributed to him[241] or he has any remaining power over principal.[242]

Although the Service takes the position that section 678(a)(2) applies to a lapsed temporary power[243] and a respected commentator agrees,[244] others argue that the wording of the section requires that the powerholder act before the section applies.[245] They argue that the powerholder who passively permits a temporary power to lapse has neither "released [n]or otherwise modified" his power. While this argument is not insupportable, there is nothing in the legislative history of section 678 to indicate that Congress intended the statute to apply only to one who executes a document to release or modify a power and not to one who releases

239. *See* text accompanying notes 132-34 & 144-54 *supra.*
240. I.R.C. § 677(a).
241. I.R.C. §§ 673 & 677(a).
242. I.R.C. § 674.
243. Ltr. Rul. 8142061 (the lapse of a five or five power).
244. Westfall, *supra* note 238.
245. *See, e.g.*, Mason, *An Analysis of Crummey and the Annual Exclusion*, 67 MARQ. L. REV. 573, 587 (1982); Natbony, *supra* note 153; Simmons, *Drafting the Crummey Power*, 15 U. MIAMI INST. EST. PLAN. ¶ 1713.4 (1981).

or modifies the power passively by permitting it to lapse.[246] Similarly, those who believe that section 678(a)(2) should not apply to a lapsed power point out that the powerholder does not control the trust property after the lapse if his only other interest in the trust is that of a discretionary income beneficiary. While the word "control" ordinarily denotes power rather than beneficial interest, a grantor who is treated as the owner of a trust by virtue of sections 673 or 677 may have a beneficial interest, rather than a power. There is no that indication Congress intended to exclude such interests from section 678(a)(2). Indeed, it is much more likely that Congress intended to continue to treat a former powerholder as an owner in all situations in which a grantor would be so treated.

The five or five power presents a slightly different problem under the income tax. It is clear that the powerholder is the owner each year under section 678(a)(1) of that portion of the trust over which he holds the power, whether he exercises it or not. For example, a powerholder who has the power to withdraw the greater of $5,000 or 5% of the principal of a trust in a year in which the principal is worth $200,000 is the owner of 5% of the principal. Therefore, he is the taxpayer with respect to five percent of each item of income and deduction of the trust for that year, including items that are allocated to principal for trust accounting purposes

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246. Both Committee Reports state that the powerholder will be treated as the owner "if he has modified this power (by release or otherwise) . . . ." S. REPT. on 1954 Code, *supra* note 199, at 4089; H.R. REP. on 1954 Code, *supra* note 199, at 4719. The Committee Reports indicate that Congress intended to codify the *Mallinckrodt* regulations in I.R.C. § 678. These regulations state that the powerholder will be taxed "[e]ven though such a power has been partially released or otherwise modified . . . ."

One might argue that there is evidence of congressional intent to exclude lapses from I.R.C. § 678(a)(2) in the failure to include them explicitly. The predecessor of I.R.C. § 2041, enacted in 1951, included the provision now embodied in I.R.C. § 2041(b)(2), which states that a lapse is to be treated as a release. I.R.C. § 678(a)(2), enacted three years later, contains no such provision. However, this is also inconclusive because the income tax provision applies to "modifications," a word not used in the estate and gift tax section and which could also include a lapse.

One author has suggested that I.R.C. § 678(a)(2) was not intended to apply to a lapsed power because a lapse is not a transfer. *See* Natbony, *supra* note 153. This position is questionable on two grounds. First, the statute does not contain any requirement that the powerholder make a transfer. Second, the powerholder who fails to exercise a power to withdraw property from a trust, with the result that it remains available for ultimate distribution to the remainderpersons, clearly should be treated for income tax purposes identically to one who withdraws the property and places it in another trust which he has created and which has the same beneficiaries.

but have income tax consequences, such as capital gains.[247] If the corpus were worth only $50,000 in a given year, the powerholder would have the right to draw down $5,000, and he is the taxpayer with respect to 5,000/50,000, or 10%, of all such items for that year.

It is less clear how the powerholder's income tax liability should be calculated for succeeding years. Section 678 does not state explicitly, as do the estate and gift tax provisions,[248] that the lapse of a five or five power is not a release. Therefore, it is unclear whether a powerholder who has another interest in the trust continues to be treated as the owner under section 678(a)(2) of the portion of the trust over which he formerly had a five or five power when he permits the power to lapse. If a lapse is a release for income tax purposes, there is no reason to treat the lapse of a five or five power differently from the lapse of any other power to vest principal in oneself.[249] Thus, the holder of a five or five power who also has another interest in the trust that would cause a grantor to be treated as the owner under sections 671 through 677, will become the owner of a greater portion of the trust in each year that he permits his five or five power to lapse.[250] There-

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247. Treas. Reg. § 1.671-3(a)(3); Ltr. Rul. 8211057; Ltr. Rul. 7852042; and Ltr. Rul. 570075020A.

248. I.R.C. §§ 2041(b)(2) & 2514(e).

249. *Accord*, Westfall, *supra* note 238; *see also* 3 J. CASNER, ESTATE PLANNING 1279 (4th ed. 1980); Costello, *Capital Gains Realized By Trusts: Taxation to Persons Other Than the Trustee*, 22 TAX LAW. 495, 522, n.93 (1969). *Contra*, J. PESCHEL & E. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES ¶ 9.05B (1978). *See also* Natbony, *supra* note 153; Covey, *The Estate Planning Benefits Available Via A "$5,000 or 5%" Withdrawal Power*, 34 J. TAX 98, 100 (1971).

There is very little authority on this point. The only case involving the income tax consequences of an annually lapsing power to withdraw a portion of trust principal was decided prior to the enactment of I.R.C. § 678 and does not address the question of whether the powerholder was to be taxed under similar language in the *Mallinckrodt* regulations as the owner of trust property formerly subject to a power that had lapsed in an earlier year. *See Oppenheimer*, 16 T.C. 515.

The Service takes the position that the lapse of a five or five power is a release under I.R.C. § 678(a)(2). *See, e.g.* Ltr. Rul. 8142061.

250. Presumably the calculation of the portion of which he is the owner each year is similar to the calculation made for estate tax purposes with respect to powers over property valued in excess of the greater of $5,000 or 5% of trust principal. Treas. Reg. § 20.2041-3(d). Thus, for example, the cumulative income tax consequences would be as follows for the holder of a five or five power who is also a discretionary income beneficiary of the trust: If the principal is worth $200,000 at the end of the first taxable year, the powerholder will be treated as the owner of all items of income and deduction attributable to 5% of the trust principal under I.R.C. § 678(a)(1), even if he permits the power to lapse. In subsequent years, this percentage will be used to determine the portion of the prin-

fore, he may ultimately become the owner of the entire trust. Since he could have withdrawn all of the trust property over a period of time, there is simply no reason to treat him differently from one who creates a trust designating himself, for example, a discretionary income beneficiary, and transfers additional property to the trust periodically. The lapse of a power to withdraw clearly should be a "release or other modification" within the meaning of section 678(a)(2).

3. Exceptions to Section 678(a)

Section 678(b) through (d) expressly except three powers that would ordinarily fall within section 678(a).

a. Grantor Owner

The first of these three exceptions, contained in section 678(b), excludes a power to vest income in the powerholder if the grantor would be treated as the owner under sections 671 through 677. Section 678(b) simply codifies a sentence of the regulations under the 1939 Code added following the *Mallinckrodt* decision.[251] The legislative history of the 1954 Code merely restates the Code provision without explanation.[252] However, it is easily justified in that it prevents an obvious end run around the grantor trust provisions.

The wording of the section is curious; it refers only to powers over income, while section 678(a) refers to powers over income or corpus. It is clear that one who has the power to demand income from a trust that is revocable in the sole discretion of the grantor is not taxed as owner of that income. Instead, the grantor will be taxed as the owner pursuant to section 676, whether or not the income is paid to the powerholder. On the other hand, it is not clear who is the owner of principal items if both the grantor and

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cipal that the powerholder is deemed to own under I.R.C. § 678(a)(2). If the trust principal increases in the second year to $220,000, the powerholder will again be entitled to withdraw 5%. Therefore, for that year he will be the owner of 10% of each of the trust's items of income and deduction; that is, 5% under I.R.C. § 678(a)(1) because of the current year's power, and 5% under I.R.C. § 678(a)(2) because of the power that lapsed at the end of the first year. Similarly, if the trust principal decreased to $60,000 in the third year, the powerholder would be entitled to withdraw another $5,000. For that year, he would be treated as the owner of 18.33% of the trust's items of income and deduction, 8.33% under I.R.C. § 678(a)(1) because of the current year's power, and 10% under I.R.C. § 678(a)(2) because of the prior two years' lapsed powers.

251. Treas. Reg. 118, § 39.22(a)-22.

252. S. REP. on 1954 Code, *supra* note 199; 1954 U.S. CODE CONG. & AD. NEWS 4621, 4719.

another person have taxable powers over principal. For example, the grantor of an irrevocable trust that will last for at least ten years will not be treated as the owner of the income during the period of the trust;[253] however, if he retains a reversionary interest in the trust property, he will be treated as the owner during the entire term of the trust of any items of income or deduction allocable to principal, such as capital gains and losses.[254] If the grantor also gives the income beneficiary a right to demand principal during the term of the trust, the beneficiary's power will fall within section 678(a), but seems not to be within the exception of section 678(b). Obviously, both the grantor and the powerholder will not be taxed on the same item of income. Equally obviously, the grantor is the proper taxpayer. There is no more reason to permit a grantor to shift to a powerholder the tax liability for principal profits while retaining an interest in the principal than to permit him to shift the tax liability for items allocated to trust income with respect to which he retains a similar interest.

The regulations under section 677(a) imply that the word "income" in that section includes any receipt that is included in gross income under the general provision of the Code.[255] Thus, capital gains realized by a ten year trust in which the grantor has retained a reversion are taxable to the grantor as owner of the principal of the trust under section 677(a)(2) as income which may be held or accumulated for future distribution to the grantor. Unfortunately, the regulations under section 678(b) contain no such implication, and at least one private letter ruling implies that the powerholder will be treated as owner of the principal when both the powerholder and the grantor have a power over principal.[256] The regulation under the 1939 Code from which the wording of section 678(b) was taken was issued under section 22 of the 1939 Code, the predecessor of section 61. In that context the word "income" could reasonably be construed in its tax sense as including any item that would be includible in gross income, rather than in its narrower fiduciary accounting sense. Unfortunately, the language of section 678(a), referring explicitly to both corpus and income, also comes from the same regulation. It is likely that section 678(b) simply codifies the unfortunate result of imprecise drafting. Congress would do well to amend section 678(b) to except from

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253. I.R.C. § 673(a).

254. Treas. Reg. § 1.673-1(a).

255. Treas. Reg. §§ 1.677(a)-1(f) f-g (g), example 2, *cf.* Rev. Rul. 79-223, 1979-2 C.B. 254 (because the trust agreement provides that capital gains are to be added to principal for eventual distribution to grantor, the grantor "will be treated as the owner of the income of the trust with respect to capital gains.").

256. Ltr. Rul. 8308033 (1983).

section 678(a) any item with respect to which the grantor would otherwise be treated as the owner.

b. Support of Dependents

The second exception to the general rule of section 678(a), embodied in section 678(c), states that one will not be treated as the owner of income of a trust as to which he has the power "in the capacity of trustee or co-trustee, merely to apply the income of the trust to support or maintenance of a person whom the holder of the power is obligated to support or maintain, except to the extent that such income is so applied." This provision was added by the drafters of the 1954 Code;[257] it did not appear in the *Mallinckrodt* regulations.[258] It was designed to conform the treatment of such a powerholder to that of a grantor who retains power to use trust income to support his dependents.[259] It applies only to those whose power is exercisable as a trustee. Therefore, one who has a power of appointment in the traditional property law sense that can be exercised to support his dependents is subject to income taxation under the general rule of section 678(a).[260]

This section is puzzling in several respects. First, as was noted before, the section states that the general rule of section 678(a) will not apply to one who possesses this power in the capacity of a co-trustee. Since section 678(a) refers only to powers exercisable solely by the powerholder, it would not apply in any event to one who possesses a power that can only be exercised jointly. One commentary suggested that Congress added the reference to a co-trustee because it contemplated a trust instrument in which one of several trustees was given a support power that he could ex-

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257. I.R.C. § 678(c), 68A Stat. 3, 231.

258. Treas. Reg. 118, § 39.22(a)-22.

259. I.R.C. § 167(c) (1939) (recodified as I.R.C. § 677(b)).

260. Treas. Reg. § 1.678(c)-1(b). One authority has suggested that the holder of a special power to appoint corpus for the benefit of his minor children would also be treated under I.R.C. § 678(c) as the owner of so much of the income and principal of the trust as was used for the support of those children. *Use and Drafting of Powers of Appointment*, 1 REAL PROP. PROB. & TR. J. 307 (1966). This statement assumes that I.R.C. § 678(c) applies to both income and corpus. More importantly, however, it seems to misconstrue I.R.C. § 678(a). The holder of a power to appoint to his children would have a power exercisable only for the benefit of the children. His state law obligation to support them would exist regardless of their own resources and, therefore, he would not be able to use the appointive property to satisfy his obligation of support. Such a use of the property would constitute an appointment to himself and would be outside the scope of the power. *Accord*, Mesker v. United States, 261 F. Supp. 817 (E.D. Mo. 1966) (power of a husband to appoint the corpus of a trust to his wife not a § 678(a) power).

ercise alone, while his co-trustees were granted other powers.[261] It seems equally plausible that the drafters simply imported the phrase from section 677(b), the provision dealing with the taxation of a grantor who retains such a power. In section 677(b), the reference to a co-trustee is appropriate because the general rule of section 677(a) applies to a grantor who must exercise the retained power jointly.

Second, like section 678(b), section 678(c) applies only to a power over income. The power to support one's dependents is a section 678(a) power, because it enables the powerholder to satisfy his legal obligation from trust property.[262] Therefore, the powerholder is treated as owner of trust principal and income if the power is exercisable over principal, whether he exercises the power or not. While it is certainly sound tax policy to treat one who has such a power as the owner of the portion of the trust to which the power applies, there is no reason to distinguish between a power over income and a power over principal. Furthermore, it is not clear that Congress intended to make such a distinction; indeed it is difficult to understand the reference to distributions from corpus or accumulated income in the second sentence of the provision if the first sentence applies only to income.

It is reasonably clear that Congress intended the general rule of section 678(a) to apply to one who can satisfy his legal obligations out of the principal of a trust, but intended to create a relatively narrow exception for fiduciary powers exercisable to satisfy a particular legal obligation, support of one's dependents.[263] Apparently, Congress intended such a powerholder to be treated as he would be if a third party trustee, not the powerholder, had sole discretion to use trust property for this purpose. Thus, the second sentence of section 678(c) requires the powerholder to determine the tax consequences under section 661 and 662 of that portion of any support distribution that he makes as trustee that is not made out of the current year's income. In that case, if no amount is paid out during the taxable year for this pur-

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261. Kamin, Surrey & Warren, *The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries*, 54 COLUM. L. REV. 1237, 1263 (1954).

262. Treas. Reg. § 1.678(a)-1(b).

263. H.R. REP. on the 1954 Code, *supra* note 199, at 4357; S. REP. on the 1954 Code, *supra* note 199, at 5013. It is not clear why Congress believed such an explicit statutory exception was necessary. Cases decided under that sentence of the *Mallinckrodt* regulations which was enacted as I.R.C. § 678(a) had held that powers subject to an ascertainable standard would not render the powerholder taxable as owner. *See* note 217, *supra*. A power exercisable only for the support of one's dependents is subject to such a standard. Any broader power would not be a power "merely" to apply income for the support of one's dependents, and, therefore, would not be covered by I.R.C. § 678(c).

pose, neither the person who could have been supported nor the person responsible for support will be a trust beneficiary for income tax purposes.[264] If amounts are actually paid by the trustee for support, they will be amounts properly paid, credited, or required to be distributed under sections 661(a)(2) and 662(a)(2), the general provisions dealing with the income taxation of nongrantor complex trusts. The person whose support obligation was satisfied, rather than the dependent, is treated as the beneficiary of these amounts for income tax purposes.[265] He will be taxed on a portion of the DNI of the trust to the extent that the support distributions carry out DNI under the provisions of section 662,[266] and, to the extent that the distributions exceed DNI for the year, he will either receive a tax-free distribution of principal, or he will receive an accumulation distribution under section 667.[267] Since receipts allocable to principal, such as capital gain, do not enter into the computation of either DNI[268] or accumulation distributions,[269] the trust will be taxable on such items.

The second sentence of section 678(c) seems to increase the confusion engendered by the first sentence. First, it clearly refers back to the power described in the first sentence of the subsection. But that is a power exercisable over income only. It is difficult to see how the holder of such a power could make a distribution out of principal or accumulated income without violating the terms of the trust. Furthermore, since the general rule of section 678(a) applies to powers over principal, the effect of this second sentence will be to treat the powerholder both as an owner and as a beneficiary with respect to fiduciary powers to support dependents out of principal.[270]

As was noted earlier, the wording of section 678(c) appears to have been borrowed from section 677(b), the provision dealing with taxation of a grantor who retains a similar power. The reference to a power over income in section 677(b) is appropriate because the general rule of section 677(a) deals only with powers over in-

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264. I.R.C. § 662(a).

265. Treas. Reg. § 1.662(a)-4.

266. *See* note 186 *supra*.

267. Amounts payable out of fiduciary accounting income are not subject to the throwback rules. I.R.C. § 665(b) (last sentence).

268. I.R.C. § 643(a).

269. I.R.C. § 665(b).

270. Ltr. Rul. 8113079 holds that a trustee who has discretionary power to use trust income and principal for the support of his children is taxed as owner of the income so used under I.R.C. § 671 and as a beneficiary of any principal so used under I.R.C. § 662. *See also* Ltr. Rul. 6512151560A; Ltr. Rul. 6112221560A. These rulings imply, of course, that I.R.C. § 678(c) applies to powers over both income and principal.

come.[271] Nonetheless, section 677(b) contains the same reference to distributions made out of principal or accumulated income as does section 678(c). The legislative history of these sections is not helpful in resolving these anomalies.

The failure to deal explicitly with fiduciary powers to support dependents out of trust principal will cause difficulty for taxpayers contemplating several common estate plans, especially testamentary trusts and inter vivos section 2503(c) trusts for the benefit of grandchildren.[272] It is quite common for the older generation members of a family to set up such trusts for the benefit of their grandchildren, naming their children or their children's spouses as trustees. The testator who wishes to provide for the support of her grandchildren out of a testamentary trust but also wishes to assure that the parents of the grandchildren are not treated as owners of the trust property under section 678 will either have to choose someone other than the parents to serve as trustee, or will have to confine the power to pay for support items to income.[273] The problem is more difficult for the *inter vivos* grantor.[274] If she wishes her contributions to qualify fully for the gift tax annual exclusion under section 2503(c), she must grant the trustee the power, in his or her discretion, to use the property in the trust for the benefit of the minor beneficiary. Excluding power to pay for support of the beneficiary will jeopardize the present interest exclusion.[275] On the other hand, confining the power to income only may also jeopardize the exclusion in excess of the current value of the income interest.[276] Thus, to assure full

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271. Unfortunately, there also is no counterpart elsewhere in the grantor trust provisions that indicates explicitly that a grantor who has such a power over principal is to be treated as a beneficiary, rather than an owner.

272. I.R.C. § 2503(c) allows the grantor of a trust to get an annual exclusion for the full amount of property transferred into a trust for the benefit of a minor, provided that the property and the income it generates may be expended for the benefit of the minor until he reaches age 21 and, to the extent not so expended, will pass to the minor or to his estate upon his reaching age 21 or dying sooner. It is an exception to the rule of I.R.C. § 2503(b), which limits such annual exclusions to "present interests." For a discussion of I.R.C. § 2503(b) see note 148 *supra*.

273. It seems somewhat ironic that a trustee-parent who has the power to use trust property to provide luxuries for his children, but not for support, is not taxable as owner of the trust property, since such a power would not grant him the right to satisfy his legal obligations out of trust property. *See Trust Income Taxation and the Obligation of Support*, 1 *Real Prop., Prob. & Tr. J.* 327, 335 (1966).

274. A grantor who wishes to create an I.R.C. § 2503(c) trust for the benefit of his own child and name himself trustee is faced with the same choices because I.R.C. § 677(b) contains the same wording as I.R.C. § 678(c).

275. Treas. Reg. § 25.2503-4(b)(1).

276. *See* Commissioner v. Herr, 303 F.2d 780 (3d Cir. 1962).

benefit of the annual exclusion under section 2503(c), the grantor must either choose a trustee other than a parent of the beneficiary, or risk that the parent will be taxed as owner of the trust under section 678(a), even if no distributions from the trust for support are made.[277]

It is clear that section 678(c) must be amended. There are a number of ways to proceed. There is no reason to continue treating support obligations differently from other legal obligations that a powerholder may satisfy out of trust property.[278] Indeed, since section 678(c) imposes a tax on the trustee-parent only to the extent that he uses trust income to support his children, it will likely only affect less wealthy taxpayers. Those who have other resources from which to support their children presumably will use them, while permitting trust income to incur tax at the trust's lower tax rate and accumulate for eventual distribution to the child or his descendants.[279] Clearly, this is the kind of power over disposition that section 678(a) should tax. Therefore, one simple solution to the problems outlined above is to repeal section 678(c), leaving the powerholder the owner of any trust property that he may use to support his dependents, whether or not he uses it. This solution will also conform the income tax treatment of support powers to the estate and gift tax treatment of them, at least with respect to powers exercisable solely by the person whose obligations of support may be satisfied.[280]

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277. A similar question arises concerning the taxation of property held under the Uniform Gifts to Minors Act by a parent for the benefit of his or her children. The Uniform Gifts to Minors Act provides explicitly that custodianship property and the income it generates may be used for the support of the child. *See, e.g.* TENN. CODE. ANN. § 35-7-105(a) (1984 Repl. Vol.). Therefore, a parent-custodian has power to use custodianship assets to satisfy his legal obligation to the same extent as does one who is trustee of an I.R.C. § 2503(c) trust for his child's benefit. A custodianship under the Uniform Gifts to Minors Act is not considered a separate entity for tax purposes; therefore, Subchapter J does not apply to custodianships. Income generated by custodianship property is taxable to the child. Rev. Rul. 56-484, 1956-2 C.B. 23, 24. Nonetheless, under general principles of taxation, the parent-custodian should be subject to tax to the extent he can satisfy his support obligations from the custodial property. In Rev. Rul. 56-484, the Service held that income from custodial property that was actually used to satisfy the parent-custodian's support obligation was taxable to the parent. This result is clearly consistent with the result under I.R.C. § 678(c). Taxation of principal items, such as capital gain, and of income not so used was not discussed explicitly in the ruling; however, the obvious implication of the ruling is that these items are taxable to the child.

278. *Contra, Trust Income Taxation and the Obligation of Support*, 1 REAL PROP., PROB. & TR. J. 327 (1966).

279. Income accumulated during the minority of the beneficiary who ultimately receives it, or before the beneficiary's birth, is not subject to the throwback rules. I.R.C. § 665(b) (flush language).

280. *See* note 93 *supra* and accompanying text. Of course, one who may only exercise this power of support with the consent of a nonadverse party will

On the other hand, if Congress wishes to continue to single out child support obligations for this especially beneficial tax treatment, then, at a minimum, section 678(c) should be amended to provide the same treatment whether the parent-trustee's power is exercisable over income or principal. This could be achieved simply by adding the words "or the corpus" after the word "income" in the first sentence of section 678(c). Then the powerholder would be treated as the beneficiary of the trust under section 662 to the extent that he exercised the support power, even when the power was exercisable over principal. Of course, since DNI does not include items of income allocable to principal, the trust, rather than the powerholder will then be liable for the tax on principal items, such as capital gain, even when the power is exercisable over principal.

It seems more appropriate, however, to make a more fundamental change in this area. The best solution would be to amend section 678 to treat the child as the owner of all such trusts, regardless of the identity of the trustee, whenever the trust instrument provides that income not expended for support is to be accumulated for ultimate distribution to the child or his estate. This rule should apply to testamentary trusts as well as section 2503(c) trusts.[281] It has several advantages over repeal of section 678(c). First, it eliminates the need to determine whether a particular item is a support item. This traditionally has been a rather cumbersome determination, made on a case-by-case basis under state law.[282] Second, it eliminates the trust as a separate taxpayer, simplifying the administration of such trusts and conforming their tax treatment to that of custodianships.[283]

The elimination of the trust as a separate taxpayer has the additional advantageous result of preventing an opportunity for tax avoidance available under the current pattern of taxation: It is currently beneficial for each donor to set up a separate trust for a minor beneficiary. So long as the income is accumulated, the family has the benefit of splitting income among a number of taxpayers, thereby reducing the overall tax burden by taking advantage of lower marginal tax rates. Since the accumulation distribution rules do not apply to income accumulated while the

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still not be subject to income tax as the owner of the property; *see* text accompanying notes 223 & 224, *supra*, but will be subject to estate or gift tax upon the exercise or lapse of the power.

281. Application of the rule to testamentary trusts will be more difficult than to I.R.C. § 2503(c) because testamentary trusts will often have a number of permissible beneficiaries. Therefore, it will be necessary to make rules for the allocation of income and principal among them.

282. *See generally Trust Income Taxation and the Obligation of Support*, REAL PROP. PROB. & TR. J. 327 (1966).

283. *See* note 277 *supra*.

ultimate recipient was under twenty-one years of age,[284] this tax savings is permanent. There is no reason to permit such savings where both the beneficiary and the terms of the trusts are essentially the same, merely because the donors are different.[285]

c. Disclaimers

The last exception to section 678(a), section 678(d), states that subsection (a) will not be applicable to a power which is renounced or disclaimed within a reasonable time after the holder first becomes aware of its existence. Apparently, the purpose of this section is to apply traditional gift tax principles concerning disclaimers to the income tax.[286] Thus, the holder of a section 678(a) power who files a timely disclaimer of it will be treated as though he had never had the power. This will have two effects. First, any income earned between the time the instrument granting the power became effective and the time the disclaimer became effective will not be taxable to the disclaiming powerholder under section 678(a)(1). Second, a disclaimer of a power will not be treated as a release or modification of the power for purposes of section 678(a)(2).

While the general principle of section 678(d) seems proper, it is unfortunate that the section has not been amended to conform to section 2518 of the gift tax provisions. Section 678(d) embodies the general rule concerning the gift tax consequences of disclaimers prior to 1976. However, the reasonableness requirement of prior gift tax laws spawned a series of inconsistent and occasionally questionable decisions concerning what constituted a reasonable time.[287] To eliminate the confusion caused by these decisions, Congress passed section 2518 as part of the Tax Reform Act of

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284. I.R.C. § 665(b) (flush language).

285. I.R.C. § 643(e)[f], enacted as part of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984), grants the Commissioner power to treat as one taxpayer trusts created by the same grantor for the same beneficiary if the trusts have no independent purpose and their principal purpose is tax avoidance. At a minimum, Congress would do well to extend this provision to apply to identical trusts created by different grantors for the same beneficiary.

286. Prior to 1976, one who made a timely disclaimer of property without directing to whom it should be transferred was not treated as having transferred the property, provided applicable state law permitted him to so disclaim. Treas. Reg. § 25.2511-1(c). As a result, he was not subject to gift tax. The disclaimed property was treated as having passed directly from the prior owner to such alternate takers as are designated in the governing instrument or by state law.

287. *See, e.g.*, Keinath v. Commissioner, 480 F.2d 57 (8th Cir. 1973) (disclaimer made 2 months after death of life income beneficiary but 19 years after transfer to trust held reasonable).

1976[288] and has refined it twice since.[289] Section 2518 sets forth specific rules which must be followed in order for a disclaimer to be effective for federal gift tax purposes. Because the income tax rules do not conform to the new gift tax provisions, powerholders must comply with both old and new rules in order to disclaim the interest effectively for purposes of both taxes.[290] If Congress wishes to provide a means for taxpayers to avoid ownership of property for tax purposes, the procedure should be the same for income tax as for transfer tax. Section 678(d) should be amended to conform to section 2518.

C. Proposals for Reform

Several proposals have been made recently to revise substantially the pattern of income taxation of trusts. The reformers agree that trusts present substantial tax reduction opportunities through income splitting that should be eliminated. They disagree, however, about the most appropriate means to implement this goal.

The Treasury Department 1984 Proposals advocate substantial revision of Subchapter J to eliminate the separate tax rates applicable to trusts.[291] Under the Treasury Department's model, which is quite similar to one proposed last year by the ALI,[292] trusts are classified according to whether their grantor is alive or dead, and, if the grantor is alive, then according to whether the grantor has retained certain interests in or control over the property held in trust.[293] The interests are similar to though not

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288. Tax Reform Act of 1976 § 2009(b).

289. Pub. L. No. 95-600, § 702(m), 92 Stat. 2763, 2935 (1978); Pub. L. No. 97-34, § 426, 95 Stat. 1970, 2318 (1981).

290. While the new rule may be stricter than the old one in some respects, it is more liberal in others. For example, I.R.C. § 2518(b)(2)(A) requires that the disclaimer be made within nine months of the creation of the interest, rather than within a reasonable time. On the other hand, I.R.C. § 2518(c)(3) makes it clear that a disclaimer that meets all the federal gift tax requirements is not rendered a taxable transfer merely because it does not meet all applicable state law requirements. It is likely that a disclaimer that did not meet state law requirements would not be effective to relieve the powerholder of income tax liability under I.R.C. § 678(d).

291. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 96-106.

292. ALI Subchapter J Project, *supra* note 15.

293. The Treasury Department would treat a trust as a grantor-owned trust if the grantor or the grantor's spouse has any of the following interests or powers: income or principal is required to be distributed currently to either of them; such payments may be made to either of them under a discretionary power held by either of them; either of them may revoke or amend the trust and thereby cause distributions to be made to either of them; either of them may require the trustee to lend trust income or principal to either of them; either of them has borrowed trust income or principal and has not repaid the loan completely,

identical with those that currently result in classification as a grantor trust under sections 671 through 677. If the grantor is alive and has retained an interest in the trust property or control over it, the trust is classified as a grantor-owned trust; income produced by property in a grantor-owned trust is taxed to the grantor as under current law. If the grantor has not retained any of the interests or powers that render the trust a grantor-owned trust, then the trustee will compute the taxable income of the trust and will compute and pay from trust funds a tax beginning at the grantor's highest marginal tax rate for the taxable year,[294] except to the extent that the trustee is required to distribute a "fixed or ascertainable" amount of income or principal to a specific beneficiary or beneficiaries. The trust will receive a deduction for these required distributions and they will be taxed to the beneficiary. Amounts required to be set aside permanently for a beneficiary, that will be distributed to him ultimately or includible in his estate for estate tax purposes, are also taxable to the beneficiary and deductible by the trust. To the extent that required distributions and mandatory set asides exceed DNI, they will include their proportionate share of capital gains.[295] After the death of the grantor, all income that is not required to be distributed to, or set aside permanently for, a specific beneficiary, is taxed to the trust as a separate taxpayer, except that all income from trusts created by the same grantor is aggregated and each trust is assessed its proportionate share of the total tax liability. The accumulation distribution rules are abolished.

The Treasury Department advocates retaining the concept that a person other than the grantor may be treated as owner of a trust but does not elaborate upon the circumstances that should result in such treatment, stating only that they should be "made consistent with these rules."[296] Consistent with the rule that income that is permanently set aside for the benefit of a beneficiary ought to be taxed to him, the ALI proposals, upon which the Treasury proposals are apparently based, treat a powerholder as the owner if he has a nonlapsing power to withdraw all of the property in

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or any interest thereon, before the beginning of the next taxable year. The fact that any such power can be exercised only with the consent of an adverse party does not change the result. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 99-100.

294. All trusts created by the same grantor and spouse are aggregated to prevent tax reduction through multiple runs up the tax tables. Each trust must pay its proportionate share of the total tax liability on all non-grantor-owned trust income that is taxable to the trusts.TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 100.

295. *Id.* at 103.

296. *Id.* at 102.

the trust, or if he has a testamentary general power of appointment over a trust the grantor of which is dead.[297] Presumably, these rules apply to one who has such a power over an identifiable share of the trust property. One who has an annual power of withdrawal is a mandatory beneficiary;[298] therefore, the income from the portion of a non-grantor owned trust over which the beneficiary has such a power is taxed to the powerholder during the term of the power, whether or not he exercises it. Such a powerholder does not become the grantor of a portion of the trust if he permits such a power to lapse.[299]

A Task Force of the American College of Probate Counsel (ACPC) has suggested a somewhat different pattern of income taxation of trusts.[300] Reasoning that the opportunities for tax avoidance through income-splitting are greatly enhanced by the distributions deduction, the Task Force advocates abolition of it and taxation of all trust income to the trust beginning at the highest marginal rate to which the grantor's income is subject.[301] The income of all trusts created by the same grantor would be aggregated and the tax calculated on the total; each trust would pay its proportionate share of the total liability.[302] The Task Force also advocates abolishing the grantor trust rules and the accumulation distribution rules. After the death of the grantor, a trust would be treated as a separate taxpayer, except that all trusts created by the same grantor would be aggregated for purposes of calculating the tax. The proposal provides for a special "conduit trust" election for trusts that are incomplete transfers for wealth transfer tax purposes, those that are for the exclusive benefit of a single identifiable beneficiary for that beneficiary's life, and those that have a beneficiary who may withdraw all or a portion of the trust principal or income, whether or not the right lapses annually, or who has an inter vivos general power of appointment over all or a portion of the trust.[303] In such case, the income may be taxed to the grantor or to the beneficiary, respectively, if the grantor so elects. The ACPC proposal also suggests that a powerholder who permits successive lapses of an annually lapsing

297. ALI Subchapter J Project, *supra* note 15, at 41-42.
298. *Id.* at 59-61.
299. *Id.* at 41.
300. ACPC Proposals, *supra* note 17.
301. *Id.* at 242.
302. *Id.* at 248.
303. *Id.* at 243, 245-47. The Task Force states that it would prefer that any amendment to Subchapter J follow the gift tax concept of completeness wherever it is not the same as that of the estate tax, if no changes in the wealth transfer taxes are to be made. However, it also advocates integration of the income and wealth transfer taxes to the greatest extent possible.

power to withdraw might be treated as grantor of a successively greater portion of the trust after each lapse under the general rule that taxes trust income at the grantor's rate.[304] The effect of such a provision would be to tax at the powerholder's marginal tax rate that portion of the income allocable to the total property that the powerholder could have withdrawn. The proposal does not state who would be treated as grantor of a trust that had both a living grantor and a powerholder. Presumably, to prevent tax avoidance through the choice of a low bracket powerholder, it would be the actual grantor.

Both proposals will decrease substantially the extent to which trusts may be used as income-splitting devices, and both have advantages and disadvantages in their application to powerholders. To prevent the use of trusts as income-splitting devices during the life of the grantor, Subchapter J must at least be amended to aggregate all trusts created by one grantor and to tax all trust income at the grantor's rates. During the grantor's life, the mere existence of a powerholder should have no tax consequence; to provide otherwise encourages tax avoidance through the choice of a low bracket powerholder. From this standpoint, the ALI proposal is preferable, unless the ACPC proposal is amended to delete the conduit election for a powerholder during the grantor's life. However, the ALI suggestion that the holder of a lapsing power of withdrawal be treated as a mandatory beneficiary when he does not exercise the power also seems unwise from this standpoint and should be deleted. After the death of the grantor, the greatest potential for tax avoidance comes from the identity of the trust as a separate taxpayer from its beneficiaries. Much of this potential is eliminated by aggregating the income from all trusts created by the same grantor; both proposals provide for this. There does not seem to be any way to eliminate this advantage entirely, except perhaps by allocating income proportionately among the various beneficiaries of a discretionary trust and taxing each share at the beneficiary's rate whether distributed or not. This would require complex and time-consuming calculations for all but the simplest trusts and might actually increase the opportunities for tax avoidance by encouraging grantors deliberately to name large numbers of discretionary beneficiaries to permit multiple runs up the tax rate tables, knowing that it was extremely unlikely that the trustee would ever exercise the power to distribute to them. The ALI proposal seems to provide less opportunity for tax avoidance in this respect by limiting the situations in which discretionary distributions are taxable other than

304. *Id.* at 246.

to the trust. As to the treatment of the holders of lapsing powers of withdrawal, an argument can be made that either proposal contains the possibility that the grantor will choose a powerholder with a view toward reducing taxes, but the ACPC suggestion that the powerholder be treated as grantor of an ever-increasing proportion of the trust property as he permits his powers to lapse appears sounder. Eventually, all of the trust income will be taxed at the powerholder's marginal rate under this proposal, eliminating the trust as a separate taxpayer. Furthermore, the powerholder is, in fact, in the same position as a grantor who adds small amounts annually to a trust and should be so treated. Such a rule for income tax purposes should be coordinated with the estate and gift tax rules, so that the proportion of trust property the powerholder is treated as owning for income tax purposes is includible in his estate, if he had another interest in the trust that would result in inclusion in a grantor's estate.

VI. The Generation—Skipping Transfer Tax

A. Historical Introduction

The generation-skipping transfer tax was added to the law in 1976 to close a perceived loophole in our system of wealth transfer taxation that had been criticized repeatedly for over 30 years.[305]

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305. Willard Mills, a member of the Division of Tax Research of the United States Treasury Department, apparently was the first to advocate a change in the United States' system of transfer taxation that would impose a tax at least once per generation even if one generation received only an interest for life in the property. Mills, *Transfers From Life Tenant to Remainderman in Relation to the Federal Estate Tax*, 19 TAXES 195 (1941) [hereinafter cited as Mills]. Different models for such a transfer tax were proposed several years later by William Vickrey, Louis Eisenstein, and Stanley Surrey. W. VICKREY, AGENDA FOR PROGRESSIVE TAXATION (1947); Vickrey, *An Integrated Successions Tax*, 22 TAXES 368 (1944); Eisenstein, *Modernizing Estate and Gift Taxes*, 24 TAXES 870 (1946); Surrey, *An Introduction to Revision of the Federal Estate and Gift Taxes*, 38 CALIF. L. REV. 1 (1950).

Subsequently, the Brookings Institution and the ALI studied the question of whether to institute such a tax, and if so, which model seemed best. The Director of the Brookings study, Professor Carl Shoup, advocated an accessions tax, C. SHOUP, FEDERAL ESTATE AND GIFT TAXES (1966), while the ALI's final report outlined several acceptable models. *Federal Estate and Gift Taxation*, A.L.I. (1969).

The generation-skipping transfer tax, I.R.C. §§ 2601-22, (enacted as part of the Tax Reform Act of 1976) bears some resemblance to the ALI's successions tax proposal, but is most like a model proposed by Richard Covey, special counsel to the American Bankers Association. R. COVEY, GENERATION-SKIPPING TRANSFERS IN TRUST (1976). For an excellent history and analysis of the generation-skipping transfer tax proposals made between 1941 and 1976, see, Ver-

Prior to 1976, when a taxpayer transferred property outright gratuitously to another person who, in turn, transferred it gratuitously to a third person, the property was taxed twice, once on the transfer from the first owner to the second and again on the transfer from the second owner to the third. However, when the first owner transferred property in trust for the benefit of the second for life, with remainder to the third, the second could enjoy substantial benefits from the trust and, provided he was not granted a general power of appointment,[306] the property would not be subject to any transfer tax when it passed from him to the third owner. Thus, by choosing the second form of disposition, the first transferor eliminated one transfer tax while enabling two transferees to enjoy substantially the same economic benefits from the property as the second and third owners in the first series of transactions. This pattern of taxation was criticised on two grounds: First, it placed considerable tax cost upon the decision to make outright transfers rather than transfers in trust; thus, it violated the tenet that essentially similar transactions should be taxed similarly. Second, it was said to lack vertical equity in that wealthier taxpayers were more likely to be able to make the second type of disposition. This is because the outright transfer gives the transferee maximum control, and, therefore, maximum financial security, from a smaller fund, and it saves the cost of creating and maintaining a trust.

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bit, *Annals of Tax Reform: The Generation-Skipping Transfer*, 25 UCLA L. REV. 700, 702-16 (1978).

306. Early commentators on this problem write frequently of the first beneficiary's enjoying only a life income interest. *See, e.g.*, Mills, *supra* note 305. In some respects, posing the problem in that posture understates it. As part III of this article demonstrates, the transferor can give the first beneficiary a number of interests, which, in the aggregate, give him substantially greater economic benefit from and control over the property, and even if he is given all of them, the property will not be subject to tax at his death. The trustee may be empowered to distribute principal to him in the trustee's discretion, with or without an enforceable standard, the beneficiary may be granted power to demand principal to defray expenses of his health, education, support, or maintenance without regard to his other resources and to demand annually the greater of $5000 or 5% of the trust principal. In addition, he may be appointed co-trustee and granted considerable discretion in the distribution of principal to anyone but himself, and he may possess a power to appoint the principal to anyone except himself, his estate, his creditors, or the creditors of his estate.

The fact that a beneficiary can be given all of these interests simultaneously without any transfer tax accruing at his death was apparently one of the principal concerns of the ALI when it advocated an enactment of an additional transfer tax. *See*, Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515, 573-74 (1967). It was also the position the supporters of the new legislation in 1976. See H.R. REP. on 1976 Act, *supra* note 65, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 2919, 3400.

Of course, not all transfers in trust involve members of the same family, nor do they all involve members of different generations. Furthermore, outright transfers have always been fully taxed regardless of the family relationship between the transferor and the transferee and regardless of the generations they belong to. Therefore, one could justify assessing a transfer tax each time property passed to the remainderperson of a trust, or upon the termination of each life estate or estate for years, regardless of the relationship between the life income beneficiary and the remainderperson. However, most sizeable gratuitous transfers are transfers between members of a family; property is usually passed from an older generation to the next youngest one at the death of the older.[307] Therefore, tax theorists have generally agreed that the tax savings achieved by the use of a trust during the life of the first transferee in the example above should not be permitted when it allows two generations of a family to enjoy substantial economic benefits from the property at the cost of only one transfer tax.[308] Each time the enjoyment of family wealth shifts down a generation, it should attract a transfer tax. Thus, the transfer tax consequences should be identical in situations, whether a parent transfers property outright to a child who, in turn, transfers it to a grandchild, or a parent creates a trust for the benefit of a child for life, remainder to the grandchild. The generation-skipping transfer tax was enacted as part of the Tax Reform Act of 1976 to accomplish this.[309]

B. Current Law

1. The Pattern of Taxation

The generation-skipping transfer tax, like the estate and gift taxes, applies to a broad class of transfers, many of which, of course, do not involve powers of appointment.[310] Therefore, before

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307. G. JANTSCHER, TRUSTS AND ESTATE TAXATION 92-120 (1967).

308. *E.g.*, *Federal Estate and Gift Taxes*, ALI 26-31 (1969); G. JANTSCHER, TRUSTS AND ESTATE TAXATION 185 (1967); Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 635, 674 (1967); Mills, *supra* note 305. At least one commentator has questioned whether the empirical data collected concerning the extent of such transfers by American decedents is sufficient to justify a new tax. Verbit, *The Strategy of Tax Reform: A Tale of Three Loopholes*, 34 U. FLA. L. REV. 665, 668-76 (1982), and Verbit, *Annals of Tax Reform: The Generation-Skipping Transfer*, 25 UCLA L. REV. 700, 732-34 (1978).

309. H.R. REP. on 1976 Act, *supra* note 65, at 47.

310. For detailed descriptions of the mechanics of the generation-skipping transfer tax, see, COVEY, GENERATION-SKIPPING TRANSFERS IN TRUST (1976); Wren, *Estate Planning and the Generation-Skipping Transfer Tax*, 32 CASE W. RES. L.

proceeding with an assessment of its application to transfers involving powers of appointment, it will be useful to summarize generally the statutory pattern of the new tax.

Section 2601 states that the generation-skipping transfer tax is imposed upon all generation-skipping transfers. However, because of the special statutory definition of "generation-skipping transfer," the tax applies in fact to a relatively narrow class of such transfers. First, it applies only to transfers from trusts or trust equivalents.[311] Thus, for example, an outright gift or bequest to one's grandchild is not subject to the generation-skipping transfer tax even though it is a transfer that skips a generation.[312] Second, the tax applies only to those trusts and trust equivalents that have beneficiaries who are members of two different generations, both of which are younger than the grantor's generation.[313] Generally, the word "generation" has its common meaning, although the Code also provides rules for determining the relative generations of individuals who are not related by blood or marriage.[314] For example, the tax is inapplicable to a trust that provides for distributions to the grantor's husband during his life and directs that the principal be paid to the grantor's children at her husband's death. Although the children are members of a younger generation than the husband, the husband and wife are members of the same generation.

The tax is imposed upon the happening of certain events that

REV. 105 (1981); McCaffrey, *Planning for Generation-Skipping Transfers*, 14 REAL PROP., PROB. & TRUST J. 722 (1979); Dodge, *Generation-Skipping Transfers After the Tax Reform Act of 1976*, 125 U. PA. L. REV. 1265 (1977); Stephens & Calfee, *Skip to M'Loo*, 32 TAX L. REV. 443 (1977).

311. I.R.C. § 2611(a).

312. The *ALI* considered and rejected the suggestion that such a generation jumping transfer be subject to a surtax at the time of transfer. *Federal Estate and Gift Taxes, ALI* 27 (1969). Professor James Casner, Reporter for the Project, advocated taxation of certain generation jumping transfers, *see* Casner, *American Law Institute Federal Estate and Gift Tax Project*, 22 TAX L. REV. 515, 580-81 (1967). However, other commentators have rejected such a pattern of taxation on the grounds that it discourages wealth dispersion and thus runs counter to the purpose of transfer taxation. Alexander, *Federal Estate and Gift Taxation: The Major Issues Presented in the American Law Institute Project*, 22 TAX L. REV. 635, 671-72 (1967). They believe that there is no reason to tax such transfers because they do not involve a beneficiary the termination of whose interest in the property is not subject to taxation. JANTSCHER, TRUSTS AND ESTATE TAXATION 58 (1967). The drafters of the 1976 legislation considered and rejected taxation of generation jumping transfers, apparently, because they agreed with Jantscher's analysis. S. REP. NO. 94-938, 94th Cong., 2d Sess. 21, pt. II, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 4030, 4046-47 [hereinafter cited as S. REP. on the 1976 Act].

313. I.R.C. §§ 2611(b) & 2613(c).

314. I.R.C. § 2611(c).

shift the right to enjoy (or the right to control who enjoys) any portion of the property in a generation-skipping trust or trust equivalent from a beneficiary who is at least one generation younger than the grantor to any beneficiary who is a member of a still younger generation. The statute describes two classes of taxable events: (1) a "taxable termination,"[315] which occurs when the interest of an older younger generation beneficiary terminates, for example, when a life income beneficiary dies; and (2) a "taxable distribution,"[316] which occurs when a transfer is made out of the principal of the trust to a younger younger generation beneficiary while the interest of an older younger generation beneficiary continues, for example, when the trustee exercises his discretion to distribute principal to a grandchild while the child-life income beneficiary is still alive. The tax imposed upon a taxable termination or a taxable distribution is intended to be roughly equal to the estate or gift tax that would be due on the transfer if an older younger generation beneficiary of the trust had owned the property outright and had transferred it to the younger younger generation beneficiary.[317] To achieve this, the statute requires the identification of a "deemed transferor."[318] The deemed transferor will usually be the parent or other ancestor of the distributee who is also a descendant of the grantor and a beneficiary of the trust. The tax is then calculated, using the federal estate and gift tax rate table, as though the deemed transferor had made a taxable gift of the distributed property to the distributee, if the deemed transferor is alive immediately after the taxable event, or as though the distribution had been part of his gross estate, if he is dead.[319]

The computation of the tax is illustrated as follows: In a typical testamentary residuary trust that provides for distributions to a child of the testator during the child's life and directs distribution of the principal to the child's children upon the child's death, the termination of the child's life interest will be a taxable termination as to which the child will be the deemed transferor. The generation-skipping transfer tax will be computed by first adding the fair market value of the trust principal on the date of

315. I.R.C. § 2613(b)(1).

316. I.R.C. § 2613(a)(1).

317. H.R. REP. on the 1976 Act, *supra* note 65, reprinted in 1976 U.S. CODE CONG. & AD. NEWS 2897, 3409.

318. I.R.C. § 2612.

319. I.R.C. § 2602. Occasionally, it is also necessary to identify a deemed transferee, for example, when the interest of an older younger beneficiary terminates but the property remains in trust for the benefit of younger younger generation beneficiaries. Prop. Treas. Reg. § 26.2612-1(b) provide a means of identifying the deemed transferee. *See also* I.R.C. § 2613(b)(3).

the child's death to the sum of the child's taxable estate, any adjusted taxable gifts that would be taken into consideration in computing the child's estate tax, and any prior generation-skipping transfers of which he is deemed transferor, and computing a tax on the total at estate tax rates, then computing a tax at estate tax rates on the sum of the last three items in the previous calculation (everything except the current generation-skipping transfer) and subtracting the result from the first tax.[320] The excess of the first tax over the second is the tax due on the current generation-skipping transfer.

There are a number of exceptions to these rules, two of which are important to succeeding portions of this article. First, section 2613(b)(6) excludes from the tax base the first $250,000 per deemed transferor of property passing to the grandchildren of the grantor. Second, section 2613(b)(2) provides that certain series of related taxable terminations will not be deemed to occur until the last of the series occurs. The effect of these rules is to postpone payment of the tax until the last interest or power of the last member of any particular younger generation of beneficiaries has terminated and there are no beneficiaries assigned to an older generation than that beneficiary. Therefore, in the illustration in the preceding paragraph, the grandchild exclusion of section 2613 (b)(6) will exempt from tax the first $250,000 of trust property that passes to the child's children at his death, provided that the exclusion has not already been applied to an earlier generation-skipping transfer. Furthermore, if any other members of the child's generation had any interest or power in the trust property, even as a permissible discretionary income beneficiary, the generation-skipping transfer tax will not be due until the last such interest or power terminates. The trust property is subject to tax only once per generation.[321]

Even a casual observer will wonder whether a generation-skipping transfer tax will ever be paid. The grandchild exclusion substantially reduces the incidence of taxation upon the precise transfer which the new provisions were enacted to tax. The postponement rules permit the grantor to assure deferral of the tax long after the death of the younger generation beneficiary whom he really wants to provide for, simply by adding other permissible discretionary income beneficiaries who are members of the same generation as the primary beneficiary or an older generation.[322]

320. I.R.C. § 2602(a).
321. I.R.C. § 2613(b)(7)(B).
322. The Treasury Department has attempted to limit the deferral possibilities by providing that a beneficiary who has only a nominal interest may be disregarded for purposes of applying the postponement rules. Prop. Treas.

Furthermore, although the statutory scheme works reasonably well in the simplest cases, such as our example, when the transfer is more complicated, the statute frequently either produces inconsistent results or addresses the particular transfer so inadequately as to make it unclear what result was intended. In other situations, the statute seems clear, but the proposed regulations appear to go beyond the statutory language and to direct an incorrect result. One class of transactions as to which the statute is not entirely clear is that in which a family member of a younger generation than the grantor has some power of disposition over the principal or income of a trust. In many situations, the presence of the power will make no difference because the beneficiary will also have another interest in the trust, such as the right to income for life, as to which the generation-skipping transfer tax consequences are clear, and which will dictate the incidence of taxation. The question, then, is how to treat a person whose only interest in all or a portion of the trust is a power of appointment.

2. Powers of Appointment

a. Taxable Powers in General

The generation-skipping transfer tax does not contain a provision parallel to sections 2041 and 2514 dealing specifically with the tax consequences of the exercise, release, or lapse of powers of appointment. However, there are several sections of the generation-skipping transfer tax that result in taxation of property distributed pursuant to, or in default of, the exercise of a power of disposition.

First, section 2613(b)(1) provides expressly that the exercise or nonexercise of a power held by an older younger generation beneficiary in a generation-skipping trust is a taxable termination. Section 2613(d)(2) defines "power" quite broadly to include any power to "establish or alter beneficial enjoyment of the corpus or income of the trust." This definition includes many powers of disposition that are not traditionally classified as powers of appointment and, indeed, includes powers held in a fiduciary capacity.

Reg. § 26.2613-2(b)(3). However, they have defined nominal so narrowly that it does not appear to seriously limit the deferral opportunities. For example, any lineal descendant of the grantor's grandparents who is a permissible distributee of income or principal automatically has a substantial interest, unless "under all the facts and circumstances the holder of that interest or power was never intended to exercise or benefit from the power or interest," Prop. Treas. Reg. § 26.2613-2(b)(3)(iii) & (iv).

The proposed regulations,[323] supported by the legislative history of the provision,[324] state that a present power is any power that would have rendered the underlying property includible in the powerholder's estate under sections 2036 or 2038 if the powerholder had been the settlor of the trust. This interpretation is consistent with the general purpose of the legislation, which is to tax shifts in wealth among generations of a family to the same extent as if the older younger generation beneficiaries owned the property outright and transferred it to the younger younger generation.

Mere possession of such a power of disposition over the trust property, as distinct from a beneficial interest in the property itself, renders the powerholder a beneficiary for purposes of the generation-skipping transfer tax.[325] If a powerholder is a beneficiary, then, obviously, he is a younger generation beneficiary if he is a member of a generation younger than the grantor's generation. This classification affects not only the determination of whether a taxable termination has occurred when the powerholder exercises his power, or dies having failed to exercise his power, it also affects the status of the trust as a generation-skipping trust. For example, a trust for the benefit of the grantor's wife for life, with principal payable to the grantor's grandchildren at the wife's death, is not a generation-skipping trust; the grandchildren are the only younger generation beneficiaries. However, the trust will be a generation-skipping transfer if the grantor gives his child a nongeneral power of appointment over the principal exercisable in favor of anyone but the child, her estate, her creditors, or the creditors of her estate, with principal payable, in default of exercise of the power, to the grantor's grandchildren. The child is a beneficiary who is assigned to an older younger generation than the grandchildren. Therefore, the child's death will be a taxable termination even if she does not exercise the power and the property passes to the grantor's grandchildren as takers in default.

b. General Powers of Appointment

The generation-skipping transfer tax does not apply to powers that are general powers of appointment for purposes of the federal estate and gift taxes. Although the generation-skipping transfer tax provisions do not contain a provision dealing explicitly with general powers of appointment, sections 2613(a)(4)(B) and (b)(5)(B)

323. Prop. Treas. Reg. § 26.2613-4(d).
324. H.R. REP. on 1976 Act, *supra*, note 65.
325. I.R.C. § 2613(c)(3).

exclude from the definition of taxable distribution and taxable termination, respectively, any transfer to the extent that it is subject to the estate or gift tax. Furthermore, since the exclusion from tax refers only to the applicability of the other two taxes to the transfer, the exclusion applies even if the powerholder would not be the deemed transferor if the transaction were a generation-skipping transfer. For example, suppose that the holder of a general power of appointment over the principal of a trust created by his mother directed that the entire principal subject to this power be paid to his grandchildren. Suppose further that the takers in default under the trust instrument were the children and grandchildren of the powerholder. The transfer to the grandchildren would render the powerholder subject to gift tax;[326] therefore, the transfer would not be subject to the generation-skipping transfer tax, even though the powerholder's child, and not the powerholder, would be the deemed transferor if the tax were applicable.[327] The result would be the same even if the powerholder also had a beneficial interest in the trust, *e.g.*, the right to income for life. Congress intended each transfer to be subject to only one transfer tax, even when it jumped a generation, and to be subject to the generation-skipping transfer tax only if the transfer would not be subject to transfer tax otherwise.[328] The general powerholder is treated as the owner of the property for transfer tax purposes; therefore, his generation jumping transfers must be subject to transfer tax to the same extent as those of an outright owner.

c. Nongeneral Powers to Appropriate for the Powerholder's Benefit

Assessment of the generation-skipping transfer tax consequences of the four major categories of powers excepted from the definition of general power of appointment for estate and gift tax purposes yields some surprising and possibly unintended results.

i) Powers subject to an Ascertainable Standard

The generation-skipping transfer tax statute does not specifically address the power to invade principal for the powerholder's health, education, maintenance, and support.[329] It seems reason-

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326. I.R.C. § 2514(b).

327. I.R.C. § 2612(a).

328. H.R. Rep. on the 1976 Act, *supra* note 65.

329. I.R.C. § 2041(b)(1)(A) & 2514(c)(1) exclude such a power from the definition of general power of appointment for estate and gift tax purposes, respectively.

able to conclude, therefore, that exercise of such a power will be a taxable distribution if the powerholder is a younger younger generation beneficiary of the trust. Similarly, the death of an older younger generation beneficiary who possessed such a power, or his release of it, should be a taxable termination. However, under the proposed regulations,[330] the exercise or nonexercise of such a power might not be subject to the generation-skipping transfer tax because of the implied exclusion from the definition of "power" for powers that would not cause inclusion of the subject property in a grantor's estate pursuant to sections 2036 and 2038. As was noted earlier,[331] case law has carved out of sections 2036 and 2038 an exception for property subject to a power circumscribed by an ascertainable standard. Since health, education, maintenance, and support are ascertainable standards, such a power might be excluded from the generation-skipping transfer tax base as well. It is unlikely that Congress intended this result. Not only is this type of discretionary power to consume exactly the type of power that should attract the generation-skipping transfer tax, but the exclusion of property subject to such a power will lead to an anomalous result: Anyone who is the permissible object of a trustee's discretionary power to invade principal for such purposes will be a beneficiary of the trust for purposes of the generation-skipping transfer tax,[332] but one who possesses such a power exercisable in favor of himself will not be a beneficiary. Furthermore, proposed regulation section 26.2613-2(b)(3)(ii) states that, for purposes of applying the postponement rules,[333] a right to withdraw within the scope of section 2041(b)(1)(A) is a "substantial" power so long as, considering all the facts and circumstances, the beneficiary's need is not so remote as to be negligible. This statement means that having such a power will postpone the time of taxable termination under section 2613(b)(2)(B) with respect to an interest or power that terminates before the power to invade. That is to say, there will be no taxable termination until the power of invasion terminates. But if the power to invade is not a taxable power for generation-skipping transfer tax purposes, it is difficult to see why assessment of the tax on the interest that is taxable should be postponed.

The exercise or termination of such powers to invade should clearly attract a transfer tax. Exempting such transactions from tax will put the powerholder in a better position than that of an owner who retained such a power. Although the owner's estate

330. Prop. Treas. Reg. § 26.2613-4(d).
331. *See* note 69 *supra* and accompanying text.
332. Prop. Treas. Reg. § 26.2613-4(d).
333. See text immediately following note 308 *supra*.

would not be liable for estate tax at his death, the original transfer will have been subject to gift tax when made.[334] Thus the shift in beneficial interest from the grantor to his designated successors will be subject to a transfer tax, while the shift from the powerholder to his successors will not.

ii) Jointly Held Powers

The generation-skipping transfer tax provisions make no distinction between unilaterally exercisable powers and jointly held powers. Therefore, it seems reasonable to conclude that the necessity to obtain consent from the grantor or a third person in order to exercise a power to appropriate property has no effect on the generation-skipping transfer tax consequences of the exercise or lapse of such a power. Proposed regulation section 26.2613-4(d), mentioned above in connection with powers to consume for the health, education, maintenance, and support of the powerholder, will not change this result because property subject to a retained jointly exercisable power is taxable in the estate of a grantor under sections 2036(a)(2) and 2038(a)(1). Therefore, the exercise of such a power in favor of a younger younger generation powerholder should be a generation-skipping transfer. Similarly, the release of such a power or its lapse pursuant to the terms of the governing instrument or because of the death of the nongrantor powerholder should be a taxable termination if the powerholder was an older younger generation beneficiary. Of course, the deceased powerholder is not necessarily the deemed transferor. He may not occupy the necessary relationship to the transferee under section 2612. The fact that one powerholder, or person whose consent must be obtained, has a substantial adverse interest in the property subject to the power is also apparently, and appropriately, irrelevant for purposes of the generation-skipping transfer tax.

These tax consequences are correct, since a powerholder who must obtain consent to exercise his power in favor of himself cannot have less control over the exercise of the power than a beneficiary with no power who is a permissible object of a trustee's discretionary power to invade. The termination of such a beneficiary's interest is exactly the type of transfer the generation-skipping transfer tax is intended to reach. However, the termination, release, or lapse of a power exercisable jointly with someone other than the grantor will rarely result in immediate tax liability because of the postponement rules of section 2613(b)(2).

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334. I.R.C. § 2511; Treas. Reg. §§ 25.2511-2(b) & (c).

The continuing powerholder will often be of the same generation as, or an older generation than, the terminating powerholder, or another member of the terminating powerholder's generation will be a beneficiary of the trust.

iii) Five or Five Powers

The de minimis exception of sections 2041(b)(2) and 2514(e) for lapses of powers over not more than the greater of $5000 or 5% of the principal of the trust is not included in the generation-skipping transfer tax provisions. However, the proposed regulations state that such lapses are not taxable terminations.[335] As was stated in the section dealing with the estate tax treatment of these powers,[336] to the extent that they are perceived as permitting tax avoidance, the solution clearly is to eliminate the exceptions of sections 2041(b)(2) and 2514(e) rather than to treat their exercise or lapse as a generation-skipping transfer.

d. Powers to Appoint to Persons Other than the Powerholder

Perhaps the most surprising results occur when one applies the generation skipping transfer tax to the exercise, release, or lapse of powers to appoint to a class of beneficiaries that does not include the powerholder.

Section 2613(e) treats the powerholder as not having a power in the trust in two broadly defined situations. First, an individual is not to be treated as having a power in a trust if his or her only power is to dispose of trust income or principal for the benefit of a class of beneficiaries composed of lineal descendants of the grantor assigned to a generation younger than the generation of the powerholder. Second, an individual is not to be treated as having a power in trust if the individual's only power in a trust is to dispose of income or principal in the trust to a class of beneficiaries named in the trust instrument, provided the individual has no other interest in the trust (other than as the potential appointee of another powerholder) and is not a "related or subordinate" trustee, a term defined in section 2613(e)(2)(B).

If a person has one of these two powers but has no other interest or power in trust, then, because of the exceptions of section 2613(e), he is not a beneficiary of the trust, and, therefore, obviously cannot be a younger generation beneficiary for purposes of the generation-skipping transfer tax.[337] It is important to note

335. Prop. Treas. Reg. § 26.2613-3(b).

336. *See* text accompanying notes 147-61 *supra.*

337. Apparently, these powers are powers for purposes of the generation-skipping transfer tax if the powerholder has another interest or power in the

exactly what effects this classification does and does not have. If all other beneficiaries of the trust are members of one younger generation, for example, all are the grandchildren of the grantor, the trust cannot be a generation-skipping trust even if the powerholder is of a different younger generation. Thus, for example, a discretionary trust for the benefit of the grandchildren of the grantor under which a child of the grantor has the power, either as trustee or as donee of a power of appointment, to advance principal to the grandchildren, is not a generation-skipping trust.[338] Therefore, the exercise, release, or lapse of the child's power will not be subject to any of the three transfer taxes. Furthermore, even if the trust were a generation-skipping trust, the termination of the power is not a taxable termination because the powerholder is not an older younger generation beneficiary of the trust. Thus, if the discretionary trust in the preceding example

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trust. Therefore, the child of the grantor who has no interest in the trust other than a power to appoint to the grantor's lineal descendants will not make a taxable transfer when he appoints the trust principal to the grantor's grandchildren. If the child were also a permissible distributee of income or principal, the appointment would be a taxable transfer even if the power to make discretionary distributions were held by an independent trustee.

338. The tax consequences of the broadest form of nongeneral power of appointment held by a younger generation beneficiary are less clear when all named younger generation beneficiaries are members of the same generation. For example, suppose in the preceding hypothetical one of the grantor's grandchildren, rather than a child of the grantor, possessed the nongeneral power of appointment. I.R.C. § 2613(d)(1) defines beneficiary as one who has a present or future interest or power in the trust; I.R.C. § 2613(d)(1) includes among those having an interest a permissible recipient of the income or corpus. Prop. Treas. Reg. § 26.2613-4(d) states that a permissible object of a discretionary power to distribute income or corpus has a present interest in a trust. The proposed regulation clearly is consistent with the purpose of the statute. Therefore, it would appear that anyone in favor of whom the grandchild could exercise his power of appointment is a beneficiary of the trust. Since that group clearly includes members of the grantor's child's generation (whether or not the grantor has a child), the trust has beneficiaries assigned to two different younger generations. Furthermore, it would appear that the partial exercise of the power in favor of anyone in the powerholder's generation or a younger generation is a taxable distribution since the recipient is a member of a younger generation than the grantor's child's generation. Similarly, the complete exercise of such a power, or the death of the powerholder without exercising the power, is a taxable termination, since it ends the interest of the older younger generation (the grantor's child's generation). The exercise of the power in favor of a member of the child's generation will not be subject to the generation-skipping transfer tax. The property will now be subject to gift or estate tax when it is transferred by the child; therefore, it will not have skipped a generation free of tax. Although this is inconsistent with the gift or estate tax treatment of an outright gift or bequest from the grandchild to the child, it is consistent with the generation-skipping transfer tax treatment of a trustee's discretionary distribution of corpus to a member of the oldest younger generation of beneficiaries of a generation-skipping trust. Such a distribution clearly would not be a taxable distribution under I.R.C. § 2613(a)(1).

were for the benefit of the grantor's grandchildren and great-grandchildren, the death of the child who held the power to advance principal still would not be a taxable termination. On the other hand, the exercise, lapse, or release of the power will be a taxable termination or a taxable distribution if it affects the interest of an older younger generation beneficiary of the trust. Thus, in the preceding example, the child's exercise of his power to invade principal in favor of a greatgrandchild will be a taxable distribution under section 2613(a). However, the deemed transferor will not be the powerholder, but rather will be the grandchild of the grantor who is the transferee's parent.[339] Similarly, the death of such a powerholder or his release of the power would be a taxable termination if it terminated the interests of the grandchildren, and the grandchildren, not the powerholder, would be the deemed transferors.

The present generation-skipping transfer tax thus grants a considerable advantage to those families with sufficient wealth to by-pass completely the second generation. That generation can then be granted unfettered discretion to decide who among the members of succeeding generations will receive the accumulated family wealth but the family will either pay no transfer tax at all for that privilege, or, if the transfer is taxed, the tax will either be deferred until the death of the third or a subsequent generation, or it will be taxed currently at the subsequent generation's current marginal transfer tax rate,[340] which is likely to be lower than that of the powerholder.

The exception of section 2613(e)(1) does not apply if the powerholder can distribute income or corpus to a member of his own generation other than himself. Thus the power of a child of the grantor to allocate the income or corpus of a trust among a class consisting of another child of the grantor and all the grantor's grandchildren would render the trust subject to the generation-skipping tax. If the powerholder exercised his discretion to distribute to one of his own children, the distribution would be a generation-skipping transfer, and the powerholder, not his sibling, would be the deemed transferor because the powerholder would be a younger generation beneficiary of the trust.[341]

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339. I.R.C. § 2612(a).

340. The tax will be calculated based on the marginal gift or estate tax rate of the deemed transferor. I.R.C. § 2602.

341. If the distribution is to a grandchild who is neither the child of the powerholder nor of the sibling who is a permissible distributee, it is less clear who the deemed transferor is. Clearly, it should be the powerholder. However, unless the word "ancestor" in I.R.C. § 2612(a)(2) is read to include collaterals as well as lineal ascendants of the beneficiary, the powerholder cannot be the deemed transferor.

The tax consequences change radically if a childless grantor creates a trust for a sibling's lineal descendants. For example, if G, the grantor, transfers property to his niece, A, as trustee for A's children and grandchildren, and grants A a power to appoint the principal of the trust to her lineal descendants, the section 2613(e)(1) exception will not apply to the power held by A. Therefore, A will be a younger generation beneficiary, and the trust will be a generation-skipping trust, even if A's children are the only other beneficiaries. Any exercise of A's power in favor of A's children will be a taxable distribution as to which A is the deemed transferor; A's death will be a taxable termination.

The legislative history of section 2613(e)(1) indicates that it was added to the statute to avoid imposing a tax cost on the natural disposition of property through the generations of a family.[342] Given the stated purpose for enacting the generation-skipping transfer tax, this comment is surprising. The same justification is given for the $250,000 grandchild exclusion[343] and is equally surprising in that context. If Congress believes that such a tax imposes an inappropriate burden on the natural disposition of property, a simpler and more direct approach would be to reject on the merits the arguments for the generation-skipping transfer tax. Indeed, this argument justifies repealing all transfer taxes. Furthermore, it is not entirely clear why a trust for collaterals is a less natural estate plan for a grantor who has no direct descendants than is the plan providing for the lineal descendants of a grantor who has lineal descendants. To the extent that one of the purposes of our transfer tax system is wealth dispersion,[344] section 2613(e)(1) is clearly counterproductive. It makes it quite costly for a grantor to provide for collateral relatives when he has direct descendants.

If the attribute Congress wishes to tax is the power to determine who will receive the property, that is, the power to transfer it, then eliminating the exception to the definition of "power" for powers to appoint to lineal descendants of the grantor will solve only part of the problem. Even if such a powerholder is treated as a beneficiary of the trust, he will not be treated as the deemed transferor of any property that passes to a younger generation beneficiary when he exercises, releases, or permits the lapse of the power unless he is also a parent of the beneficiary or the youngest of the beneficiary's ancestors who is also a beneficiary of the trust. The language of section 2612 will also have to be

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342. H.R. REP. on 1976 Act, *supra* note 65.
343. I.R.C. § 2613(b)(6).
344. See note 312 *supra*.

amended to make the deemed transferor the powerholder, regardless of his relationship to the beneficiary.

However, the mere power to dispose of property, unaccompanied by any beneficial interest in the property, apparently is not the attribute Congress wishes to tax, nor should it be. Discussion of the second exception in section 2613(e), the exception for powers of independent trustees, will make this clear.

As originally enacted in 1976, the generation-skipping transfer tax contained no exception for powers exercisable by independent trustees. Therefore, a trust could be a generation-skipping trust if the trustee were assigned to a generation younger than that of the grantor and older than that of any beneficiary, and the trustee's exercise of his power or its lapse would be a taxable distribution or a taxable termination, even though the trustee was not a member of the grantor's family and had no beneficial interest in the trust. Furthermore, it was not entirely clear how a generation was to be assigned to a corporate trustee, but it appeared that the trustee might be a member of any generation of which any shareholder was a member.[345]

Congress sought to eliminate this problem by adding section 2613(e)(2) in the Revenue Act of 1978.[346] Apparently, the drafters of the 1978 legislation wished to continue to tax the exercise, release, or lapse of a mere power to transfer property unaccompanied by a beneficial interest if the powerholder were a younger generation member of the grantor's family, but to exempt from tax the exercise, release, or lapse of such a power if the powerholder were unrelated to the grantor. Congress chose to draw the line between these two classes of powerholders by using a definition of "related or subordinate" trustee. Section 2613(e)(2)(B) attempts to draw the line. Unfortunately it contains terms used elsewhere in the Code for a similar purpose but it defines them differently. Section 672(c), for example, defines "related or subordinate party" for purposes of determining when a grantor has retained sufficient power to control beneficial enjoyment of the income or principal in a trust to justify taxing him as the owner of that portion of the trust. If the powers are held by a party who is related or subordinate to the grantor, the grantor is treated as having retained them. The two sections are similar but contain minor differences. For example, section 2613(e)(2)(B) refers to "lineal descendants" of the grantor, while section 672 speaks of "issue." Section 672 includes the grantor's spouse only if the spouse is living with the grantor; section 2613(e)(2)(B) includes a spouse in all events. Section 2613(e)(2)(B) includes certain partners and

345. Stephens & Calfee, *Skip to M'Loo*, 32 TAX L. REV. 447, 504 (1977).
346. Pub. L. No. 95-600, § 702(n)(2), 92 Stat. 2763, 2935 (1978).

employees of partnerships in which the grantor or any beneficiary has an interest, while section 672 contains no reference to partnerships; section 672 includes certain controlled corporations as well as the employees thereof, while section 2613(e)(2)(B) includes only employees, and the class of corporations that is relevant for purposes of section 672 is slightly different from that in section 2613(e)(2)(B). Since the distinctions are is arbitrary, it is unnecessarily confusing to have two slightly different statutes.

Furthermore, section 2613(e) contains undefined terms. For example, one class of relevant corporations for purposes of both statutes is that class "in which the stockholdings of the grantor . . . are significant from the viewpoint of voting control." Neither statute contains a definition of control; nor do the regulations under section 672. The proposed regulations under section 2613(e)(2)(B) state that whether there is control is a question of fact to which the attribution rules of section 267(c)(4) apply, and that, in addition, the stock of any person married to one listed in section 267(c)(4) will also be attributed.[347] Although the use of a rule of attribution is certainly appropriate for purposes of determining effective control of a corporation, there is nothing in the statute, nor in its legislative history, which indicates that Congress intended any attribution. Furthermore, it is not clear why the section 267(c)(4) rules, which set out attribution rules for purposes of disallowing losses between related parties, are more appropriate for this purpose than other attribution rules found in the Code.

More fundamentally, however, it is not clear that section 2613(e)(2) does anything more than provide a trap for those who fail to hire sophisticated tax advisors. It is difficult to see why the exercise of a power to distribute principal to any member of the grantor's family two or more generations younger than the grantor, by the grantor's attorney, who is a member of the same generation as the grantor's children and who can be relied upon to follow their advice, should be treated differently under the generation-skipping transfer tax from the exercise of such a power by the children themselves. If the power to dispose without the power to consume is not considered a sufficient interest in the trust to attract a tax when held by an unrelated trustee, it is not clear why it is a sufficient interest when held by a family member.

It will be clear from the foregoing analysis that the distinction between taxable and nontaxable powers of appointment is not the same for purposes of the estate and gift tax and the generation-skipping transfer tax. Although it will always be true, by virtue of sections 2613(a)(4)(B) and 2613(b)(5)(B), that the exercise, release,

347. Prop. Treas. Reg. § 26.2613-7(b)(2).

or lapse of a general power of appointment that is subject to the federal estate or gift tax will never be subject to generation-skipping transfer tax, it is not always true that a generation-skipping transfer of property subject to a power of appointment that is not subject to the federal estate and gift tax will be subject to the generation-skipping transfer tax. Furthermore, because of the postponement rules of section 2613(b)(2), the tax will rarely be due when a powerholder dies because the trust will almost always continue and have beneficiaries of the same generation as the powerholder or a higher generation.

The inconsistencies in the pattern of taxing property subject to a power of appointment under the generation-skipping transfer tax are due at least in part to Congress's failure to decide exactly what it wishes to tax. If the taxable event is to be the shift of economic benefit from one beneficiary to another, then this change in economic interest should be the only taxable event reached by the statute. It should be irrelevant whether the change is caused by the exercise or lapse of a power of appointment or of a fiduciary power, or by the occurrence of some other event such as the expiration of a term of years or the death of a beneficiary. To achieve optimal parity with taxation of transfers from outright owners, the tax base should be the value, on the date of termination, of the property as to which a prior interest has terminated, and the tax should be computed beginning at the marginal transfer tax rate of the person whose interest has terminated.

On the other hand, if Congress seeks to tax as transfers changes in the power to affect economic enjoyment of property that the powerholder cannot transfer to himself, then the exercise or lapse of such a power must be a taxable event. In that case, the tax base is the full value of property subject to such a power. The deemed transferor in such a case is the powerholder, and neither his family relationship to the beneficiaries and the grantor nor the fact that he occupies a fiduciary office should be relevant to the tax consequences.

It appears that the first objective is preferable and more consistent with our pattern of transfer taxation. Implementation of it will eliminate many of the problems concerning the taxation of transactions with respect to a power. Indeed, under such a pattern, the status of powerholder would be irrelevant to the incidence of taxation. In every case, the power has at least one object, a person who is a permissible recipient of the property subject to the power. Whenever the powerholder exercises or releases his power, or allows it to lapse, in a way that eliminates the present or future interest in the property of one permissible object of the power, the property can reasonably be subjected to a transfer tax. If the tax is to be imposed only once every generation, then such exercise of a power should be a taxable event only if the object whose interest has been terminated is in a higher generation than the actual transferee and in a lower generation than the last owner or beneficiary, the termination of whose interest attracted a transfer tax.

C. Proposals for Reform

The generation-skipping transfer tax has been criticized widely since its enactment for its complexity. Indeed, there was a provision repealing it retroactively in the Senate version of the Deficit Reduction Bill of 1984.[348] However, the statute is effective with respect to most taxable terminations and taxable distributions occurring after June 11, 1976, with several transitional exceptions for trusts that were irrevocable on that date or were in existence on that date and became irrevocable because of the death of the grantor before January 1, 1983.[349]

The Treasury Department 1984 Proposals suggest that the present generation-skipping transfer tax be repealed retroactively and outline a new generation-skipping transfer tax to be enacted.[350] The stated purposes of the proposed substitution are to simplify the statute and to limit its application to a smaller class of taxpayers so that it will not affect those of modest wealth. As will be demonstrated below, the new proposal is substantially simpler than the current law. In addition, it appears to be substantially more equitable in its treatment of property subject to a nongeneral power of appointment. Unfortunately, however, the Treasury Department advocates implementing the second of its stated goals by exempting from the tax base one million dollars worth of generation-skipping transfers per transferor valued as of the date of the initial transfer.[351] While this undoubtedly prevents those of modest wealth from being subject to the tax, it is clear that it will also exempt many individuals of substantial

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348. S.2062, 98th Cong., 2d Sess., § 802 (1984). *See* 1984 U.S. CODE CONG. & AD. NEWS 2172.

349. Treas. Reg. § 26.2601-1.

350. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 389-92. The text of the proposal is a summary of a Treasury Department proposal promulgated on April 29, 1983, containing a new generation-skipping transfer tax statute and examples of its operation. The 1983 proposal is reprinted at 3 FED. EST. & GIFT TAX REP. (CCH) 12, 064 (1984). The only change in the 1983 proposal advocated by the 1984 proposal is that the tax be imposed on a tax-inclusive basis, that is, that the amount of the tax be included in the tax base, as is the federal estate tax. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 391. The 1984 proposal advocate a similar change in the federal gift tax. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 378.

351. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 390. The transferor referred to is the grantor of the generation-skipping transfer, not the deemed transferor under the current statute.

wealth from the tax. Indeed this high exemption will render the tax inapplicable to such a substantial proportion of generation-skipping transfers that it is not clear that the statute is worth enacting at all. But if the structure of the new tax is sounder than the current one, the coverage of the tax can be increased by reducing the exemption. Therefore, it is useful to examine the proposed new pattern of taxation.

The proposed statute will greatly simplify the taxation of generation-skipping transfers in general and those involving exercise of a nongeneral power of appointment in particular. The need to identify a deemed transferor has been eliminated. The tax is now computed at a flat rate, equal to eighty percent of the highest estate tax rate in effect on the date the taxable event occurs.[352] The Treasury Department, apparently having abandoned wealth dispersion as one of the purposes of transfer taxation, now states explicitly that wealth is most appropriately taxed once per generation.[353] Therefore, generation jumping transfers, called "direct generation-skipping transfers" under the proposed statute, are subject to the tax. Under proposed section 2612(b), the term "generation-skipping transfer" includes an outright transfer to a beneficiary who is two or more generations younger than the grantor and a transfer to a trust in which all those who have an interest (defined in proposed section 2612(e)) are at least two generations younger than the grantor. There is an exception to this definition for transfers that will return to the grantor or the grantor's estate or are subject to a power of disposition held by the grantor.[354] Under the new statute, direct generation-skipping transfers are subject to the tax immediately, in addition to the estate or gift tax.

The proposed statute, like the current one, defines two taxable events with respect to generation-skipping transfers other than direct generation-skipping transfers, taxable distributions,[355] and taxable terminations.[356] The definitions are considerably simpler than those in the current statute but the scope of shifts in interest that are taxed is generally the same.[357] Essentially, the

352. Proposed I.R.C. § 2602.

353. TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 391.

354. Apparently, the purpose of this exception is to delay imposition of the generation-skipping transfer tax until the transfer is complete for gift or estate tax purposes. The Treasury Department 1984 Proposals also contain suggestions for the amendment of the estate and gift tax provisions that will subject all transfers to only one of the two taxes.TREASURY DEPARTMENT 1984 PROPOSALS, *supra* note 14, at 378-83.

355. Proposed I.R.C. § 2612(c).

356. Proposed I.R.C. § 2612(d).

357. The major difference between the proposed statute and the current

tax is imposed on all distributions from the trust to a beneficiary two or more generations younger than the grantor and on the entire trust at the time the last interest of the last beneficiary who is one generation younger than the grantor terminates. Therefore, although the complex postponement rules of current section 2613(b)(2) have been eliminated, the tax is imposed only when all interests of the oldest younger generation of beneficiaries have ceased. Generations would be determined under the new statute exactly as they are under the present statute.

One has an interest in a trust for purposes of the new statute if one has the right to receive income or corpus from the trust or is a present permissible recipient of income or corpus.[358] The proposed statute thus eliminates entirely the need to deal separately with a powerholder *qua* powerholder. One may have an interest in the trust to the extent that one may distribute income or corpus currently to oneself, and the permissible objects of the exercise of one's power may have interests to the extent that one may distribute property currently to them. Any distribution to one who is two or more generations younger than the grantor is a taxable distribution, and the lapse or termination of such a power is a taxable termination if, as a result of the lapse or termination, the interests of the permissible objects of the power terminate within the meaning of proposed section 2612(d), the definition of taxable termination.[359]

Since the power itself is no longer an interest in the trust for purposes of the generation-skipping transfer tax, the generation-skipping transfer tax consequences of the exercise, lapse, or release of the power will depend upon the generation assignments of those who do have an interest in the trust. If the powerholder has no interest in the trust himself, but the power is exercisable in favor of a class of beneficiaries all of whom are at least two generations younger than the grantor, the trust will constitute a direct generation-skipping trust. Therefore, the tax will be due

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one in this respect is that the current statute exempts distributions of fiduciary accounting income from the tax base; the proposed statute does not. *Compare* I.R.C. § 2613(a) *with* Proposed I.R.C. § 2612(c). However, the proposed statute minimizes the possibility of simultaneous imposition of the income tax and the generation-skipping transfer tax by proposing an amendment to I.R.C. § 164 that would permit the beneficiary a deduction in computing his personal income tax liability for that portion of the generation-skipping transfer tax attributable to amounts upon which he is subject to income tax.

358. Proposed I.R.C. § 2612(e).

359. The termination of any interest is a taxable termination unless, immediately after the termination, property may be distributed to a beneficiary who is one generation younger than the grantor, or no property may be distributed to anyone who is two or more generations younger than the grantor. Proposed I.R.C. § 2612(d).

upon the creation of the trust; and the exercise, lapse, or release of the power will not constitute a generation-skipping transfer. So, for example, a grantor might create a trust, naming his daughter trustee, and provide that the income be paid to his adult grandchildren as the trustee deems necessary for their health, maintenance, and support and that the remainder be distributed as the daughter appoints by will among the grantor's grandchildren and greatgrandchildren. The daughter has no interest in the trust; therefore, it is a direct generation-skipping transfer and is subject to tax at its creation. Neither the daughter's distributions of income, nor her exercise, release, or lapse of her limited power of appointment, nor the final distribution of the remainder following the death of the last grandchild, will constitute a generation-skipping transfer. A transfer to greatgrandchildren upon termination of the trust will not attract an additional direct generation-skipping transfer tax, even though these transferees are three generations younger that the grantor.[360] If, on the other hand, the grantor makes the daughter a permissible discretionary recipient of the income, the generation-skipping transfer tax will not be due at the creation of the trust. However, any distribution to a grandchild will be a taxable distribution. Upon the daughter's death, there will no longer be any beneficiary who is not at least two generations younger than the grantor; therefore, her death will be a taxable termination of her income interest which will attract the tax, whether she exercises her power or permits it to lapse. When the trust finally terminates, there will be no additional tax, even if all the property is distributed to greatgrandchildren. The grantor is still the transferor under proposed section 2612(a) because the property will not have been subject to tax with respect to the same transferor. The daughter's release of her limited power during her lifetime will not be a taxable event because she will still be a permissible recipient of the income.

The exception for the power to appoint among lineal descendants has wisely been eliminated. Therefore, this transaction will be subject to tax to exactly the same extent as would a transfer by the grantor for the benefit of, for example, a niece and other lineal descendants of a sibling of the grantor.

If the daughter in the above example also had power to invade corpus for her own health, maintenance, and support, the generation-skipping transfer tax consequences would remain unchanged. Corpus distributions to the daughter would not constitute taxable distributions, because she is not two generations younger than the grantor.

360. Proposed I.R.C. § 2612(d)(2).

The current generation-skipping transfer tax has frequently been criticized on the ground that it is too easy to postpone imposition of the tax by proliferating discretionary beneficiaries. The Treasury Department proposal attempts to respond to this criticism. An interest may be disregarded under the new statute if it is "used primarily to postpone the [generation-skipping transfer] tax. . . ."[361] This provision appears to give the Commissioner authority to ignore the discretionary interest of the older generation beneficiary in the above example. Unfortunately, in practice, it seems likely to prove little more than a trap for the unwary. Well-advised taxpayers will not give the older generation beneficiary a purely discretionary interest, but will, instead, circumscribe the trustee's power to distribute to him with some standard, such as maintenance or medical care. It is clearly impossible to predict that even the wealthiest beneficiaries will never suffer such economic reverses as to require such a distribution. Therefore, it will be extremely difficult for the Commissioner to prove that any older generation beneficiary's interest was created primarily to postpone the imposition of the generation-skipping transfer tax.

A Study Group of the ALI has proposed a slightly different pattern of taxing generation-skipping transfers that is also worthy of consideration.[362] The ALI proposal also taxes direct generation-skipping transfers and simplifies substantially the generation-skipping transfer taxation of property subject to powers of appointment. In addition, to prevent appreciation in property during the lifetime of the first younger generation from escaping taxation, the ALI proposal substitutes a per grantor credit against the tax, similar to the federal estate and gift tax unified credit, for the one million dollar per grantor exclusion of the Treasury Proposal.[363] The generation-skipping transfer tax is computed on the value of the property at the time the taxable termination or taxable distribution occurs. The report indicates that, at the transfer tax rates expected to be in effect in 1987, the credit will shelter $834,000 worth of generation-skipping transfers from tax per grantor.

The ALI proposal attempts to integrate the three transfer taxes into one cohesive system of taxation governing transfers in trust by dividing all trusts into owned and non-owned trusts. Owned trusts are those that are incomplete transfers for federal

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361. Proposed I.R.C. § 2612(e)(2)(D)(iii).

362. *Federal Estate and Gift Tax Project: Study on Generation-Skipping Transfers under the Federal Estate Tax, A.L.I. Discussion Draft No. 1* (1984).

363. *Id.* at 26.

estate and gift tax purposes.[364] Non-owned trusts are all other trusts. Non-owned trusts are treated as separate taxpayers and assessed gift tax on certain transfers.

The proposal includes an intricate system for determining when a particular taxable termination or taxable distribution is taxed under the gift, estate, or generation-skipping transfer taxes, much of which does not affect the taxation of property subject to a nongeneral power of appointment in a way that is significantly different from its effect on transfers pursuant to the exercise of a trustee's discretion. From this standpoint, it improves the pattern of generation-skipping transfer taxation as does the Treasury Department Proposal.

One of the most innovative features of the ALI proposal is its handling of property subject to a general power of appointment. The ALI Study Group proposes to repeal sections 2041 and 2514.[365] Instead, it would treat the holder of a nonlapsing general power to withdraw all of the property from a trust as the owner of the trust under the generation-skipping transfer tax proposal. Anyone with a lesser power is treated as any other beneficiary.[366] The report of the Study Group indicates that the reason for this change is to prevent grantors from engaging in tax avoidance by choosing as powerholders those whose estates are sufficiently small to be nontaxable, who will not exercise the power. If this were permitted, the grantor could shelter his transfers in the powerholder's federal estate tax unified credit; the property would not be subject to the generation-skipping transfer tax because it would be subject to the estate tax.

The ALI approach is both creative and simple in its delineation of which powers qualify the holder as owner and which do not. Unfortunately, it does not go far enough to eliminate completely the tax avoidance that the Study Group has identified. It appears that completely foreclosing this opportunity for tax avoidance may be impossible. Presumably, it is just as easy to find a powerholder who will not exercise his unlimited power or will exercise it correctly as to find one who will let a limited power lapse. The very wealthy grantor, therefore, will chose such powerholders in the first younger generation and create sufficient separate shares to obtain the desired number of powerholders' unified credit amounts to shelter the desired amount of property from tax. Conversely, one with a limited power of withdrawal may find himself under pressure to withdraw property from the trust

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364. *Id.* at 9. The proposal also recommends changing the concept of incomplete transfers somewhat. *Id.* at 21.

365. *Id.* at 87.

366. *Id.* at 43.

and create a new trust of which he will be grantor in order to make use of his unified credit and generation-skipping tranfer tax credit.

It appears that the only way to eliminate the tax avoidance available through the use of the younger generation's unified credit is to treat even an unlimited powerholder as merely a beneficiary of a non-owned trust, so that transfers to those in generations younger than his would be taxed by reference to the original grantor. This will place a substantially greater tax burden upon transfers in trust than upon outright transfers to the first younger generation. Thus, we will have come full circle and developed a statutory framework that encourages outright transfers to replace the one we believed encouraged transfers in trust.

VII. Conclusion

Powers of disposition are among the most useful estate planning tools available in the Anglo-American pattern of property transmission. They permit a property owner to give another family member the ability to rearrange family wealth as the needs of the various family members change, even after the death of the owner, while simultaneously permitting him to entrust management of the property to an unrelated professional manager. Often there are sound financial reasons for this division of responsibility that have nothing to do with the tax consequences of the transaction. Unfortunately, precisely because of their flexibility under the law of property, these powers of disposition pose extremely difficult problems for those attempting to draft a rational system of taxation of gratuitous transfers.

We have changed the way in which we tax transfers pursuant to the exercise or lapse of a power of appointment several times during the last seventy years. None of the patterns has been entirely satisfactory. The change in our conception of the taxable event from an actual transfer to a mere shift in the beneficial enjoyment of the property from one beneficiary to another has facilitated somewhat our ability to determine when a powerholder should be subject to tax. It appears that the pattern of taxation of a generation-skipping transfer tax, rather than that of the traditional estate or gift taxes, is more suitable to the taxation of transfers pursuant to the exercise or lapse of powers. It permits us to see the powerholder as occupying a position similar to that of a trustee and to treat as the taxable events the shifts in beneficial interest of the permissible objects of the power when the power is exercised or permitted to lapse. This pattern of taxation requires the identification of a grantor with reference to whom the generations are assigned. The need to identify the grantor, in turn, leads to the question of whether any powerholder has sufficient control over the disposition of the property to be treated as an owner. This, in turn, leaves us to choose between two alternatives, both of which seem at least partly unsatisfactory. If we hold that a powerholder can never be treated as an owner, we place a substantial tax cost upon the choice to transfer family wealth in trust rather than outright. If we construct a pattern of taxation in which a powerholder is treated as an owner for tax purposes, we encourage a proliferation of such powerholders unless we eliminate entirely any per grantor exemption from tax, or at least make it so small as to discourage wealthy property owners from attempting to take advantage of it. This in turn may unnecessarily tax outright transfers of small accumulations of wealth.

The approach taken in the ALI study group report on generation-skipping transfers appears to be the soundest solution to the transfer tax problem conceptually, and it also appears to be the proposal that is easiest to integrate with an improved pattern of income taxation of grantor trusts. Unfortunately, even the ALI Proposal does not eliminate entirely the possibility of transfer tax manipulation through the use of powers of appointment. In addition, it is extremely complex. The best combination of equity and simplicity will likely be achieved through the adoption of the Treasury Department 1984 Proposals, with a reduction of the initial exclusion from the generation-skipping tax base and inclusion in the estate and gift tax base of lapsing powers of invasion.