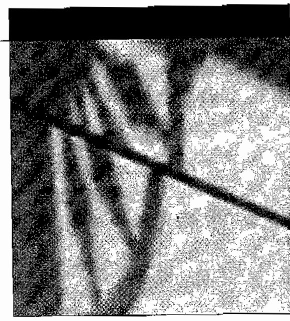

Lifetime Special Powers of Appointment Offer Unique Planning Opportunities

WILLIAM R. CULP, JR. AND MARK L. RICHARDSON, ATTORNEYS

A lifetime special power of appointment ("LSPOA") in an irrevocable trust offers unique tax, creditor protection, and dispositive planning opportunities. An LSPOA provides the powerholder with the lifetime power to appoint trust property to a designated group of appointees, other than the powerholder, the powerholder's creditors, the powerholder's estate or creditors of the powerholder's estate.[1] An LSPOA is a powerful tool because the powerholder has the authority to decide who will own the trust property.

An LSPOA provides unique planning advantages because the settlor of an irrevocable trust (the "Settlor") can be a potential appointee of the LSPOA without causing adverse estate tax consequences as long as there is no express or implied agreement that the assets will be appointed back to the Settlor and so long as the Settlor's creditors cannot reach the trust assets under state law. In contrast, under the laws of most jurisdictions, if the Settlor of an irrevocable trust is a beneficiary of the trust, the trust assets will be included in his estate and will be subject to the claims of his creditors. An LSPOA can also offer great flexibility because it can allow the powerholder to transfer trust assets without fiduciary constraints[2] and with less risk of raising fraudulent conveyance issues. Furthermore, a creditor cannot force the powerholder to exercise the LSPOA.[3]

While an LSPOA is a powerful and flexible planning tool, it should be used with caution because its use can have unintended tax and non-tax consequences. From a non-tax standpoint, because an LSPOA gives the powerholder the presently exercisable power to decide who will own trust property, the grant and scope of this authority should be considered carefully. An LSPOA requires a thoughtful selection of the powerholder and the potential class of appointees plus a thorough analysis of state law. From a tax standpoint, the grant and exercise of an LSPOA can trigger income, gift, estate, and generation-skipping transfer ("GST") tax consequences.

This article will (1) explore several creditor protection planning opportunities available with an LSPOA, (2) analyze some of the tax issues of using an LSPOA, and (3) provide sample language for the creation of an LSPOA.

Planning for creditor protection

In evaluating a structure to provide creditor protection for a client,

WILLIAM R. CULP, JR. and MARK L. RICHARDSON are members of the law firm of Culp Elliott & Carpenter, P.L.L.C. in Charlotte, North Carolina. The authors have previously written for professional publications, and Mr. Culp is the co-author of *Valuation Practice in Estate Planning and Litigation*. Messrs. Culp and Richardson focus their practice on tax law, and are both board-certified specialists in estate planning and probate law.

there is often a tension between (1) the degree of access to the assets the client desires and (2) the strength of the protection afforded by the structure. Generally, the more access a client has, the less protection offered by the structure. The scenarios described in this article may achieve an acceptable balance between access to the assets and creditor protection. Typically, if the Settlor is a beneficiary of an irrevocable trust, his creditors can reach the trust assets.[4] Despite this general rule, there are a number of states, such as Alaska, Delaware, and Nevada, which by statute provide creditor protection for self-settled trusts.

In evaluating the benefits of using an irrevocable trust with an LSPOA for creditor protection, it is helpful to compare this strategy with an outright transfer to an individual. For purposes of this article, we will refer to an irrevocable trust that contains an LSPOA as an "LSPOA Trust."

Outright transfer. A frequently-used technique to protect assets from creditors is to transfer assets to someone else with the expectation that the recipient will make the assets available to the donor, if needed, or will transfer the assets back to the donor at an appropriate time. This creditor protection technique is commonly used by a physician who transfers assets to his spouse to protect the assets from malpractice claims. The technique is also used by the elderly who transfer assets to their children so that they can qualify for Medicaid benefits.

Significantly, there cannot be an agreement, either expressed or implied, that the assets are held for the benefit of the donor. If an agreement existed, a creditor of the donor could reach the assets because the assets would be held by the donee as the donor's agent or because the arrangement would be considered a self-settled trust. In addition, if the donor is attempting to defeat current or known future creditors, the donor must consider the possibility that the transfer may raise fraudulent conveyance issues.

An outright transfer to a family member is simple and in some cases proves to be effective. Nevertheless, this approach is riddled with potential pitfalls. A major problem with an outright transfer is that the donee is under no obligation to return any of the assets or benefits from the assets to the donor. The donee has unrestricted control of the transferred assets. One of the best ways to create discord in a happy family is for a family member to give assets to a spouse or child with the hope that this person will give the assets back in the future. Moreover, a transfer to anyone other than the donor's spouse will be treated as a taxable gift, and the federal and state gift tax consequences of the transfer must be taken into account.

Even if the donee can be trusted to hold the transferred assets for the benefit of the donor, the transferred assets are subject to claims of the donee's creditors, including possible marital claims if the donee is married. The donee may also die, and the assets would pass to the donee's heirs (either according to the will of the donee or by intestate succession).

If the donee is the spouse of the donor, the potential for divorce must be considered. In the case of a stable marriage, the donor may be comfortable with a transfer of assets to his or her spouse. But, if the marriage is unstable, an outright transfer of assets to the spouse may pose unacceptable risks. The authors recognize that in the event of divorce, the donor may be legally entitled to one-half of the assets transferred to the donee spouse. However, the adage that possession is nine-tenths of the law is applicable to this scenario. There is a significant difference between being legally entitled to an asset and owning the asset.

Transfer to an LSPOA Trust. Once the risks of an outright transfer are recognized, the planner should consider the use of an irrevocable trust. A carefully drafted irrevocable trust

1 A special power of appointment is any power of appointment other than a general power of appointment. Section 2041(b)(1) defines a "general power of appointment" as essentially a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

2 A power of appointment that is not held by a trustee is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power. A power that runs with the office of trustee is strongly presumed to be a fiduciary power. Restatement (Third) Trusts § 50, comment a.

3 *Scott on Trusts*, § 147.3.

4 See Uniform Trust Code ("UTC") § 505(a)(2) and the official comments. The general rule is that a creditor of the Settlor can reach the maximum amount that the trustee can distribute to the Settlor.

can solve many of the problems of an outright transfer and can offer enhanced creditor protection and tax benefits. An irrevocable trust is preferable to an outright transfer because (1) the trust can ensure that the beneficiaries do not have unrestricted access to the trust assets, and (2) the assets are protected from the creditors of the trust beneficiaries, including any marital claims of a beneficiary's spouse.

An LSPOA can enhance the creditor protection benefits of an irrevocable trust because an LSPOA gives the powerholder the ability to appoint the trust assets to a class of appointees, which can include the Settlor. The Settlor could be a permissible beneficiary of the LSPOA Trust or not. As will be discussed later, if a beneficiary or a disinterested third party has an LSPOA over trust assets, the LSPOA provides a potential way for those assets to be appointed back to the Settlor, if desired.

It is also possible to include an LSPOA in a self-settled trust to allow the powerholder to appoint the trust assets from the self-settled trust and away from the Settlor and the Settlor's creditors. Another alternative to defeat a creditor of the Settlor would be to distribute the trust income and principal of a self-settled trust to a beneficiary other than the Settlor. This method for moving the trust assets is not as attractive as moving the trust assets through use of an LSPOA. A trustee generally has the duty to hold assets for the benefit of the beneficiaries pursuant to the terms of the trust, and the distribution of all the assets to one or more beneficiaries to the exclusion of other beneficiaries may be a breach of the trustee's fiduciary duty. In contrast, an LSPOA should be freely exercisable and not be subject to review by a court.[5]

It is also important to clarify that we are not evaluating the creditor protection benefits of having a third party (such as a parent) transfer assets to an irrevocable trust for the benefit of a person (such as a child) desiring creditor protection. A properly-drafted irrevocable trust funded by a third party will generally be effective to protect the trust assets from the beneficiary's creditors. This type of trust can be used advantageously to receive a person's inheritance, receive gifted assets from the parent or purchase assets from parents, and to own new business ventures.[6]

Features of an LSPOA Trust

The design and implementation of an LSPOA Trust gives rise to several planning alternatives.

1. *Will the Settlor be a beneficiary?* An LSPOA Trust can be designed as either a self-settled trust or a non-self-settled trust. In the case of a non-self-settled trust, a Settlor can transfer assets to a trust outside the reach of creditors. The LSPOA creates the potential for a beneficiary or a disinterested third party, as the powerholder, to transfer the trust assets to or for the benefit of the Settlor, if desired.

In the case of a self-settled trust, the Settlor is a discretionary beneficiary of a trust funded by the Settlor. The retention of a beneficial interest by the Settlor is an effective way to assure access to the trust assets, but a self-settled trust may not provide the desired creditor protection. Even in a state that provides asset protection for self-settled trusts, there is some question as to the effectiveness of such protection, especially for non-resident Settlors. An LSPOA may be used to enhance this protection. If a creditor seeks to reach the assets of the self-settled trust, an LSPOA can be used to move the assets from the LSPOA Trust to an individual or entity other than the Settlor, and away from the reach of the Settlor's creditors.

2. *Identity of the powerholder.* Because the powerholder of an LSPOA has the authority to appoint trust property among the designated class of appointees without fiduciary constraints, the identity of the powerholder is an important consideration. A trustee owes a fiduciary duty to the beneficiaries. In contrast, the powerholder of an LSPOA generally does not owe a fiduciary duty to the beneficiaries. This gives the powerholder greater flexibility in exercising the LSPOA but also means that careful selection of the powerholder is crucial. In choosing a person to hold the LSPOA, the Settlor will generally want to select someone who may be willing to appoint assets to or for the benefit of the Settlor, if desired, or away from the Settlor's creditors if the Settlor is a beneficiary of a self-settled trust.

The powerholder may be either a beneficiary of the trust (such as the Settlor's spouse or a child), or a third party. The holder of the LSPOA should not be the Settlor because this may create too much control in the Settlor and may provide an opening for creditors to assert that the Settlor did not part with dominion and control of the trust assets.[7] The identity of the powerholder can also have income tax consequences upon the grant of the LSPOA and gift tax consequences upon the exercise of the LSPOA, as will be discussed later.

3. *Class of appointees.* The class of appointees of an LSPOA can be limited (for example, the class could be limited to the issue of the Settlor), or expansive (the class could include anyone other than the pow-

5 See *supra* note 3

6 See Oshins and Ice, "The Inheritor's Trust™ The Art of Properly Inheriting Property," 30 ETPL 419 (Sept. 2003), and Oshins and Ice, "The Inheritor's Trust™ Preserves Wealth as Well as Flexibility," 30 ETPL 475 (Oct. 2003)

7 See Spero, *Asset Protection, Legal Planning and Strategies*, ¶ 10.07[1] (Warren, Gorham & Lamont)

erholder, the powerholder's estate, or the creditors of either). The Settlor may want to limit the class of appointees to guard against the ability of the powerholder to appoint the assets to a party friendly with the powerholder. The LSPOA could be drafted with a class of appointees limited to the Settlor's issue, and a trust protector could be given the power the expand the class to include anyone other than the powerholder, the powerholder's creditors, the powerholder's estate or the creditors of the powerholder's estate.

If the Settlor will be included in the class of appointees, it is generally preferable to include the Settlor in the class without specifically naming the Settlor. For instance, the permissible appointees could be drafted to include any person other than the powerholder, the powerholder's estate, or the creditors of either. Before including the Settlor as a permissible appointee, the planner should review relevant state law to confirm that the inclusion of the Settlor as a permissible appointee will not increase the risk that the Settlor's creditors could reach the trust assets.

4. *Power of trust protector to create LSPOA or modify existing power of appointment.* The careful planner should analyze whether the ability of the powerholder to exercise the LSPOA should be restricted or subject to conditions. For example, the LSPOA Trust would not initially include an LSPOA, but a trust protector could be authorized to grant a beneficiary or a third party an LSPOA.[8] Providing a trust protector with the power to grant a power of appointment is a useful drafting technique that provides flexibility to an irrevocable trust. A trust protector is an independent party who is given certain tax-sensitive powers. A trust provision that permits a trust protector to grant a testamentary general power of appointment to a beneficiary is a relatively common estate planning technique.[9] The grant of a general power of appointment can be used to cause trust property to be included in the estate of a beneficiary if the beneficiary's death would cause all or a portion of the trust otherwise to be subject to GST tax.

The exercise of the LSPOA could also be conditioned on obtaining the consent of the trust protector. Restrictions and conditions on the exercise of the LSPOA can create a check and balance system, and can make it less likely that the powerholder will exercise the LSPOA in a manner that was not intended by the Settlor.

Another alternative would be to give a trust beneficiary a testamentary special power of appointment ("TSPOA"), limited to the issue of the powerholder. A trust protector could be given the power to modify the TSPOA. The trust protector could then modify the TSPOA and make it an LSPOA, and also expand the permissible appointees to include the Settlor. Alaska law recognizes the ability of a trust protector to modify a power of appointment if permitted under the trust instrument.[10]

5. *Complete or incomplete gift.* An LSPOA Trust can be drafted so that a transfer to the trust by the Settlor is either a complete or incomplete gift for gift tax purposes. If the Settlor wishes to fund the LSPOA Trust with a substantial amount of assets and does not want the transfer to be treated as a taxable gift for gift tax purposes, the Settlor could retain a TSPOA so that the gift is incomplete for gift tax purposes. A transfer to an LSPOA Trust is generally an incomplete gift to the extent the Settlor retains the power to change the interests of the beneficiaries or add new beneficiaries.[11]

It is recommended that the Settlor retain a TSPOA to accomplish an incomplete gift rather than retaining an LSPOA. The retention of an LSPOA by the Settlor may expose the LSPOA Trust to the Settlor's creditors under the theory that the Settlor has not given up dominion and control over the assets.[12]

6. *No express or implied agreement to appoint property.* To achieve the desired tax and creditor protection benefits, there should be no express or implied agreement for the powerholder to appoint the property back to the Settlor. The fact that a powerholder of an LSPOA Trust has the power to appoint trust property back to the Settlor, without more, would not seem to create an implied agreement to transfer the property back to the Settlor. Generally, there is no retention of a right or power regarding the enjoyment of the property transferred merely because a person—such as the spouse of the Settlor—tends to follow the Settlor's wishes.[13]

If there is an express or implied agreement to appoint trust property to the Settlor pursuant to the LSPOA, the trust assets could be

[8] McBryde and Keydel, "Back to the Future for the Estate Planner: Building Flexibility in Estate Planning Documents," 30 *U. Miami Heckerling Inst. on Est. Plan.* ¶ 1201-1 (1996).

[9] Harrington, Plaine, and Zaritsky, *Generation-Skipping Transfer Tax*, ¶ 9.052(d) (Warren, Gorham & Lamont).

[10] See Alaska Stat. § 13.36.370.

[11] Reg. 25.2511-2(c).

[12] See note 7, *supra*.

[13] *Cf.* Regs. 20.2037-(1)(c)(1) and 20.2037-(1)(c)(2). Under Section 2037, a decedent does not "retain a reversionary interest" because of the possibility that the decedent during his/her lifetime might receive back an interest in the transferred property by inheritance through the estate of another person. Generally, there is no retention of a right or power because someone tends to follow the Settlor's wishes in matters. See Estate of Ballard, 47 BTA 784 (1942), *aff'd* 138 F.2d 512, 32 AFTR 8 (CA-2, 1943), in which the husband's relationship with his wife did not mean the husband retained the wife's power to terminate the trust. See also Akers, "Selection of Trustees: A Detailed Review of Gift, Estate and Income Tax Effects and Non-tax Effects," 38 *U. Miami Heckerling Inst. on Est. Plan.*, Chapter 3, ¶ 311.5 (2004).

included in the Settlor's estate under Sections 2036-2038, and a creditor of the Settlor may argue that the Settlor did not part with dominion and control of the assets. As a practical matter, it should be more difficult to establish an implied agreement if the powerholder has an interest in the trust that is adverse to the Settlor.

It may be possible for the IRS or a creditor to establish that there is an implied agreement for the powerholder to appoint the trust assets to the Settlor in the right circumstances. For instance, if the Settlor transferred all his assets to an LPSOA Trust, this may be sufficient to imply an agreement to exercise the LSPOA in favor of the Settlor,[14] especially if the powerholder periodically appointed assets to the Settlor and no distributions were made to any other party.[15] Several recent family limited partnership ("FLP") cases have dealt with the issue of whether there was an implied agreement to support a deceased partner using the FLP assets contributed by that partner.[16]

It is important to note that Section 2036 applies to a transfer "whether in trust or otherwise." If a gift is made outright to a child with the understanding that the gift property would be returned to the parent, if needed, then Section 2036 should apply and a creditor should be able to reach the property because the child was holding the property as the agent of the parent. On the other hand, a gift to a child, without more, should not be considered a gift with a retained interest by the parent, even though the child can give the property back to the parent or anyone else, if the child sees fit. Similarly, it would seem that a gift in trust for the benefit of a child, even if the child is provided with an LSPOA with the ability to appoint the trust assets to the Settlor, without more, should not create a retained interest by the Settlor.

The test of whether an implied agreement exists must be made at the time of the transfer. Reg. 20.2036-1(a) provides that "[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." This raises a number of interesting issues. For example, if a child/beneficiary of a trust was an LSPOA powerholder and did not know the power existed at the time of the transfer to the LPSOA Trust, or if a trust protector of the LPSOA Trust creates the LPSOA in a child after the transfer to the LPSOA Trust, it would seem difficult to establish that an implied agreement was made at the time of the transfer to the trust.

Moreover, if the original gift to the trust is an incomplete gift because the Settlor retained a TSPOA, the issue of an express or implied agreement is irrelevant for tax purposes because the trust property subject to the TSPOA will be included in the Settlor's estate under Sections 2036-2038. Alaska trust law provides that "[a]n agreement or understanding, express or implied, between the Settlor and the trustee that attempts to grant or permit the retention of greater rights or authority than is stated in the trust instrument is void."[17]

Lifetime vs. testamentary powers of appointment

An LSPOA is very similar to a TSPOA, which is a mainstay in irrevocable trust planning. A TSPOA is often given to a trust beneficiary and is used to, in effect, amend an irrevocable trust at the death of the beneficiary. A TSPOA allows the powerholder a "second look" at the terms of the trust, and is sometimes called a "re-write provision."

A typical case where a TSPOA is used occurs when a Settlor creates a trust for the benefit of his spouse (or for the benefit of his spouse as primary beneficiary and his children as secondary beneficiaries). The Settlor's spouse is given a TSPOA to appoint at death all or part of the trust property to one or more of the children, to the exclusion of the other children. The TSPOA allows the Settlor's spouse to favor one or more children over the other children. The spouse may also be given a more expansive TSPOA, and additional persons or entities could be added as permissible appointees of the trust property.

Examples of LSPOA Trusts

Several examples of LSPOA Trusts are set forth below, as is a comparison to a QTIP trust. These examples illustrate common types of irrevocable trusts with the addition of an LSPOA.

Example 1—Non-self-settled LSPOA Trust; Settlor is not a beneficiary. A Settlor could fund an irrevocable trust for the benefit of his spouse and issue. The Settlor would not be a permissible beneficiary of the trust. One of the Settlor's children could be given a worldwide LSPOA (the class of appointees would include the Settlor), or a trust protector could be given the power to grant an LSPOA to a child. The ability of the Settlor's child to exercise the LSPOA (or the grant of the LSPOA to the child) could be delayed until the

[14] *Cf.* Estate of Paxton, 86 TC 785 (1986), in which the Settlor transferred practically all assets to the trust.

[15] *Cf* Estate of Skinner, 316 F.2d 517, 11 AFTR2d 1855 (CA-3, 1963)

[16] Estate of Schauerhamer, TCM 1997-242 , Turner, 94 AFTR2d 2004-5764 (CA-3, 2004)

[17] Alaska Stat. § 34.40.110(i).

Settlor and the spouse are no longer married (either because of divorce or the death of the spouse).

While the Settlor is married, distributions could be made to or for the benefit of the Settlor's spouse. The distributions could, in the spouse's discretion, be used for the enjoyment of both the spouse and the Settlor, or could subsequently be transferred from the spouse to the Settlor. If the Settlor and the spouse are no longer married, the child who holds the LSPOA would have the ability to exercise the LSPOA in favor of the Settlor to appoint the assets to or for the benefit of the Settlor, if desired.[18] If the trust is formed for the benefit of the Settlor's children only, the LSPOA could be presently exercisable or granted in the discretion of the trust protector, and could be given to the spouse or a child.

It is critical that there be no explicit or implied agreement that the powerholder will exercise the LSPOA in favor of the Settlor. If no agreement exists and assuming relevant state law does not provide otherwise, it would appear that a creditor of the Settlor could not force the child to exercise the LSPOA in favor of the Settlor.

Additional protection could be drafted into the LSPOA Trust as follows:

• For enhanced creditor protection and the possibility of estate tax benefits, the LSPOA Trust can be structured so that it holds non-voting membership interests in a limited liability company ("LLC"). For example, an LLC could be divided into 95% non-voting interests and 5% voting interests.

For planning purposes, it is often desirable to place assets to be protected from creditors in an LLC prior to a transfer and then transfer only the non-voting interests to the LSPOA Trust. If creditors were successful in reaching the trust assets, those assets would consist of non-voting interests in an LLC. To prevent a creditor from reaching the voting interests of the LLC and possibly obtaining control of the entity, the Settlor should not retain ownership of the voting LLC interests. The voting LLC interests could be held in an irrevocable trust created by a third party for the benefit of the Settlor. If the assets of the LSPOA Trust are included in the Settlor's estate, the non-voting interests may be entitled to a valuation discount for estate tax purposes.

• A significant advantage of this type of LSPOA Trust is that its terms mirror those of trusts commonly used for estate planning purposes, and it does not look like an asset protection trust. The LSPOA Trust can be useful to achieve a client's estate planning objectives. A major disadvantage of this type of LSPOA Trust is that the child holding the LSPOA may not want to exercise it in favor of the Settlor in the future, if and when the Settlor desires the assets. This risk is real and should not be dismissed lightly, but this risk almost assures that this type of LSPOA Trust could not be reached by the Settlor's creditors.

• The Settlor's spouse could be given a TSPOA that would allow the spouse to appoint the assets back to the Settlor at the spouse's death. If the spouse is a beneficiary of the LSPOA Trust and the Settlor and his spouse remain married, it may not be necessary to give the spouse a LSPOA because the Settlor has indirect access to the trust assets through the ability of the spouse to receive income and principal distributions from the LSPOA Trust.

• To protect against the possibility of a divorce of the Settlor and his spouse, the LSPOA Trust could provide that the beneficial interest of the spouse terminates upon a divorce. Upon a termination of the spouse's interest in the LSPOA Trust, the trust property would then be held for the benefit of the Settlor's children.

From an equitable distribution perspective, this alternative is not necessarily better than an outright gift to the spouse. If an outright gift is made, upon divorce the Settlor should legally be entitled to half the assets held by the donee spouse. However, in the case of a gift to a trust for the benefit of the Settlor's spouse and children, the Settlor may not be entitled to any of the

18 The exercise of an LSPOA may trigger a taxable gift by (1) the Settlor if the original gift to the LSPOA Trust was an incomplete gift or (2) the powerholder under the rationale of *Estate of Regester*, 83 TC 1 (1984) (discussed later).

trust assets upon divorce. If the spouse is considered deceased upon divorce, the trust will be for the benefit of the children and neither the ex-spouse nor the Settlor will be a beneficiary. It should be possible for a subsequent spouse of the Settlor to be included as a beneficiary if the LSPOA Trust defines the spouse as the person whom the Settlor may be married to from time to time.

Example 2—Self-settled LSPOA Trust; Settlor is a beneficiary. The Settlor could fund an irrevocable trust for the benefit of the Settlor, his spouse, and issue. Because the Settlor funded the trust and is a beneficiary, the LSPOA Trust is a self-settled trust. A child of the Settlor could be given an LSPOA, or the trust protector could have the power to grant an LSPOA to a child of the Settlor. A creditor of the Settlor could not reach any assets of the trust (in theory, at least) if the trust was sitused in a state that protects the assets of a self-settled trust, such as Alaska, Delaware, or Nevada.

If the trust was sitused in a state that did not offer protection for self-settled trusts, a creditor of the Settlor should be able to reach the portion of the trust that could be distributed to the Settlor by the trustee.[19] If a creditor became aggressive in trying to reach any of the trust assets, the powerholder of the LSPOA could appoint the assets to another individual or trust (possibly one in which the Settlor is not a beneficiary), and the assets would not be available for distribution to the Settlor. After the exercise of the LSPOA, the assets would be further removed from the reach of the Settlor's creditors.

• In this example, the Settlor is a beneficiary of the LSPOA Trust, and therefore, it should not be as important for the Settlor to be among the class of permissible appointees of the LSPOA. In this example, the LSPOA is used primarily to provide a mechanism to appoint the assets from the LSPOA Trust. The assets could be appointed to a trust sitused in a state that provides protection for self-settled trusts, to a trust sitused in a foreign jurisdiction that provides such protection, or to a trust in which the Settlor is not a beneficiary. The ability of the powerholder of the LSPOA to appoint assets from the LSPOA Trust may deter a creditor, even though the power remains unexercised.

• A conservative and effective way to structure the trust would be to provide that the Settlor is only a discretionary income beneficiary and is not a beneficiary as to principal. If the Settlor is only a discretionary income beneficiary, then even in states that do not provide creditor protection for self-settled trusts, the Settlor's creditors should be able to reach only the income of the trust and not the principal. A creditor should be able to reach only the portion of the trust that could be distributed to the Settlor by the trustee. If a creditor attempted to reach the income interest, the Settlor's retained income interest could also be protected because the powerholder of the LSPOA could appoint the trust assets to another individual or to a trust in which the Settlor is not a beneficiary.[20]

• If the Settlor is only an income beneficiary and is not a beneficiary as to principal, the use of an LLC may provide added protection for the income interest. If the LSPOA Trust only owns non-voting interests in an LLC and the non-voting members cannot authorize distributions, the LSPOA Trust would generally not have any income to distribute unless the voting members of the LLC authorized a distribution. The non-voting members could not be compelled to make a distribution. The voting interests, which would hold the power to trigger LLC distributions, should be owned by another trust that is protected from creditors, including the Settlor's creditors. The ownership of the LLC could consist of 5% voting and 95% non-voting interests so that a majority of the economic value of the LLC could be owned by the LSPOA Trust.

• If a self-settled trust is used, it is important for the Settlor to retain a TSPOA so that the transfer to the trust will not be a completed gift. The retention of a TSPOA by the Settlor will cause the trust property to be included in his estate under Sections 2036-2038.

Example 3—Self-settled LSPOA Trust; Settlor is a contingent beneficiary. Under this structure, the Settlor would not initially be a beneficiary of the LSPOA Trust, but the trust would provide that the Settlor would be a beneficiary upon the occurrence of a future event. If the Settlor is married, the LSPOA Trust could be drafted so that the Settlor would become a beneficiary only upon the death of his spouse. This structure is attractive to the Settlor because he can retain indirect access to the trust assets while the spouse is alive, and after the death of the spouse, the Settlor would become a beneficiary of the LSPOA Trust. During marriage, distributions of income and principal can be made to the spouse, and the spouse can

[19] See note 4, *supra*.

[20] The Restatement (Third) of Trusts, § 58, general comment c, seems to acknowledge the effectiveness of such a plan when it provides that "if an income beneficiary also holds a presently exercisable power to appoint principal of the trust only to others, the power does not invalidate spendthrift protection of the income interest. Exercise of such a power (although a corpus distribution would carry with it the income interest in the property) is not a transfer prevented by the spendthrift restraint, as long as the beneficiary does not attempt to so exercise the power as to appoint only the income interest."

subsequently transfer the distributed property to the Settlor or use the property for the benefit of the Settlor and the spouse.

Because the Settlor is a potential beneficiary of the LSPOA Trust, it is probably beneficial to situs the trust in a state that provides creditor protection for self-settled trusts. However, even under the laws of states that do not protect the assets of a self-settled trust from the Settlor's creditors, those creditors arguably should not be able to reach the trust assets until the death of the Settlor's spouse. If the Settlor could not become a beneficiary until after his spouse's death, no income or principal could be distributed to the Settlor until that time. The trust could be drafted so that the Settlor's spouse would be considered deceased upon a divorce from the Settlor. A child of the Settlor could be given an LSPOA, or a trust protector could have the power to grant an LSPOA to one of the Settlor's children or to a third party. If a creditor threatened to reach the trust assets, the powerholder of the LSPOA could appoint the assets away from the LSPOA Trust.

Example 4—Inter vivos QTIP trust for spouse. To fully evaluate and understand the uses of an LSPOA Trust, it is helpful to compare an LSPOA Trust to an inter vivos QTIP trust. An inter vivos QTIP trust can be an effective way to protect assets from creditors, but in some respects, it is not as attractive as a LSPOA Trust because it is not as flexible. An inter vivos QTIP trust must be held for the sole benefit of the spouse and cannot provide an LSPOA to anyone, including the spouse who is the beneficiary of the inter vivos QTIP trust. The assets in the inter vivos QTIP trust can be appointed back to the Settlor only upon the death of the spouse pursuant to a TSPOA.

An inter vivos QTIP trust should generally be considered only for spouses in a stable marriage. This trust cannot be drafted so that the income interest of the beneficiary spouse terminates upon divorce. However, the parties can execute an agreement that provides that the assets of an inter vivos QTIP trust will be considered marital property for the purposes of equitable distribution, so long as there is no agreement that the assets will pass back to the Settlor upon divorce.[21] Moreover, because an inter vivos QTIP trust requires mandatory income distributions to the Settlor's spouse, such a trust would potentially expose the income interest to the spouse's creditors.

- From a gift tax standpoint, an inter vivos QTIP trust is advantageous because a Settlor will receive an unlimited gift tax marital deduction for assets transferred to the trust.

Fraudulent conveyance issues

If a person transfers assets, a creditor may be able to reach the assets if the transfer is considered a fraudulent conveyance. State and federal fraudulent conveyance statutes should not prevent a Settlor from protecting his assets so long as there are no current claims threatened or pending at the time of transfer of the assets and the Settlor is not rendered insolvent by the transfer. If a Settlor is attempting to protect assets from threatened or pending claims or is rendered insolvent by the transfer, the fraudulent conveyance statutes become a significant impediment. Also, in certain cases, future creditors may create a fraudulent conveyance concern.

The determination that the Settlor is solvent after a proposed transfer is important in avoiding a claim that the transfer is voidable as fraud. It is often recommended that a Settlor transfer a "nest egg" to an LSPOA Trust and retain sufficient assets to maintain his standard of living and pay existing and reasonably anticipated future creditors.

This article has discussed the ability of the powerholder of an LSPOA to appoint assets from a self-settled LSPOA Trust, primarily in situations in which it is feared that future creditors of the Settlor may attempt to reach the trust assets. This scenario assumes that the initial transfer of assets to the LSPOA Trust was not fraudulent. Once the LSPOA Trust has been funded, the subsequent exercise of the LSPOA to appoint assets away from the LSPOA Trust arguably should not be considered fraudulent. This is an important consideration if the Settlor (1) forms a self-settled trust in a state that does not provide self-settled trust protection and (2) retains only an income interest, and a child later exercises an LSPOA to appoint the assets to another trust.

Foreign asset protection trusts

The inclusion of an LSPOA in a foreign asset protection trust may not be desirable. If the powerholder of an LSPOA is a U.S. resident or citizen, this power creates a target in the U.S. for a creditor to attack. Unless the powerholder releases the LSPOA prior to a suit by a creditor, the creditor may attempt to obtain a court order forcing the powerholder to exercise the LSPOA in a manner that benefits the creditor. Although the general rule is that an LSPOA is not subject to fiduciary standards and a creditor cannot compel the exercise of the LSPOA, an LSPOA does create another tie to the U.S. if the powerholder is a

21 See Ltr. Rul. 9140069, in which the Settlor and the Settlor's spouse entered into an agreement that provided that assets transferred to a QTIP trust would be considered marital property upon divorce for purposes of determining equitable distribution of martial property.

U.S. resident or citizen. A U.S. judge may hold a powerholder in contempt if he or she does not exercise the LSPOA to bring the assets back to the United States.

Tax issues

Income tax issues. An LSPOA creates a risk of inadvertently causing a trust that would otherwise be a non-grantor trust to be characterized as a grantor trust to the Settlor. An LSPOA which gives the powerholder the authority to appoint assets to non-beneficiaries should be considered a power to add beneficiaries, which can trigger grantor trust status as to the Settlor.[22]

The exercise of an LSPOA by a beneficiary generally should not constitute an exchange under Section 1001.[23] Nevertheless, advisors should be diligent as to any unusual circumstances regarding the exercise of an LSPOA in a trust to be sure there is not a *Cottage Savings*[24] problem. The exercise of an LSPOA by a beneficiary in exchange for valuable consideration may constitute an exchange under Section 1001.

Incomplete gift by Settlor. A transfer to a trust is generally an incomplete gift to the extent the Settlor retains the power to change the interests of the beneficiaries among themselves, to remove one or more beneficiaries, or to add one or more beneficiaries.[25] Furthermore, if state law permits a creditor of the Settlor to reach the trust assets, the gift will be incomplete.[26]

A special power of appointment retained by the Settlor of an irrevocable trust can be used to ensure that the transfer to the trust is incomplete for gift tax purposes. It would generally seem to be better practice to have the Settlor retain a TSPOA, instead of an LSPOA, because the TSPOA gives the Settlor less control for a creditor to try to exploit.[27]

If the initial transfer to the LSPOA Trust is structured as an incomplete gift, the exercise of the LSPOA can trigger gift tax consequences to the Settlor. The exercise of the LSPOA by the powerholder completes the gift for gift tax purposes. For example, if the Settlor made a transfer to an LSPOA Trust and the transfer was an incomplete gift for gift tax purposes, the subsequent exercise of an LSPOA by the powerholder in favor of a child of the Settlor will be a gift by the Settlor to the child.

The exercise of an LSPOA by the powerholder in favor of the Settlor (no gift if transfer from Settlor to Settlor), the Settlor's spouse (no gift tax due to marital deduction), or a charity (no gift tax due to charitable deduction) should not cause adverse gift tax consequences. In addition, it should be possible to exercise the LSPOA in favor of an irrevocable trust in which the Settlor has retained a TSPOA, thereby allowing the transfer to remain incomplete for gift tax purposes. This may allow the movement of assets from a self-settled LSPOA Trust to a trust in which the Settlor is not a beneficiary without triggering gift tax consequences, so long as the Settlor retains a TSPOA in such trust.

Possible gift by powerholder. The exercise of an LSPOA may be a taxable event for gift tax purposes for the powerholder, if the powerholder is a beneficiary of the LSPOA Trust. If the beneficiary/powerholder of an LSPOA is entitled to mandatory income distributions from the LSPOA Trust, the Tax Court and the IRS assert that exercise of an LSPOA in favor of an appointee will result in a taxable event for gift tax purposes.[28] While the authority is not clear, the exercise of an LSPOA by a discretionary (as opposed to a vested) income beneficiary/powerholder arguably should not result in a gift by the discretionary beneficiary/powerholder of a trust, especially if some assets remain in trust after the exercise of the LSPOA.[29] If a beneficiary's interest in a trust is subject to an ascertainable standard, the exercise of the power should not result in gift tax consequences.[30]

There are ways to plan around this potential problem. If the powerholder of the LSPOA is not a beneficiary of the LSPOA Trust, the exercise of the power should not trigger gift tax consequences to the powerholder. Also, if authorized by the LSPOA, the property could be appointed to a trust in which the powerholder remains a discretionary beneficiary along with the other persons, such as the Settlor, whom the powerholder desires to benefit.[31] For this purpose, the planner should consider the advisability of adding

22 See Akers, *supra* note 13, at ¶ 318.7(c). An LSPOA held by a beneficiary may not trigger grantor trust status to the Settlor because the beneficiary would be an adverse party to the exercise or non-exercise of the power. See Reg. 1.674(d)-2(b)

23 See Ltr. Rul. 200112038, in which the IRS ruled that the exercise of a power of appointment granted to a beneficiary is not a sale or exchange under the Cottage Savings doctrine

24 Cottage Savings Ass'n, 499 U.S 554, 67 AFTR2d 91-808 (S.Ct 1991).

25 Reg. 25.2511-2(c)

26 See Akers, *supra* note 13, at ¶ 311.5

27 The more control and strings a Settlor retains, the more likely it is that the transfer is a voidable transfer or a sham that should be ignored for debtor/creditor purposes. For this reason, it may be desirable for the Settlor to retain a TSPOA which would appear to provide less retained control than an LSPOA. See note 7, *supra*

28 In *Estate of Regester*, *supra* note 18, the Tax Court held that the exercise of an LSPOA by an income beneficiary in favor of a remainder beneficiary resulted in a taxable gift because the income beneficiary lost the right to income from the principal that was appointed to the remainder beneficiary.

29 The IRS has taken the position that the exercise of an LSPOA by a discretionary income beneficiary can be a taxable gift. See Ltr. Rul. 8535020

30 See Reg. 25.2514-3(e), Example 2. However, the IRS has rejected this position. See Ltr. Rul. 9451049.

31 See Ltr Rul 9344016.

the clause in paragraph 4 of the sample LSPOA language at the end of this article.

If the gift to the LSPOA Trust is an incomplete gift because the Settlor has retained a TSPOA, an appointment by the powerholder/beneficiary under the LSPOA would not be a gift by the powerholder but would be a gift by the Settlor. One way to avoid a completed gift by the Settlor is for the powerholder to appoint the property to a trust in which the Settlor has retained a TSPOA.

It is also possible for the exercise of an LSPOA to cause a taxable lapse of a general power of appointment.[32]

Estate tax issues for powerholder. An unexercised LSPOA generally does not cause adverse estate tax consequences to the powerholder. The only way that an otherwise properly-drafted LSPOA would cause estate tax inclusion to the powerholder would be if the LSPOA were deemed to be a general power of appointment for estate tax purposes[33] or if the exercise of the LSPOA by the powerholder falls within the so-called Delaware Tax Trap.[34]

Estate tax issues for Settlor. If the Settlor dies before the exercise of the LSPOA, the assets of the LSPOA Trust should not be includable in the Settlor's estate even though the possibility existed that the assets of the LSPOA Trust could be appointed to the Settlor, unless there was an express or implied agreement that the LSPOA would be exercised in favor of the Settlor or unless state law permitted a creditor of the Settlor to reach the trust assets.[35] If there was an express or implied agreement that the holder of the LSPOA would appoint the assets of the LSPOA Trust back to the Settlor, the trust assets could be included in the Settlor's estate under Sections 2036-2038.[36]

It is also important to keep in mind that if the transfer to the trust is an incomplete gift for gift tax purposes because the Settlor retained a TSPOA, the issue of whether the existence of an LSPOA causes a Section 2036-2038 retained right or power is irrelevant for transfer tax purposes. The property transferred will be included in the Settlor's estate under Sections 2036-2038 because of the retained TSPOA.

GST tax issues. The exercise of an LSPOA may result in GST tax.[37] If an LSPOA is exercised in favor of a person two or more generations younger than the Settlor, the GST tax can be triggered.

State law issues. Before using an LSPOA in a trust, the planner should consult relevant state law.[38] State law should be consulted to confirm that the inclusion of the Settlor as a permissible appointee under an LSPOA does not expose the assets of the LSPOA Trust to the Settlor's creditors.

Sample LSPOA language

Lifetime Special Power of Appointment. ______________ shall be the holder (the "Powerholder") of the lifetime special power of appointment

32 See TAM 9419007 in which the powerholders of separate trusts had both an LSPOA and a right to receive the property at age 30. The TAM concluded that the exercise of the LSPOA constituted a taxable gift.

33 One way an LSPOA can be deemed to be a general power of appointment upon grant is if the powerholder is deemed to have the power to appoint the property to the powerholder, the powerholder's estate, or the creditors of either. See Section 2041. An LSPOA can also be deemed to be a general power of appointment if (1) it is a reciprocal LSPOA, discussed below, or (2) the exercise of the LSPOA by the powerholder may satisfy a support obligation of the powerholder (see Rev. Rul. 79-154, 1979-1 CB 301). The reciprocal power of appointment doctrine arises where beneficiaries of different trusts can appoint trust property to one another, unrestricted by an ascertainable standard. In such instance, the IRS will uncross the trusts and will take the position that each beneficiary will be considered to hold a general power of appointment over the trust of which he or she is a beneficiary. See Ltr. Ruls. 9235025 and 9451049. A reciprocal LSPOA could arise if two beneficiaries are each given a presently exercisable LSPOA to appoint the same property. In such an event, each powerholder could agree with the other powerholder to appoint to the other. The IRS has ruled that reciprocal LSPOAs create a general power of appointment.

34 The so-called Delaware Tax Trap arises when a special power of appointment is exercised to create a new special power exercisable without regard to the date of creation of the first power. See Section 2041(a)(3).

35 See Akers, *supra* note 13, at ¶ 311.5.

36 Under Section 2036, the Settlor must "retain" a right to enjoy or affect the enjoyment of the property transferred. Under Section 2038, the transferor must have a power at death to change the enjoyment of the property. See Dodge, 50-5th T.M. (BNA), *Transfers with Retained Interests and Powers*. See also Ltr. Rul. 9141027 which held that the trust assets were included in the husband's estate where the husband transferred assets in trust for the wife's benefit with the wife's agreement that she would execute a codicil appointing property to a trust for the husband's benefit at her death. Apparently, a different rule would apply if the trust for the benefit of the wife was a QTIP trust. See Ltr. Rul. 9140069, in which the husband created an inter vivos QTIP trust for the benefit of the wife, with the understanding that the wife would execute a codicil appointing the property back to the husband at death. This letter ruling found that despite the agreement with the wife, the QTIP was not included in the husband's estate because the QTIP Regulations provide that an interest in a QTIP trust retained by a Settlor will not cause the property subject to a retained interest to be includable in the gross estate of the Settlor.

37 Section 2652(c)(1)(B).

38 For example, the North Carolina Department of Revenue takes the position that a gift in trust and the retention of a special power of appointment by the Settlor is a completed gift for state gift tax purposes. See Culp and Richardson, "The Gift Tax in North Carolina, A Review of Recent Events," The Will & The Way, NCBA's Estate Planning and Fiduciary Law Section, Vol. 25, No. 2, p. 5 (2006).

described in this paragraph. The Trustee shall transfer all or so much of the principal and/or income of the Trust to such one or more appointees (other than directly or indirectly to the Powerholder, the estate of the Powerholder, the creditors of the Powerholder, the creditors of the estate of the Powerholder, or any entity in which any of the foregoing have a direct or indirect interest) in such manner and proportions, either outright or in trust, to either a new or existing trust, as the Powerholder shall appoint during the Powerholder's life. The Powerholder may, at any time and from time to time during his/her life, by written instrument delivered to the Trustee, release such lifetime special power of appointment with respect to any or all of the property subject to such power or may further limit the persons or entities in whose favor this power may be exercised or the extent to which this power may be exercised. This power of appointment may be exercised from time to time by written instructions signed by the Powerholder and delivered to the Trustee. Notwithstanding the foregoing:

1. No transfer shall be made to anyone which has the effect of discharging any legal obligation (including, but not limited to, the obligation to support any person) of the Powerholder, the spouse of the Powerholder, the Settlor, or the Settlor's spouse.

2. The lifetime special power of appointment granted hereunder shall not be effective to the extent it could be considered a general power of appointment because it could be a reciprocal power with someone else holding another power of appointment or power of distribution in this Trust or any other trust. By way of illustration and not limitation, the special power of appointment may not be exercised to appoint assets, directly or indirectly, to or for the benefit of any person who holds a power of appointment that may be exercised to appoint assets to or for the benefit of the Powerholder.

It is recommended that the Settlor retain a testamentary special power of appointment to accomplish an incomplete gift rather than retaining an LSPOA.

3. The lifetime special power of appointment shall not apply to any "incidents of ownership" with respect to life insurance policies insuring the life of the Powerholder which are owned by the Trust.

4. For purposes of this lifetime special power of appointment, the Powerholder shall not be considered to have appointed trust property to himself or herself if the trust property is appointed to an irrevocable trust that contains the following provisions and limitations: (1) no distributions may be made to the Powerholder except for health, education, maintenance, and support; (2) no distributions may be made from the trust to satisfy a support obligation of the Powerholder or the spouse of the Powerholder; (3) the Powerholder shall not have the power to appoint the property directly or indirectly to the Powerholder, the estate of the Powerholder, the creditors of the Powerholder, the creditors of the estate of the Powerholder, or any entity in which any of the foregoing have a direct or indirect interest; and (4) upon the death of the Powerholder, the trust property shall not be paid to the Powerholder, the estate of the Powerholder, the creditors of the Powerholder, or the creditors of the estate of the Powerholder.

Sample language—Power to create LSPOA.

The trust protector shall have the power to grant a lifetime special power of appointment ("LSPOA") to a beneficiary of the Trust. The LSPOA may permit the trust assets to be appointed outright or in trust. The trust protector shall have discretion in structuring the grant of the LSPOA provided that the power granted is a special power of appointment and not a general power of appointment under Section 2041 or 2514 of the Internal Revenue Code.

Conclusion

An LSPOA is a complex estate planning device that can provide flexibility to an irrevocable trust. An LSPOA Trust can provide unique creditor protection benefits but an LSPOA should not be included in an irrevocable trust unless the planner carefully considers both the tax and non-tax implications. ■

KEY PROVISIONS OF THE PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006, which was signed into law on 8/17/06, contains liberalized payout and rollover rules for retirement plans, makes a host of other changes relating to retirement plans, revises certain charitable giving rules, and makes a number of charitable reforms. Articles on the new rules pertaining to corporate-owned life insurance ("COLI") appear on pages 3 and 56 of this issue. The following are some of the other key provisions of the new law that are of interest to estate planners.

Liberalized rules for plan and IRA contributions, distributions, and rollovers. For distributions after 2006, the Act permits rollovers of distributions from an eligible retirement plan of a deceased employee to a non-spouse beneficiary's IRA. The rollover is treated as an eligible rollover distribution, and distributions from the beneficiary's IRA are subject to the RMD rules that apply to inherited IRAs of non-spouse beneficiaries.

For tax years beginning after 2006, after-tax contributions can be rolled over from a qualified retirement plan to another qualified retirement plan or a tax-sheltered annuity. The transfer must be made via direct rollover.

For distributions after 2007, the Act allows distributions from qualified retirement plans, tax-sheltered annuities, and governmental Section 457 plans to be rolled over directly into a Roth IRA. For tax years beginning after 2009, the $100,000 modified AGI limit on conversions of traditional IRAs to Roth IRAs is eliminated.

Some EGTRRA changes made permanent. A number of pension and IRA changes made by EGTRRA are now made permanent, such as: (1) increases in the IRA contribution limits, including catch-up contributions; (2) increases in the limits on contributions, benefits, and compensation under qualified plans, tax-sheltered annuities, and eligible deferred compensation plans; (3) the option to treat elective deferrals as after-tax Roth contributions; and (4) catch-up 401(k), SEP, and SIMPLE IRA contributions.

EGTRRA provisions relating to Section 529 qualified tuition programs have been made permanent—for example, distributions from a 529 plan are excludable from income to the extent used to pay for qualified higher education expenses. The Act also authorizes the IRS to prescribe any Regs., including estate, gift, and GST tax Regs., that are necessary or appropriate to carry out the purposes of Section 529 and prevent abuse of those purposes.

Charitable giving incentives. For distributions in tax years beginning in 2006 and 2007, the Act provides an exclusion from gross income, up to $100,000, for otherwise taxable IRA distributions from a traditional or Roth IRA that are qualified charitable distributions. The distribution must be made directly by the IRA trustee to a charitable organization on or after the date the IRA owner attains age 70-1/2.

Charitable reform provisions. For charitable contributions in tax years beginning after the enactment date, the Act disallows a deduction for any contribution of cash, check, or other monetary gift unless the donor maintains as a record of the contribution a bank record or a written communication from the donee.

For contributions, bequests, and gifts made after the enactment date, charities receiving a fractional interest in an item of tangible personal property must, among other requirements, take complete ownership of the item within ten years or the death of the donor, whichever is first.

The Act directs the IRS to undertake a study on the organization and operation of donor-advised funds and supporting organizations to determine if such organizations are operating consistently with the purposes that are the basis for their tax-exempt status. Contributions made after 180 days after the enactment date, to certain sponsoring organizations for maintenance in a donor-advised fund, aren't eligible for a charitable deduction. The Act also includes requirements for improved accountability of donor-advised funds.

ESTATE PLANNING will cover these provisions of the new law in detail in future issues. ■