Modification of Trust Power of Appointment Given Retroactive Effect by IRS

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In Private Letter Ruling 201737008, issued by the IRS on September 15, 2017, the Service gave retroactive tax effect to a court modification of the power of appointment held by the donor's spouse over the donor's trust. Based on the retroactive County Court modification in this ruling, the surviving spouse's power of appointment over the trust was held to be a special power of appointment for tax purposes from the trust's inception, thereby avoiding estate taxation on the trust assets in the taxable estate of the spouse at her later death.

Section 2041 of the Internal Revenue Code ("Code") taxes a trust as part of a trust beneficiary's estate if the beneficiary has a "general power of appointment" over the trust. A "general power of appointment" is one which can be exercised in favor of the beneficiary holding the power, the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

In this case, the grantor had created an irrevocable trust to benefit the grantor's spouse and descendants. The donor's spouse was given a testamentary power of appointment over the trust, which could be exercised in favor of such persons or charities and on such trusts, terms and conditions as the spouse appointed by her last Will. Both the grantor and his spouse were living at the time the IRS ruled on the trust modification. Inadvertently, the trust terms did not specifically limit the permissible scope of the power of appointment to persons other than the spouse, her estate, her creditors or the creditors of her estate. This limitation was in fact intended by the grantor and had been omitted by the drafting attorney in error. The County Court handling probate matters in the jurisdiction where the trust was established entered an order narrowing the scope of the power of appointment to a "special" power of appointment by the addition of the limiting language required by Code Section 2041. This new limiting language prohibited the appointment of the trust assets by the spouse in her Will to herself, her creditors, her estate or the creditors of her estate. This limitation was deemed necessary and proper by the County Court to correct the drafting lawyer's error. The Court Order made this modification to conform the trust language to the grantor's intent, retroactively to the date of creation of the trust. The IRS found that the County Court Order that had been entered was consistent with applicable state law that would be applied by the highest court of the state, a prerequisite for IRS recognition of the Order.

Interestingly, the IRS also concluded that the reformation of the trust was not itself the exercise or release of the general power of appointment by the donor's spouse under Code Section 2514 so as to constitute a gift by the spouse for federal gift tax purposes.

While this IRS Private Letter Ruling may not be cited as precedent, it does indicate the direction of the IRS' thinking on recognizing trust modifications properly made under state law. It also shows that the IRS is willing to grant such retroactive court modifications for tax purposes as well.

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