Powers of appointment
Why decide today when you can put it off until tomorrow?

One potential problem with wills, trusts and other traditional estate planning tools is that they force you to make decisions about how your wealth will be distributed years or decades in advance. A power of appointment may solve that problem. It's a document that authorizes another person — such as a family member or trusted advisor — to designate who will receive certain property.

Two types of powers

Powers of appointment come in two forms: *general* powers and limited (or special) powers. The distinction is important, not only because it defines the level of authority conferred, but also because it can have significant tax implications. When someone receives a general power of appointment over property, the property is included in his or her taxable estate. When a person receives a *limited* power, generally there are no estate tax consequences for him or her.

A general power of appointment authorizes your designee (called the "holder") to direct your property to anyone, even to him- or herself. A limited power of appointment allows the holder to direct distributions to certain people, or a certain class of people — such as children and grandchildren — under specified circumstances. It can also be used to benefit the holder, provided distributions are limited based on "ascertainable standards" related to the holder's health, education, maintenance or support.

Careful drafting is critical because an innocent slip of the pen can have disastrous consequences. For example, under federal law a power "which is limited by an ascertainable standard relating to health, education, support, and maintenance" isn't considered to be a general power of appointment. But a document that allows distributions for the holder's "comfort, welfare or happiness" would likely be considered to confer a general power of appointment because it goes beyond the basic necessities of life.

It's also important to specify a backup, or "taker in default," if the original holder declines or is unable to exercise the power of appointment.

Discretionary spending

Even the most comprehensive estate plan can't anticipate every possibility. A power of appointment allows you to postpone certain decisions until more information is available. The holder has the discretion to distribute your wealth in a manner that best fulfills your estate planning goals.

For example, Jerry has a daughter, Elaine, and three young grandchildren. He plans to set aside a portion of his wealth for his grandchildren, but he doesn't want them to rely on the trust to support themselves; he'd like to encourage them to achieve some measure of success on their own.

One option is to have his advisors draft an incentive trust that conditions distributions on good behavior. Jerry can define good behavior to mean virtually anything, from obtaining a college degree to staying gainfully employed to becoming more involved in socially responsible activities.

These trusts can be effective, but what happens if a situation arises that the trust doesn't address? Suppose one of Elaine's children lands an unpaid internship with a stock brokerage firm. The position doesn't meet the trust's definition of "gainful employment," but it's a worthwhile pursuit that's designed to lead to gainful employment.

To build more flexibility into his estate plan, Jerry gives Elaine a limited power of appointment to allocate assets among her children as she sees fit. This gives her the discretion to determine how the property will be distributed and in what amounts, and even allows her to leave out one or more children if she feels they haven't lived up to Jerry's expectations.

Generating tax savings

You also can use a general power of appointment to avoid generation-skipping transfer (GST) taxes. The GST tax is a flat tax imposed at the highest marginal estate tax rate (currently 45%) on transfers that skip a generation (to a grandchild, for example). There's a GST exemption, which is $2 million in 2008. Once you exceed the exemption, however, generation-skipping transfers are subject to GST tax in *addition* to estate taxes.

Let's say that Jerry, from our previous example, has used up his GST and estate tax exemptions. If he puts an additional $6 million in trust for his grandchildren, nearly 80% of that amount will be devoured by estate and GST taxes.

Suppose, instead, that Jerry gives a general power of appointment to Elaine, whose estate tax exemption (currently $2 million) and gift tax exemption (currently $1 million) are intact. Although the power of appointment constitutes a taxable gift from Jerry to Elaine, it avoids GST tax. And even though the property will be included in Elaine's estate, she can use her exemptions to shield a portion of the assets from gift and estate taxes, resulting in a lower overall tax burden.

A matter of trust

Unless you have a crystal ball, it's difficult to predict what your family's circumstances will be years or decades from now. If you have someone you can trust to carry out your wishes when that time comes, a power of appointment can be an effective and flexible tool.

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