POWER OF APPOINTMENT SUPPORT TRUST (POAST)

An Innovative Approach to Transfer Greater Wealth and Reduce Income Taxes
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Introduction
The so-called “squeeze” or “sandwich” generation balances the demands of aging parents and growing children. Adding to those demands is the desire to implement estate planning strategies that minimize estate, gift, and generation-skipping transfer (GST) taxes (collectively, the “transfer taxes”), as well as income taxes. With the limited amount of transfer tax exclusions and credits available to the wealthy individual, there’s often competition for those tax benefits. The person with wealth often faces the question: “Do I provide for my parents or my children/grandchildren?”

Fortunately, with the recent changes in the transfer tax laws, it may be possible to do both. This paper explores an integrated trust technique that allows the wealthy individual (who we’ll call the “donor”) to provide benefits to both parents1 and descendants. The Power of Appointment Support Trust (POAST) takes advantage of transfer tax exclusions that would likely be wasted by the parents and instead utilizes such exclusions for the donor’s descendants’ benefit. A collateral benefit is that the POAST also allows for a cost basis adjustment at the donor’s parent’s death.

Background
Before the passage of the American Taxpayer Relief Act of 2012, estate tax planning traditionally emphasized the impact of transfer taxes, while deemphasizing income taxes. Historically, this was a rational approach since the gift and estate tax cost frequently exceeded any possible income tax liability. Additionally, with much lower transfer tax exclusions, little was to be gained by transferring assets upstream to a parent, because such transferred assets would be subject to transfer taxes again at the parent’s death.

Today, however, the substantially increased transfer tax exclusions eliminate the imposition of transfer tax for many individuals. Often, some or all of an individual’s exclusions remain unused at death, and are thus wasted. For individuals with less wealthy parents and collateral family members (aunts, uncles, in-laws, etc.) a properly structured POAST can provide support for an aging family member while capitalizing on that family member’s unused exclusions to enhance wealth transfer to descendants.

Additionally, in light of the increases in income tax rates, a properly structured POAST could potentially reduce income tax liability to the family, as described later in this paper.

Since the POAST borrows some of the same techniques utilized in traditional planning, let’s first review the tried and true planning concepts used by wealthy families and then explore how those techniques are implemented to structure the tax-beneficial POAST.

Downstream Planning: The Traditional Approach
Traditionally, most of the emphasis in estate planning consists of transferring assets in flexible trusts for downstream generations. To achieve flexibility, these trusts typically include a provision called a “power of appointment” (POA) that gives descendants the ability to make adjustments to a trust, if necessary and consistent with the grantor’s intentions.2
Use of Powers of Appointment

Today, with dynastic, multigenerational trusts, predicting all future contingencies is improbable, if not impossible. As a result, it is still preferred to give the downstream beneficiary (called the “power holder”) the traditionally used POA (or to give a trustee or trust protector the ability to give the beneficiary a POA) to redirect trust assets consistent with the grantor’s intent. The power holder’s ability to exercise the power may sometimes “disappoint” some beneficiaries (whose goal in life may be to lay in wait for the trust’s fund), earning the tongue-in-cheek reference to a POA as a “power of disappointment.” The breadth of a POA (limited or general) determines the transfer and income tax, as well as asset protection, consequences.

Limited Powers of Appointment

The limited power of appointment (LPOA) gives the power holder the right to direct trust property to anyone other than the following four persons/entities (also known as the “forbidden four”): (1) the power holder; (2) his/her estate; (3) his/her creditors; or (4) the creditor of his/her estate. Most commonly, it gives the power holder the right to appoint trust property to descendants, and, on occasion, it would expand to grant limited rights to a descendant’s spouse and/or charity. A beneficiary with an LPOA is given the opportunity to assess the situation when preparing his/her estate plan, which may be years after the creation of the trust. They effectively have a second look to determine if redirecting trust assets would be appropriate, given the environment and contingencies that may have arisen since the trust’s creation (e.g., to meet special needs or unforeseen circumstances, such as domestic discord, mental illness, or substance abuse). Generally, LPOAs do not trigger transfer or income tax consequences.

General Powers of Appointment

In contrast to LPOAs, general powers of appointment (GPOAs) have tax and asset protection considerations. A GPOA gives a beneficiary the power to appoint trust property to anyone, and must specifically include any of the forbidden four. Because of the breadth of the power, the power holder is viewed as having unlimited control over the ultimate disposition of the subject property.

The trust’s property is treated as if it is owned directly by the power holder for transfer tax purposes, and will be included in his or her estate. As a result of estate inclusion, the trust’s assets receive a date of death cost basis adjustment. Additionally, for GST tax purposes, the power holder is treated as the transferor of the property and any unused GST exemption can be allocated to the trust, making part or all of it GST exempt.

Since a GPOA may expose trust assets to creditors, a GPOA may not be advisable if there are significant asset protection issues looming. However, in cases where asset protection is less of a concern than income and transfer taxes, the GPOA is suggested, as there may be no real downside.

A Case for the Power of Appointment Support Trust (POAST)

While traditional planning commonly looks downstream to leverage available transfer tax exclusions and credits, the new transfer and income tax environment allows us to look both upstream and downstream. Today, the wealthy individual can use the POAST to provide support for less wealthy parents or senior family members while capturing unused transfer tax exclusions and minimizing income tax on appreciated assets when the supported beneficiary dies.

Shorter-Term Adjustment to Basis

In traditional planning, cost basis adjustments for appreciated assets, with few exceptions, are available on the death of a beneficiary holding a GPOA. However, these events occur, on average, about every 25 years. Through the use of a POAST, assets held in the trust could be entitled to a significantly earlier date of death basis adjustment at the time of the donor’s parent’s death.
Capture Unused GST Tax Exemption

For wealthier families, the GST tax exemption is one of the most valuable exemptions available today, as it insulates assets from any associated transfer tax for the longest period allowable under the respective state law. Once GST tax exemption has been allocated to a transfer in trust, current law insulates those protected assets from future transfer tax. By utilizing the POAST, assets that are subject to the parent’s GPOA are effectively included in the parent’s estate, allowing an allocation of the parent’s available GST exemption to the estate assets—significantly increasing the amount of GST exempt assets available to multiple generations.

Benefits of Making a Taxable Gift

Since the GPOA granted in the POAST effectively eliminates income tax on capital gains (and the additional surtax on net investment income) at the parent’s death, the payment of gift tax associated with the gift transfer generally makes economic sense. Gift transfers result in an effective federal transfer tax rate of roughly 29% while the effective tax rate on transfers at death is 40%. The opposition to pre-pay gift tax due to higher federal and state income tax rates has weakened considerably where the income tax is effectively planned away through earlier cost basis adjustments.

Trading Gift Tax for Additional GST Tax Exemption

Generally, the donor’s GST tax exemption is best reserved for traditional downstream planning. In the POAST, it makes little sense to use any of the donor’s GST tax exemption, since the donor’s parent will use his/her GST exemption (that may otherwise be wasted) to protect the trust upon the parent’s death. Effectively, the donor is trading the payment of gift tax for the parent’s available GST exemption. This presents a tremendous complement to existing downstream planning.

Exploring the entire family picture could also uncover other senior generation family members whose lifestyle could be enhanced by the support available through the POAST. Don’t think just parents—consider uncles, aunts, cousins—as the opportunities are only limited by the family’s unique structure and family dynamics.

Grantor Trust Status and the POAST

As we know, the income tax rules do not always work in concert with the transfer tax rules. While the grantor trust provisions were originally enacted to prevent perceived income tax manipulation, they did open the door for extremely favorable wealth transfer planning, including the so-called “intentionally defective grantor trust” or IDGT.

Absent any administrative change to the language of the trust, the POAST should be structured so that the donor will be considered the grantor of the trust for income tax purposes until the donor’s own death, and, thus, will be responsible for all associated income tax liabilities during that time period.

Conclusion

The POAST uses well-respected, time-tested wealth transfer techniques in a different way to accomplish multiple objectives, including support for less wealthy family members, income tax mitigation, and enhanced dynastic wealth transfer. While it is easy to become enamored with the latest and greatest strategies that could save significant amounts of income and transfer taxes, planning must still be aligned with the family’s overall goals and objectives. Wealthy individuals need to reflect on the following questions before considering additional planning:

1) Have I exhausted all of my currently available transfer tax exemptions through traditional planning?
2) Do I have any family members whose lives can be enhanced by providing support?
3) Is additional wealth transfer for future generations a significant personal objective?

If the answer to all of these questions is yes, the POAST may very well be a strong alternative to complement existing planning. As no planning is free from all risk, it is advisable to structure this arrangement carefully by engaging qualified legal counsel.
Exhibit 1: Traditional Approach

Senior Generation’s Estate

Donor’s Estate

Assets for Children

GST Exempt Assets

GST Nonexempt Assets

Gifts in excess of available exclusion will incur gift tax.

Exhibit 2: Power of Appointment Support Trust

Senior Generation’s Estate

Donor’s Estate

Assets for Children

GST Exempt Assets

GST Nonexempt Assets

*Gifts in excess of available exclusion will incur gift tax.
Endnotes

1 While we refer to “parent” to illustrate the POAST, this arrangement is not limited to parents. It can be used with any extended family member, including parents, in-laws, cousins, aunts, etc.

2 The grantor may also provide a mechanism where a trustee or a trust protector could make adjustments, or give the trustee or trust protector the power to grant the junior generation a power of appointment.

3 For example, Section § 502(a) of the The Uniform Powers of Appointment Act provides that property subject to a testamentary GPOA is subject to the power holder’s creditor claims to the extent that the power holder’s estate is inadequate to satisfy such claims.

4 Over that last several years, proposals to limit the duration of transfer tax protection for GST exempt trusts to 90 years have been introduced, but no action has been taken to date.

5 To transfer $1 million by gift, the gift tax would be $400,000. Therefore, it takes a beginning balance of $1.4 million to make a $1 million taxable gift. If the same $1.4 million was transferred at death, the estate tax would be $560,000.

6 See Bryan D. Austin & Christopher P. Cline, Gifting in a Changing Tax Landscape, Do Taxable Gifts Still Make Financial Sense?, Abbot Downing (2015) where the authors identify the relevant financial considerations when making taxable gifts, including the opportunity cost from prepayment of gift tax.

7 For the family to benefit from the donor remaining as the grantor for income tax purposes (even after the death of the donor’s parent), the donor’s parent should not actually exercise the GPOA. Under Treasury regulations, if the donor’s parent exercises the GPOA, grantor trust status is terminated.