DRAFTING RECIPROCAL SPOUSAL GENERAL POWERS OF APPOINTMENT

Persons in common law states may be able to secure the same benefits available in community property states - obtaining a basis step up for the surviving spouse in all marital assets. These persons in common law states may seek to apply this step up technique by using reciprocal spousal general powers of appointment. This article examines how the general powers of appointment would work, discusses the legal issues surrounding their efficacy, and suggests language to effectuate them.

Background

Property that is includible in a decedent's estate for Federal estate tax purposes normally receives a new basis under Section 1014(a) for income tax purposes. That new basis is the property's fair market value on the date of the decedent's death. If a Federal estate tax return is filed, the value of the property as finally determined for Federal estate tax purposes is presumptively correct under Section 1014 in establishing the property's new basis. The finally-determined value is the value of the property on the date of the decedent's death or the alternate valuation date.

Subsequent capital gain is minimized to the extent the new basis is greater than the decedent's basis in the property because of the transferee of the property receiving a "step up" in basis. Exceptions to this step up rule include property commonly referred to as "income in respect of a decedent" (or "IRD") property, such as the following property:

- unrecognized interest on United States savings bonds,
- accounts receivable of cash basis taxpayers,
- qualified retirement plan assets, and
- individual retirement accounts.

Married taxpayers who reside in "community property" states or resided in "community property" states are eligible to receive an additional benefit as to their community property. This benefit is unavailable to married couples residing in "common law" states. The ownership portion of the community property attributable to the surviving spouse under Section 1014(b)(6) will receive a new basis upon the death of the deceased spouse if at least one-half of the community property is includible in the decedent's estate for Federal estate tax purposes. This new basis will be determined under the same principles accorded the decedent's interest in the community property.

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General Powers of Appointment May Achieve a Full Step up in Basis in Spousal Assets

Estate planners are fully aware of the disparity under Section 1014 as to the treatment of community property and common law property. As such, it has been an enticing challenge for estate planners to devise a method that achieves the same "step up" in basis for the surviving spouse owning common law property that is available as to a surviving spouse's interest in community property. A much-discussed method is to give each spouse a general power of appointment over the other spouse's property interests.

Under the general power of appointment technique, upon the death of the first spouse, the decedent's property would be includible in the decedent's estate under Section 2033 if owned outright and under Section 2038 if owned in a revocable trust, and the surviving spouse's property would be includible in the decedent's estate under Section 2041. This estate tax inclusion would not only achieve a "step up" in basis in all eligible property with respect to the decedent's property, but absent the applicability of a statutory exception, in the surviving spouse's property as well.

The decedent's power of appointment would lapse at the decedent's death. Due to that lapse, the surviving spouse's property that previously was subject to the power of appointment would be deemed to pass to the surviving spouse for estate and gift tax purposes at that time as a result of the lapse.

Joint Trusts Versus Separate Trusts

Estate planners may seek to achieve the step up in basis in all spousal assets through using a trust. The question then arises as to whether a joint trust or separate trusts would be more efficient or desirable in reposing reciprocal general powers of appointment.

Joint Trusts

Reciprocal general powers of appointment designed to benefit from Section 1014 are most widely used in the context of joint trusts. A joint trust generally involves a single trust to which both spouses contribute their respective assets. The trust assets are then held as a common fund or pool for the benefit of both spouses.

In situations in which the spouses' combined assets do not exceed the Section 2010 applicable exclusion amount, little or no attention normally need be given to the transfer tax consequences of the joint trust arrangement. In situations in which the spouses' combined assets exceed the applicable exclusion amount, the joint trust approach presents a number of potential adverse transfer tax consequences.

For example, absent careful drafting, a completed gift could occur at or after the formation and funding of the joint trust. In addition, careful drafting is required to create the

bypass trust/marital trust relationship within the joint trust so that the assets in the bypass trust do not become includible in the surviving spouse's estate for Federal estate tax purposes as a result of being funded with the surviving spouse's interest in the joint trust assets. The joint trust approach is suggested as a simpler alternative to the traditional separate revocable trusts approach. Nevertheless, the need to create severable spousal interests within the joint trust, as well as the requisite careful crafting of its provisions to avoid adverse transfer tax results, have led many commentators to question whether the joint trust has anything to recommend it other than saving paper.

Joint Versus Separate Trusts

Drafting a joint trust is inherently complex. Thus, the authors prefer creating separate revocable trusts for each spouse in situations where transfer tax planning is indicated. This tax planning would include plans that incorporate reciprocal general powers of appointment. In addition to the benefit of greater simplicity in drafting separate trusts, separate trusts also have the security of always achieving a full step up in basis of all eligible trust assets in the trust of the deceased grantor.

Conversely, a joint trust format employing reciprocal general powers of appointment could fail to secure a full step up in basis of all eligible trust assets. In that event, there would only be a partial step up in basis in all joint trust assets attributable to the fractional ownership interest of the deceased grantor (reduced by any appropriate fractional interest discounts). This partial step up could cause undue income taxation upon a subsequent taxable disposition of trust assets by the successor in interest in such property, e.g., the surviving spouse or trustee of testamentary trusts created by the deceased spouse.

In addition to being able to fund separate revocable trusts in a manner designed to minimize later gain upon the sale of assets by the surviving spouse in the event reciprocal general powers of appointment fail to achieve the desired result, separate trusts have the benefit of permitting a deviation from proportional ownership between the spouses in circumstances in which such proportional ownership may be inappropriate. For example, a significant disparity in life expectancies of the spouses or the much greater exposure of one spouse to third party claims may dictate not only a difference in values between the trust interest of both spouses, but also the types of assets which fund such interests. Moreover, the use of separate revocable trusts need not risk the failure of the proper balancing of the size of each spouse's estate for transfer tax purposes in the same manner as the proportional interest approach of joint trusts is achieved. For example, the assets in the trust of the first spouse to die may be insufficient to fully utilize his or her applicable exclusion equivalent amount or generation skipping exemption. In that event, the general power of appointment granted by the surviving spouse to the deceased spouse over the surviving spouse's trust assets could be drafted and exercised so as to permit the deceased spouse to accomplish the optimum transfer tax result.

The Obstacle of Section 1014(e)

Prior to the enactment of the Economic Recovery Tax Act of 1981 ("ERTA"), there was a substantial impediment to the use of reciprocal general powers of appointment to achieve a full step up in basis. The marital estate tax deduction was then limited to the greater of $250,000 or one-half of the adjusted gross estate. Thus, to the extent the lapse of the decedent's power of appointment resulted in a transfer to the surviving spouse that did not qualify for the marital estate tax deduction, adverse estate tax consequences ensued in cases where the resultant taxable estate exceeded the then much lower applicable exclusion amount. The enactment of ERTA removed this estate tax impediment to the use of reciprocal general powers of appointment by providing for an unlimited marital deduction. ERTA, however, also included another provision, Section 1014(e), that can operate to preclude the benefits of this planning device.

Under Section 1014(e), property that has a fair market value in excess of its basis to the transferor at the time of its transfer will not be eligible for step-up-in-basis treatment if the transferee dies within one year of the transfer and, as a result of the transferee's death, the transferred property is "acquired from" the transferee by the original transferor or "passes from" the transferee to the original transferor under the anti-step up provisions under Section 1014(e). The issue, when considering reciprocal general powers of appointment, is whether Section 1014(e) applies to the general power of appointment held by a deceased spouse over the surviving spouse's interest in trust property. Not surprisingly, the Service's position is that it does.

The Service's Position

TAM 9308002

In TAM 9308002, the IRS considered the impact of Section 1014(e) in a situation involving a joint trust. Under the provisions of the trust, each spouse could revoke the trust at any time as to an undivided one-half interest in the trust assets. Upon the death of the first spouse to die, all trust assets were subject to the debts and taxes of the deceased spouse, thereby causing inclusion of the surviving spouse's one-half interest in trust assets in the decedent's gross estate under Section 2041.

The IRS concluded that Congress's purpose in enacting Section 1014(e) was to prevent the transfer of property to a transferee within one year before the transferee's death in order to receive a step up in basis upon the transferee's death. The IRS determined that due to the unlimited marital estate tax deduction and substantially increased applicable exemption under ERTA, transfers might not result in any increased estate tax liability. The IRS concluded that Congress intended that a transferor must relinquish actual dominion and control of property more than one year prior to the date of death to avoid the proscription of Section 1014(e). As such, the IRS denied the step up in basis of such property includible in the deceased spouse's estate under Section 2041 resulting from the surviving spouse's retained right to revoke the joint trust as to

the trust property attributable to the surviving spouse which retained right did not end prior to the deceased spouse's death.

PLR 200101021

In a recent ruling, PLR 200101021, the IRS reaffirmed its position in another joint trust situation. Under the provisions of the trust instrument considered by the IRS, each spouse retained the right to revoke the trust during the joint lifetimes of both spouses, upon which event the trust property was to be distributed to both spouses as tenants in common. The first spouse to die also possessed a testamentary general power of appointment over all trust assets.

The ruling provided no substantive comment or analysis. Here the IRS ruled that both the property interest contributed to the trust by the surviving spouse and the property interest acquired by the surviving spouse, either directly or indirectly, upon exercise or lapse of the general power of appointment held by the predeceased spouse were ineligible to receive a step up in basis. The IRS determined that Section 1014(e) served as a proscription.

Criticisms of the Service's Position

Practitioners have widely criticized the Service's analysis and conclusion in TAM 9308002.[1] Among these criticisms are the Service's failure to explain how the one-year rule of Section 1014(e) applies in the absence of a "gift" to the deceased spouse by the surviving spouse, as required under Section 1014(e)(1)(A). The mere grant of a general power of appointment is not a gift of the property over which the power may be exercised.[1]

The Service's position is that the property contributed by the surviving spouse was not acquired or did not pass from the deceased spouse, as required under Section 1014(a). This position is also assailable. The IRS reasoned that property could not have passed from the deceased spouse to the surviving spouse because the surviving spouse never relinquished control of the property. In reaching this conclusion, The IRS failed to analyze Section 1014(b)(9), which provides that property acquired through the exercise or non-exercise of a general power of appointment satisfies the Section 1014(a) requirement that the property be acquired or pass from the decedent.[2]

Interestingly, the IRS concedes that trust property contributed by the surviving spouse must be included in the deceased spouse's gross estate under Section 2041(a)(2). Nevertheless, the IRS disregards the power for purposes of Sections 1014(a) and 1014(b)(9). This dichotomy may not be entirely inconsistent if Section 1014(b)(9) is read to require the surviving spouse to

[1] Howard M. Zaritsky, *Running With the Bulls: Estate Planning Solutions to the "Problem" of Highly Appreciated Stock*, 31-14 University of Miami Law Center on Estate Planning § 1404.

[2] Richard A. Williams, *Stepped-Up Basis in Joint Revocable Trusts*, Trusts & Estates (June 1994); *see also* Frederic A. Nicholson, *Ruling on the Joint Spousal Trust Ignore Statutory Intent*, 59 Tax Notes 121 (April 5, 1993)

have in fact "acquired" the property through the exercise or non-exercise of the deceased spouse's power of appointment. However, the Service's failure to discuss the construction of Section 1014(b)(9) undermines its position.

Finally, in the event the property subject to the general power of appointment passes upon the predeceased spouse's death (as a result of either the exercise or lapse of the power) in trust for the benefit of the surviving spouse and other beneficiaries, arguably such property was not "acquired from" the predeceased spouse by the surviving spouse and the property did not "pass from" the predeceased spouse to the surviving spouse within the meaning of Section 1014(e).

Support for the Service's Position

Despite broad criticism by practitioners, the Service's position is not entirely without support. It has been suggested, for example, that the "gift" requirement of Section 1014(e) should not be read too narrowly. Once that analytical hurdle is overcome, arguably any increase in the deceased spouse's gross estate that is attributable to the surviving spouse's contributions, whether to a joint trust or to the surviving spouse's separate trust that has the effect of increasing the marital deduction, should prevent the contributed property from qualifying for a step-up in basis. At the least this result arguably should apply to any income interest in the property includible in the predeceased spouse's estate under Section 2041 that continues for the surviving spouse.

"Passing" for Marital Deduction Purposes

Proponents of this anti-step up position argue that the word "passes" has a fairly well-established meaning in the application of the marital deduction under Section 2056. As such, the proponents argue that same meaning should control for purposes of Section 1014(e) when property is treated as "passing" for marital deduction purposes, whether the property passes outright or to a trust that qualifies for the marital deduction.[3] Likewise, under that same rationale, even when the marital deduction is not implicated, such as when assets includible in the predeceased spouse's estate under Section 2041 pass to a bypass trust for the surviving spouse, the mere economic increase in the deceased spouse's gross estate attributable to the surviving spouse's contribution arguably should prevent a step-up in basis to the extent of the surviving spouse's income interest in such property.[4]

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[3] Keydel, *Question and Answer Session II of the Twenty-Eighth Annual Institute on Estate Planning*, 28-20 University of Miami Law Center on Estate Planning § 2007 (***); Keydel, *Question and Answer Session II of the Twenty-Seventh Annual Institute on Estate Planning*, 27-18 University of Miami Law Center on Estate Planning §1811 (***).

[4] *Id.*

While this argument in favor of the Service's position has a certain superficial appeal, it places undue weight on the statutory use of the term "passes" without considering the context in which it is applied. Unlike Section 1014(e), Section 2056 specifically addresses the term "passes" to clarify that a transfer to a QTIP trust is deemed to be a transfer to the surviving spouse for purposes of the marital deduction.[5] In so doing, the statute creates a constructive transferee (the surviving spouse), but the statute does not create a constructive transfer.

A constructive transfer, however, is central to the Service's position under Section 1014(e). If property contributed by the surviving spouse is not deemed to pass from the deceased spouse to the surviving spouse at the deceased spouse's death, then Section 1014(e) alone will not prevent the property contributed by the surviving spouse from receiving a stepped-up basis. Section 2056(b)(7)(A)(i) deals with a constructive transferee and not a constructive transfer. As such, reliance on Section 2056 for guidance on the meaning of the term "passes" under Section 1014(e) is misplaced.

Even if property contributed by the surviving spouse can be deemed to pass to the surviving spouse upon the deceased spouse's death, the threshold issue of whether a gift has occurred remains. The IRS purported to identify this deemed gift in PLR 200101021. According to the IRS, the surviving spouse makes a gift of that portion of the joint trust property attributable to the surviving spouse's contribution upon the deceased spouse's death because the surviving spouse's power to revoke the trust terminated upon the deceased spouse's death.

"Gift" Upon Death of a Predeceased Spouse

If the Service is correct and the gift occurs upon the death of the predeceased spouse, the one year rule of Section 1014(e) would inevitably apply because the gift and the death of the decedent would occur simultaneously and, therefore, the gift would never occur more than one year prior to the death of the predeceased spouse. Under this view Section 1014(e) may be avoided only if the "gift" is never complete or if the property passes to someone other than the surviving spouse or to a trust in which the surviving spouse does not have a vested interest. If the recipient is the bypass trust, any income distributions from the trust for the benefit of the surviving spouse should be discretionary. A mandatory income distribution would create a life income interest in the surviving spouse, which arguably would prevent a basis step up to the extent of that interest.

It has also been suggested that a general power of appointment when coupled with the surviving spouse's power to revoke may not constitute a general power of appointment sufficient to cause inclusion in the deceased spouse's gross estate under Section 2041, and, therefore, beneficial income tax treatment under Section 1014(a).[6] A further suggested argument is that the

[5] I.R.C. § 2056(b)(7)(A)(i).

language of Section 1014(b)(9) that requires the property passing to the surviving spouse to be "acquired through the exercise or non-exercise of a power of appointment" is not met because "the surviving spouse's rights to the property preexisted the death of the spouse." This view rests primarily upon the notice requirement for the exercise of the power under the joint trust at issue in TAM 9308002, which afforded the surviving spouse an opportunity to revoke the trust, and therefore the power, before the power could be exercised.[7] Notwithstanding this argument, the IRS conceded estate tax inclusion in both the TAM and the PLR.

Drafting to Avoid the Service's Position

One option to avoid application of Section 1014(e), as interpreted by the Service in TAM 9308002 and PLR 200101021, is to allow the trust to be revoked only upon the joint action of both spouses. This effectively eliminates the surviving spouse's unilateral "dominion and control" over the property contributed by the surviving spouse to the joint trust. Assuming such rights were created more than one year prior to the predeceased spouse's death, the requirement for joint revocation avoids the Service's argument that any gift by the surviving spouse to the deceased spouse which arguably could invoke the provisions of Section 1014(e) was not complete until the date of the predeceased spouse's death.[8] This joint revocation would also avoid the argument that the power of appointment granted to the deceased spouse is illusory. The inability of either spouse to unilaterally revoke the trust as to the portion he or she contributed, however, presents other transfer tax issues on trust formation, which are discussed below.

Structuring of the Plan to Avoid Gift and Estate Tax Problems

The Federal gift tax is implicated upon formation of any trust in which both spouses have an interest (*i.e.*, a joint trust). Each spouse's contribution to the trust is a gift to the extent of the interest of the other spouse. However, each spouse's retained right to unilaterally revoke the trust and have his or her contribution returned will prevent the gift from being complete.[9]

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[6] Michael D. Mulligan, *Income, Estate and Gift Tax Effects of Spousal Joint Trusts*, 22 Est. Plan. 195 (July/August 1995). Charles Davenport, *Tax Basis Revocable Trusts: Many Questions, Few Answers*, 97 Tax Notes Today 235-41 "" (December 8, 1997).

[7] Nancy E. Shurtz, *An Academic's View of Tax Basis Revocable Trusts*, Trusts & Estates 43, 44-45 (January 1995)

[8] Michael D. Mulligan, *Income, Estate and Gift Tax Effects of Spousal Joint Trusts*, 22 Est. Plan. 195 (July/August 1995).

[9] Roy M. Adams & Thomas W. Abendroth, *The Joint Trust: Are You Saving Anything Other Than Paper?*, Trusts & Estates 39, 40-42 (August, 1995).

A unilateral power to revoke in each spouse is particularly notable when the spouses' respective contributions to a joint trust are not equal.[10] To avoid imposition of the gift tax, however, a joint trust need only provide for distribution of the trust assets upon revocation to the spouses as tenants in common. Even when only one spouse contributes property to the trust, the gift tax marital deduction will apply to prevent negative gift tax consequences when the gift becomes complete upon trust revocation.[11]

The power to revoke a joint trust might be restricted to the joint action of the spouses in an effort to solve the potential Section 1014(e) issue discussed above. In that event, a gift occurs upon formation and funding of the trust. Nevertheless, the general power of appointment over all trust assets which each spouse possesses as a potential predeceasing spouse should cause the gift to be incomplete.[12]

Spouse's Power of Revocation

The deceased spouse's separate revocable trust or joint trust may be drafted to take advantage of the deceased spouse's applicable exclusion amount. In that event, the surviving spouse's general power of appointment over the assets of the predeceased spouse's separate revocable trust or power of revocation over the assets of a joint trust attributable to his or her contributions should terminate upon the first spouse's death. The power of revocation should terminate at least to the extent such assets will be utilized to fund the deceased spouse's applicable exclusion amount in a bypass trust or a QTIP trust for the benefit of the surviving spouse. The surviving spouse's power of revocation must terminate to prevent the trust assets which fund a bypass trust or QTIP trust for which a QTIP election was not made from being included in the surviving spouse's estate under Section 2038(a)(1).

Lapse of General Power of Appointment

Finally, there is the issue of the lapse of the surviving spouse's general power of appointment over the deceased spouse's interest in trust property upon the death of the deceased spouse. The issue is whether the lapse would, notwithstanding the inclusion of such trust property in the deceased spouse's estate, constitute a release of the power under Section 2041(a)(2). A release would cause the surviving spouse to be treated as the transferor of the property that was previously subject to the power, thereby creating potential transfer tax problems for the surviving spouse. If such release resulted in a deemed gift to a donee other than

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[10] Jeffrey C. Thede, *The ABCs of Joint Trusts*, 11 Probate & Property 57 (March/April 1997).

[11] Richard A. Williams, *Stepped-Up Basis in Joint Revocable Trusts*, Trusts & Estates (June 1994); *see also* Frederic A. Nicholson, 59 Tax Notes 121 (April 5, 1993).

[12] Michael D. Mulligan, *Income, Estate and Gift Tax Effects of Spousal Joint Trusts*, 22 Est. Plan. 195 (July/August 1995).

the predeceased spouse in a manner qualifying for the marital gift tax deduction, e.g., to a bypass trust or QTIP trust created by the predeceased spouse, adverse gift tax consequences could ensue. To insure any such gift remains incomplete, despite the death of the deceased spouse, the surviving spouse would have to be given a testamentary special power of appointment over any bypass trust or QTIP trust funded with assets subject to such general power of appointment.

Moreover, the property of the predeceased spouse subject to such release thereby could inadvertently become includible in the surviving spouse's taxable estate. For example, the release of the power over such property by the surviving spouse may result in a deemed transfer to the trust of the deceased spouse rather than to the spouse. This deemed transfer would cause the surviving spouse to have a retained interest for estate tax purposes in any such property allocated to the bypass trust in which the spouse was a beneficiary or QTIP trust under Section 2036 and possibly Section 2038. Thus, the property that was previously subject to the surviving spouse's power of appointment would thereby remain includible in the surviving spouse's taxable estate. This would occur even if the gift resulting from the lapse was incomplete due to the surviving spouse possessing a special power of appointment over such trusts. If such adverse transfer tax consequence resulted from the release, the efficacy of the bypass trust or QTIP trust for which a QTIP election was not made in preventing inclusion of assets in the surviving spouse's estate would be fatally compromised.

PLR 2001011021

Although PLR 2001011021 did not permit the "step up" in basis in the surviving spouse's interest in trust assets, this ruling did resolve the above-discussed transfer tax issues in favor of the taxpayer. According to PLR 200101021, the termination of a power of revocation in the hands of the surviving spouse will result in a completed gift from the surviving spouse to the deceased spouse which qualifies for the marital deduction under Section 2523(a).[13] If the gift did not qualify for the marital deduction, a completed gift would likely occur to the remainder beneficiaries of the bypass trust or QTIP trust, or to other non-spousal beneficiaries. Such adverse gift tax consequence could otherwise have been avoided only by making the gift incomplete by granting a testamentary special power of appointment over the bypass trust or QTIP trust to the surviving spouse.[14]

In addition, the deceased spouse's interest in either the joint trust or the separate revocable trust is includible in the deceased spouse's gross estate for Federal estate tax purposes. As a result, any "taint" that otherwise would have occurred upon the lapse (and deemed release) of the surviving spouse's power of appointment over such interest is removed. Thus, the lapse

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[13] Priv. Ltr. Rul. 2001-01-021 (October 2, 2000). *Compare* Nancy E. Shurtz, *An Academic's View of Tax Basis Revocable Trusts*, Trusts & Estates 43, 46 (January 1995) *and* Keydel, *Question and Answer Session II of the Twenty-Ninth Annual Institute on Estate Planning*, 29-20 University of Miami Law Center on Estate Planning § 2020 (***).

[14] Richard A. Williams, *The Benefits and Pitfalls of Joint Revocable Trusts*, Trusts & Estate 41, 41-42 (November 1992).

will not cause inclusion of the property which passes to a bypass trust or any portion of a QTIP for which a marital estate tax deduction was elected in the surviving spouse's estate for Federal estate tax purposes.

This non-inclusion is the result most commentators expected, and the principle is substantively indistinguishable from that applicable to an inter vivos QTIP. The QTIP trust assets are includible in the donee spouse's estate for Federal estate tax purposes. As a result, the grantor spouse of an inter vivos QTIP is permitted to retain an interest in the trust following the deceased spouse's death without the trust assets being subject to the retained interest provisions of Sections 2036 through 2038.[15]

Structuring the Power of Appointment

Reciprocal general powers of appointment can be structured in a manner that minimize downside transfer tax risks yet preserve the potential for a full step up in basis of all eligible trust assets upon the first spouse's death by observing the foregoing analysis and incorporating appropriate savings clauses. Such savings clauses should be included in the provisions reposing the general powers of appointment. In effect, the savings clause dictates that the power of appointment is not reposed in the spouse or exercisable by the spouse to the extent it would not achieve a basis increase under Section 1014(a) or result in adverse transfer tax consequences. These types of savings clause are normally upheld by the courts so long as they are "condition precedent" in nature, and their efficacy is beyond serious debate.[16]

In the context of planning techniques involving general powers of appointment, the savings clause would provide that the power of appointment does not exist or is not exercisable in the event:

1. it would not result in a basis increase under Section 1014(a);
2. its presence would result in a completed gift that is not eligible for the marital gift or estate tax deduction;
3. its lapse would result in a completed gift ineligible for the marital gift or estate tax deduction; or
4. its lapse would result in the inclusion in the surviving spouse's estate for Federal estate tax purposes of property that was subject to the power prior to the lapse.

An additional savings clause would ensure that any actual transfer of assets by one spouse to the other spouse's trust or the deemed transfer of assets that results from the lapse of

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[15] Treas Reg. § 25.2523(f)-1(d)(1).

[16] *See* Miami Beach First National Bank v. United States, 443 F.2d 116 (5th Cir. 1971); Guiney v. United States, 425 F.2d 145 (4th Cir. 1970); Cornfeld, *Formulas, Savings Clauses and Statements of Intent*, 27 U. Miami Inst. On Est. Plan. 14 (1970).

the deceased spouse's power of appointment over the surviving spouse's assets qualifies for the marital gift and estate tax deduction under Sections 2523(e) or 2056(b)(5). Such deduction would otherwise be at risk in trusts that permit assets to be distributed to persons other than the grantor spouse or that do not otherwise require income from assets transferred to the trust be distributed to the grantor spouse at least annually so as to qualify the trust for the marital gift and estate tax deduction. Using this additional savings clause also has the salutary aspect of insuring that any assets transferred by one spouse to the other spouse's revocable trust, either in the trust funding process or pursuant to testamentary bequests, similarly qualify for the marital gift and estate tax deduction.

Below are the authors' suggested provisions for inclusion in the separate revocable trusts of each spouse. The general power of appointment provision limits permissible appointees to the creditors of the grantor's spouse with respect to a lifetime exercise and the grantor's spouse's estate or revocable trust with respect to a testamentary exercise. Expanding the permissible appointees at the death of the grantor's spouse to include the estate or revocable trust of the grantor's spouse permits the predeceased spouse to exercise the power in a manner which would distribute the assets subject to the power to beneficiaries other than the surviving spouse or to a bypass trust or QTIP trust for the benefit of the surviving spouse. In the event that the argument that Section 1014(e) is inapplicable due to no gift having occurred as a result of reposing the general power of appointment in the predeceased spouse is invalid, this would preserve the additional argument that the property did not "pass to" the surviving spouse within the meaning of Section 1014(e).

The power is also structured to be inapplicable if it would not achieve its desired objective. For example, the power would not be reposed if it would not result in a step up in basis under Section 1014(a) because of Section 1014(e). For a second example, the power would not be reposed due to the applicability of Section 542 of the Economic Growth and Tax Relief Reconciliation Act of 2001, which during the year 2010 would deny a step up in basis for property merely subject to a general power of appointment.

Thus, the permissible appointees and assets subject to the power are limited to that reasonably necessary to maximize the efficacy of achieving the desired objective without unduly exposing assets to an unanticipated exercise of the power. In circumstances where asset protection is of primary concern, the power could be made even more restrictive, e.g., requiring the donee spouse to give notice to the donor spouse prior to its exercise or permitting only a testamentary exercise in favor of the creditors of the powerholder's estate, albeit thereby making the power more vulnerable to a Section 1014(e) challenge.

General Power of Appointment

Grantor herein reposes a general power of appointment in Grantor's spouse, exercisable during Grantor's lifetime by Grantor's spouse alone, in favor of the creditors of Grantor's spouse with respect to an exercise during the lifetime of Grantor's spouse and the Grantor's spouse's estate or Trustee of a trust in

which the Grantor's spouse was the Grantor with respect to an exercise effective upon the death of Grantor's spouse, over all trust assets the income tax basis of which, by virtue of the inclusion of such trust assets in the taxable estate of Grantor's spouse, would be determined under Section 1014(a) of the Internal Revenue Code. Such general power of appointment shall be exercisable during the lifetime of Grantor's spouse by delivery of an instrument exercising the power to the Trustee of the Trust and at the time of Grantor's spouse's death pursuant to the provisions of Grantor's spouse's Last Will and Testament or Revocable Trust, provided such instrument, Last Will and Testament or Revocable Trust exercising such power specifically refers to this provision. Notwithstanding the foregoing provisions, such general power of appointment shall not be exercisable:

(i) over any Trust assets at any time the fair market value of which is not in excess of the income tax basis of such assets to the Trust;

(ii) if the granting of such power would constitute a gift to Grantor's spouse which does not qualify for the marital gift tax deduction;

(iii) if the lapse of such power, by virtue of Grantor predeceasing Grantor's spouse, would cause any trust assets over which such power was otherwise exercisable to be includible in the taxable estate of Grantor's spouse under Sections 2036 or 2038 of the Internal Revenue Code; or

(iv) if the lapse of such power by virtue of Grantor predeceasing Grantor's spouse would result in a taxable gift by Grantor's spouse.

Additional Savings Clause

It is Grantor's intent that any transfers to this Trust by Grantor's spouse during Grantor's lifetime that are subject to gift tax or estate tax qualify for a marital gift tax deduction under Section 2523(e) or the marital estate tax deduction under Section 2056(b)(5). Consequently, notwithstanding any other provision of this Trust Agreement to the contrary, any and all transfers or deemed transfers to this Trust with respect to which Grantor's spouse would be the transferor for transfer tax purposes that do not otherwise so qualify shall be held and administered consistent with such intent, including the following provisions:

a) Grantor shall be entitled for life to all of the income from such property, payable annually or at more frequent intervals;

b) Grantor shall have a general power of appointment, exercisable alone and in all events, during Grantor's life by written instrument delivered to the Trustee or upon Grantor's death, either under the provisions of this Trust Agreement or pursuant to Grantor's Last Will

and Testament, over such property in favor of Grantor, Grantor's creditors, Grantor's estate and the creditors of Grantor's estate; and

c) No person other than the Grantor shall have any authority to appoint any such property or any part of such property to any person other than Grantor.

To the extent any other provisions of this Trust Agreement is inconsistent with such intent so as to create an ambiguity, such ambiguity shall be resolved in favor of Grantor's intent as evinced under this provision.

Summary

Commentators are on both sides of the issue as to whether the reciprocal general power of appointment technique is appropriate and effective. Consequently, unless and until judicial authority weighs negatively on this technique, it will remain viable to potentially attain its desired result. It is the authors' opinion that, if litigated, a carefully drafted reciprocal general power of appointment is likely to sustain a Section 1014(e) challenge by the IRS.

For spousal situations in which there are no transfer tax concerns, reciprocal general powers of appointment carry no downside transfer tax risks, and thus normally would be utilized most efficiently in a joint trust context. The technique creates additional potential transfer tax liability for spousal situations subject to transfer tax concerns.

PLR 2001011021 denies the efficacy of this technique from the Service's perspective in achieving a "step up" in basis. Nevertheless, PLR 2001011021 does benefit the taxpayer in ruling against the downside transfer tax risks discussed herein that could be occasioned by its usage. However, PLR 2001011021, being only a private letter ruling, has no precedential value and does not bind the IRS to any circumstance other than the specific situation for which the ruling was requested. The IRS might well take a different perspective on the transfer tax consequences of the technique if the Section 1014(e) issue ultimately should not be resolved in its favor. Thus, estate planners should consider using appropriate savings clauses, such as the above sample clause, to obviate potential downside transfer tax risks. It is possible, if not likely, that no adverse transfer tax consequences would otherwise ensue from the reposition of such reciprocal general power of appointment even in the absence of the savings clause. In that event, the provisions of the savings clause would by their terms remain inoperable. Thus, the argument in favor of a full step up in basis of the interest of both spouses in all eligible trust assets upon the death of the first spouse would be preserved.

The authors believe there is little transfer tax risk in using this technique provided appropriate savings clauses are included, even in spousal estates otherwise subject to transfer taxes. Consequently, given the minimal potential adverse transfer tax consequence, the potential step up in basis that may result from employing this technique weighs heavily in favor of its

employment in situations in which the potential income tax benefit is significant. Moreover, contrary to the conventional mindset, the usage of this technique is not restricted to joint trusts. It is easily adaptable to the separate revocable trust format typically utilized by most practitioners for spousal transfer tax planning.

Although proper planning should obviate any downside transfer tax risk in using this technique, there is a potential penalty on any income tax benefit which could result from claiming a fair market value basis under Section 1014(a) for assets acquired from the deceased spouse as a result of the lapse of a reciprocal general power of appointment. There is no defining case law on this issue, making it possible that the courts might subsequently determine, for one or more of the reasons discussed above, that the trust property subject to the general power of appointment reposed in the deceased spouse was not entitled to a "step-up" in basis under Section 1014(a). A taxpayer is subject to a penalty if the taxpayer has reported basis on an income tax return that is 200% or more of the basis determined to be the correct basis and that overstatement of basis has reduced the taxpayer's income tax liability by more than $5,000 (or $10,000 in the case of a corporation other than an S corporation or personal holding company). In that event, the taxpayer is subject to a penalty equal to 20% of the tax that the surviving spouse would have paid if he or she had reported the "correct" basis.[17] This penalty situation may occur, for example,

- when the surviving spouse (or other successor in interest) sells property subject to the general power of appointment reposed in the deceased spouse, and
- the surviving spouse claims less gain or a greater loss than he or she would have claimed if the "correct" basis had been used to determine gain or loss.

Unlike the 20% substantial understatement of income tax penalty, this penalty may not be avoided even if there is substantial authority or adequate disclosure coupled with a reasonable basis for the position. There is a dearth of case law on the Section 1014(e) issue in the ensuing twenty year period since its enactment. As such, one would have to conclude that the likelihood of the issue arising in an income tax audit, let alone a penalty being imposed upon an adverse determination, is quite small. Nonetheless, in situations where it might apply due to the consequent basis increase exceeding the 200% threshold resulting in an income tax diminution of more than $5,000 for an individual taxpayer, its potential imposition should be considered by the taxpayer prior to taking a return position. Moreover, if the basis reported is 400% or more of the "correct" basis, a penalty equal to 40% of the tax that should have been paid will be assessed.[18]

It is also normally advisable to include a marital deduction trust savings provision, such as the sample form in this article, even in transfer tax situations in which estate planners might choose not to utilize this technique. In the absence of such marital deduction trust savings provisions, a large percentage of revocable trusts would not technically qualify for the marital

[17] I.R.C. § 6662(a), (b)(3), (e).

[18] I.R.C. § 6662(h).

deduction when one spouse makes an inter vivos or testamentary transfer of property directly to the other spouse's revocable trust. For example, such failure may result from trust provisions that either permit trust income to accumulate in the trust in the event of the Grantor's disability or authorize trust property to be distributed to someone other than the Grantor (*e.g.*, to the Grantor's dependents or for gifting purposes) during the Grantor's lifetime. The IRS apparently has not mounted a concerted effort to disqualify such transfers for the marital gift and estate tax deduction. Nevertheless, revocable trusts are vulnerable to such a challenge when they both fail to technically meet the marital deduction trust requirements when these trusts are the recipients of transfers from the other spouse and additionally fail to include appropriate savings clause provisions.