Don't Get Burned

Estate Tax Considerations for Certain "Hot Powers" Under Colorado's Uniform Power of Attorney Act

BY KELIANNE CHAMBERLAIN

This article discusses estate tax inclusion for agents under financial powers of attorney with authority to make certain gifts of the principal's assets or create or change the principal's beneficiary designations.

A well-rounded estate plan includes a financial power of attorney naming an agent to make decisions and take actions for the principal if the principal is unable to act alone. However, the authority granted by the principal to an agent to make gifts or create or change beneficiary designations may inadvertently cause the principal's assets to be included in the taxable estate of the agent. This article describes some of the interplay between Colorado's Uniform Power of Attorney Act and the Internal Revenue Code regarding estate tax inclusion.

Introduction to Powers Under the Uniform Power of Attorney Act

A power of attorney is a document in which one person (the "principal") names and authorizes another (the "agent") to act on the principal's behalf.[1] Colorado has adopted a version of the Uniform Power of Attorney Act (Act).[2] The Act has also been adopted by several other states, including our neighbors, Wyoming and Utah.[3] The Act includes a statutory form financial power of attorney at CRS § 15-14-741 (the statutory form). Under the Act, unless otherwise specified in the document, the statutory form and any other Colorado power of attorney created on or after January 1, 2010, is "durable," meaning it remains effective during the principal's incapacity.[4] All authority of an agent under a power of attorney ends at the principal's death.[5] The authority may begin immediately upon signing the power of attorney (a "standing" power of attorney) or may begin at some later determination of the principal's incapacity (a "springing" power of attorney).[6]

A defining feature of the Act and the statutory form is the definition of authority granted by the principal to the agent, and the distinction between "general powers" and "specific powers." The general powers are incorporated into the statutory form by the following key words and phrases:[7]

- real property
- tangible personal property
- banks and other financial institutions
- operation of entity or business
- personal and family maintenance
- estates, trusts, and other beneficial interests
- benefits from governmental programs or civil or military service
- stocks and bonds
- commodities and options
- insurance and annuities
- claims and litigation
- retirement plans
- taxes.

In turn, each of these key words and phrases is defined by statute.[8] Even if a power of attorney does not follow the statutory form, however, a statement like "I grant my agent the authority to do anything I could do" should provide the agent all of the general powers under the Act.[9]

Conversely, specific powers are not granted to an agent unless they are expressly stated in the power of attorney.[10] So, even making the broad statement above ("I grant my agent the authority to do anything I could do") will *not* grant the agent these specific powers.[11] These specific powers are sometimes also referred to as "hot powers" because they are so powerful. For example, one hot power is to "create, amend, revoke, or terminate an inter vivos trust" on behalf of the principal, giving the agent broad authority over the principal's estate plan.[12]

Although it may sometimes be appropriate for a power of attorney to omit all of the hot powers, certain hot powers can be key to an efficiently administered plan for some clients. For example, in an estate plan that includes a revocable trust and in which the named successor trustee and the named agent under power of attorney are the same individual, it may be a good idea to grant the hot power to "[e]xercise [a] power held by the principal in a fiduciary capacity. . . ."[13] This allows the agent to act for the principal in the trustee role even before an effective resignation or removal provisions in the trust have been implemented.

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In addition, a principal who owns a membership interest in a limited liability company with other members may consider granting the agent the hot power to exercise powers, rights, or authority as a member of a limited liability company.[14]

This article focuses on two of the hot powers under CRS § 15-14-724(1): making a gift and creating or changing a beneficiary designation. Both of these hot powers relate to an agent exercising control over gratuitous transfers of the principal's assets. However, this analysis may apply to other hot powers. An overview of the laws regarding gifts and powers of appointment gives context to the estate tax implications of an agent's authority.

TERMINOLOGY:

Power of attorney means a writing by one person (the "principal") granting authority to another person (the "agent") to act in the place of the principal. *See* CRS § 15-14-702(7).

Power of appointment means a power granted to a person (the "donee") to dispose of property not otherwise owned by the donee. *See* 26 CFR § 26.2041-1(b).

Gift and Estate Tax Exemptions

Colorado does not currently have an estate tax. In 2023, a decedent may transfer up to a combined $12.92 million during life or at death without incurring federal estate tax.[15] The Tax Cuts and Jobs Act of 2017 (TCJA) provided this historically high exemption by doubling the federal estate tax exemption in effect prior to the enactment of the TCJA.[16] However, the TCJA also includes an automatic expiration or "sunset" of the high exemption amount on December 31, 2025.[17] After the sunset, the exemption will revert back to prior levels. Specifically, the exemption amount on January 1, 2026, will be $5 million plus inflation from 2010.[18] The precise exemption amount cannot be determined at this time but is projected to be somewhere between $6 million and $7 million.[19] The highest effective tax rate for a decedent's assets that exceed the exemption is 40% of the fair market value of those excess assets.[20]

Generally, gifts made during a taxpayer's life reduce the taxpayer's remaining available federal exemption.[21] However, taxpayers may make certain gifts that are not counted against the exemption, including annual exclusion gifts.[22] In 2023, the federal gift tax exclusion amount is $17,000 per donor per donee.[23] Spouses may consent to combine their annual gift tax exclusion amounts (called "gift splitting"), resulting in a possible $34,000 excluded annual gift per donee in 2023.[24] As with the exemption, the annual exclusion amount is tied to inflation.[25] Other exclusions are available for certain medical and educational expenses in excess of the annual exclusion amounts.[26]

Although the current estate tax exemption is very high, many financially successful individuals, including farm and ranch owners and small-business owners, face the very real possibility of estate tax liability on their estates. Additionally, the reduced exemption after sunset will increase the number of taxpayers who need to do estate planning to mitigate estate taxes. The Internal Revenue Service has confirmed that the value of gifts made before December 31, 2025, will not be "clawed back" after the exemption sunsets to a lower value, even if those gifts exceed the exemption in place on January 1, 2026.[27] Based on this guidance, some estate planning clients have made or are planning to make significant lifetime gifts prior to December 31, 2025, to "lock in" the exemption for those gifts after January 1, 2026.[28]

Introduction to Powers of Appointment Under the Internal Revenue Code

The Internal Revenue Code (IRC) describes the interests that are included in a decedent's taxable estate.[29] One of these interests is a certain type of "power of appointment" held by a person on death.[30] The IRC distinguishes the estate tax treatment of "general" powers of appointment and all others (called "non-general," "special," or "limited"). Unlike the terms "general" and "specific" under the Act, under the IRC, the "general" power of appointment is more powerful and consequential (for estate tax purposes) than the "special" power of appointment. The taxable estate of a person who dies holding an inter vivos or testamentary general power of appointment includes the assets over which the general power of appointment could have been exercised, even if it was not actually exercised.[31]

A general power of appointment is a power exercisable in favor of the power holder (the "donee"), the donee's estate, the donee's creditors, or the creditors of the donee's estate, with limited exceptions.[32] Any one of these powers alone is enough to characterize the power of appointment as general.

Certain restrictions prevent the power of appointment from being general. If the donee may appoint assets for their own benefit, but limited to an "ascertainable standard related to the health, education, support, or maintenance of the donee," the power of appointment is not general.[33] In addition, if a donee may appoint to the donee only in conjunction with (a) the creator of the power, or (b) a person having a substantial adverse interest in the exercise of the power in favor of the donee, the power of appointment is not general.[34]

A power of appointment is commonly included in an irrevocable trust for the benefit of the donee, in which the trust expressly states that the donee has a power to appoint the trust assets in specified ways. For example, a testamentary trust that will last for the donee's lifetime may grant the donee a power of appointment to name the residuary beneficiaries of the trust upon the donee's death. A well-drafted trust may even state whether the power of appointment is intended to be general or not. However, regardless of the language used in an instrument, if the effect is to grant a donee these rights, a power of appointment exists.[35]

This means that if a donee has the power to invade the trust for the benefit of the donee, and that power is not limited by an ascertainable standard or by the consent of an adverse party, the donee has a general power of appointment.[36] Similarly, if the donee has the power to modify the trust in a way that benefits the donee, their estate, their creditors, or the creditors of their estate without those limitations, either during the lifetime or upon the death of the donee, then the donee has a general power of appointment.[37] This also means that the instrument granting these powers to a donee does not necessarily have to be a will or trust.[38]

Applying these principles, a power of appointment may be granted to an agent as donee under a power of attorney.[39] This is particularly true if the agent is granted the hot powers for making a gift of the principal's property or creating or changing beneficiary designations on behalf of the principal. Drafters of powers of attorney should keep these concepts in mind and only include hot powers after considering how they would impact the agent's taxable estate.

Gifting Authority Under a Colorado Power of Attorney

A principal may wish to grant gifting authority to an agent for several reasons. The principal may want to continue charitable or religious gifting programs they have established, or they may anticipate the need to reduce their estate within the parameters of certain government benefit programs or for estate tax purposes. Authorizing an agent to provide for the general support of a principal's spouse or children does not require specific gifting authority, because general authority under the Act includes "personal and family maintenance."[40]

The authority to make a gift of the principal's assets can have far-reaching consequences. Gifting assets removes them from the principal's estate, so they are not available for the principal's use and not disposed of under the principal's will or trust at death. The Act anticipates certain risks inherent in granting an agent gifting power. Unless the power of attorney provides otherwise, an agent who is not an ancestor, spouse, or descendant of the principal may not exercise authority to direct the principal's property to the agent or any individual to whom the agent owes a legal obligation of support.[41] This limitation does not apply to an agent who is an ancestor, spouse, or descendant of the principal.[42]

Additionally, unless the power of attorney provides otherwise, the limitations of CRS § 15-14-740 apply to the gifting power. One of these limitations is that the agent may only make gifts of the principal's property in accordance with the agent's understanding of the principal's goals.[43] If the agent doesn't know the principal's objectives, the agent may only make gifts of the principal's property if they determine it's in the principal's best interests based on all relevant factors.[44] This gifting limitation is consistent with the general duties of an agent to act in accordance with the principal's reasonable expectations, or if those expectations are unknown, in accordance with the principal's best interests.[45] The statutory limitations do not expressly limit the recipients of gifts made by an agent.[46] Additionally, an agent may only make gifts within the federal estate tax annual exclusion amount, or double that amount if the principal is married and the principal's spouse consents to gift splitting for the gift.[47] This is true even if the federal estate tax annual exclusion amount would not otherwise be required to shield that gift from estate tax inclusion, such as for qualified medical or educational expenses.[48]

> "Applying these principles, a power of appointment may be granted to an agent as donee under a power of attorney. This is particularly true if the agent is granted the hot powers for making a gift of the principal's property or creating or changing beneficiary designations on behalf of the principal."

For many estate planning clients, these limitations may be satisfactory to help protect both the principal from an agent's overuse of the gifting authority and the agent from including the principal's assets in the agent's taxable estate. On the other hand, clients may wish to specify permitted recipients of those gifts. For example, a principal may wish to authorize gifts to the principal's spouse or descendants, but not to the spouses of the principal's children.

Notably, these statutory gifting limitations could preclude the agent from accomplishing the principal's goals if those goals require the agent to transfer more valuable property. For example, a client whose taxable estate would benefit from locking in the value of gifted assets prior to the sunset of current estate tax exemption amounts will likely intend for an agent's gifting power to include making gifts that exceed the annual exclusion amount. These clients should consider overriding the statutory limitations to increase the value of property the agent has authority to gift.

All principals who grant an agent the authority to make a gift of the principal's property should consider the effect of that authority on the agent's taxable estate. The authority of an agent to gift the principal's assets to the agent is a general power of appointment.[49]

Authority to Create or Change Beneficiary Designations Under a Colorado Power of Attorney

A beneficiary designation is a contract with an asset's custodian or other arrangement providing for the post-death, non-probate payment or transfer of the asset.[50] Although the principal may set beneficiary designations prior to losing capacity, the principal may nevertheless wish to grant to an agent the authority to create or change those beneficiary designations for several reasons.

An agent may hire and fire money managers for a principal under the general authority for "banks and other financial institutions."[51] However, beneficiary designations generally do not transfer between custodians. An agent may also direct the investment of the principal's assets under the general authority for "stocks and bonds."[52] Neither of these general authorities includes creating or changing beneficiaries for those accounts.[53]

Beneficiary designations are commonly used for individual retirement accounts and 401(k) plans because less favorable income tax rules apply to those accounts in the absence of a beneficiary designation.[54] Beneficiary designations are also commonly used for life insurance policies and nonqualified investment accounts to avoid probate on those assets. A principal may wish to ensure that even if investments are moved from one investment company to another, the beneficiary designations can be created on new accounts as necessary to preserve the principal's income-tax efficient and non-probate estate plan.

Further, the circumstances of named beneficiaries may change during the principal's incapacity. For example, a beneficiary who becomes disabled and reliant on means-tested government programs may lose those benefits if the beneficiary receives an outright distribution of the beneficiary-designated asset. Authorizing an agent to create or change beneficiaries retains flexibility to correct that undesirable result for the beneficiary prior to the principal's death.

Beneficiary designations override the terms of the decedent's will as to the beneficiary-designated asset.[55] This makes the authority to create or change beneficiary designations very powerful. The Act provides limited guardrails on the authority. As with the gifting authority, unless the power of attorney provides otherwise, an agent who is not an ancestor, spouse, or descendant of the principal may not exercise authority to direct the principal's property to the agent or to any individual to whom the agent owes a legal obligation of support.[56] Further, exercise of the authority is limited by the general requirements to act as the principal expects, or otherwise in the best interests of the principal.[57] At the least, a principal including this authority in a power of attorney may want to limit the permitted designees to the principal's family or other intended recipients. In addition, all principals who grant an agent the authority to create or change beneficiaries should consider the effect of that authority on the agent's taxable estate. The authority of an agent to designate the agent as beneficiary of the principal's assets is a general power of appointment.[58]

Limitations on Agent Authority

To avoid estate tax inclusion for the agent, authority in a power of attorney for gifting and creating or changing beneficiary designations should be sufficiently limited so that the agent will not exceed the power the principal intended to grant, and so that the agent will not have a general power of appointment over the principal's assets for estate tax purposes. This requires applying the rules and definitions in the IRC.

One way to do this is to specify in the power of attorney that no agent (not even an ancestor, spouse, or descendant of the principal) may exercise authority to direct the principal's property to the agent, the agent's estate, the agent's creditors, or the creditors of the agent's estate.[59] However, the agent may be a person whom the principal would like to include in the permissible group of gift recipients or designees, such as a spouse or a child. In this case, the power of attorney could allow the agent to gift to or designate the agent, but only if the gift or designation is limited for the agent's health, education, maintenance, and support.[60]

Alternatively, before exercising the gifting or beneficiary designation authority, the agent could be required to obtain the written consent of a party with a substantial adverse interest in the exercise of such authority in favor of the agent.[61] This could require the consent of another permissible recipient of the exercise of the gifting or beneficiary designation authority who would not benefit from the agent exercising the authority in favor of the agent. For example, a principal who wished to include all of the principal's children as permissible recipients could name one child as agent but require the agent to obtain the consent of another child before the agent could exercise the gifting or beneficiary designation authority in favor of the agent.[62]

Conclusion

A power of attorney is an indispensable part of an estate plan. For some principals, granting an agent the authority to make a gift of the principal's property or to create or change beneficiary designations can be key to preserving the principal's intended estate plan. However, relying on the statutory form or otherwise granting these hot powers without limitations might not adequately protect the agent from estate tax liability. Helping principals understand general powers of appointment will allow them to create the flexibility they need without adversely affecting their agents.

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NOTES

1. CRS § 15-14-702(7).
2. *See* CRS §§ 15-14-701 et seq.
3. *See* Wyo.Stat.Ann. §§ 3-9-101 et seq.; Utah Code Ann. §§ 75-9-101 et seq.
4. CRS § 15-14-704(1).
5. CRS § 15-14-710(1)(a).
6. CRS § 15-14-709(1).
7. *See* CRS §§ 15-14-724(3), -727 to -739, and -741.
8. *See, e.g.*, CRS §§ 15-14-727 (regarding real property), -729 (regarding stocks and bonds), and -739 (regarding taxes).
9. CRS § 15-14-724(3).
10. CRS § 15-14-724(1).
11. CRS § 15-14-724(3).
12. CRS § 15-14-724(1)(a).
13. *See* CRS § 15-14-724(1)(g)(I).
14. *See* CRS § 15-14-724(1)(j). *See also* CRS § 15-14-732, which describes the general power related to the operation of an entity or business.
15. 26 USCA §§ 2001(a), 2501(1), 2505(a), and 2010(c); IRS Rev. Proc. 2022-38 § 3.41.
16. *See* Pub. L. No. 115-97 § 11061 (amending 26 USCA § 2010(c)(3)(C)).
17. *Id.*
18. 26 USCA § 2010(c)(3)(A).
19. *See, e.g.*, "Prepare for Future Estate Tax Law Changes," Fidelity (July 11, 2023), https://www.fidelity.com/learning-center/wealth-management-insights/TCJA-sunset-strategies.
20. 26 USCA § 2001(c). The lowest estate tax rate is 18%, which applies to assets up to $10,000 over the estate tax exemption. The top estate tax rate applies at $1 million over the estate tax exemption.
21. *See* 26 USCA §§ 2501(1), 2505(a), and 2010(c).
22. *See* 26 USCA § 2503(b).
23. *Id.*; IRS Rev. Proc. 2022-38 § 3.43.
24. 26 USCA § 2513.
25. 26 USCA § 2503(b)(2).
26. 26 USCA § 2503(e).
27. *See* 26 CFR § 20.2010-1(c).
28. Generally, gifts prior to January 1, 2026, would need to exceed the exemption available after January 1, 2026, to produce this tax benefit.
29. *See* 26 USCA §§ 2031 et seq.
30. *See* 26 USCA § 2041.
31. 26 USCA § 2041(a)(2).
32. 26 CFR § 20.2041-1(c)(1).
33. 26 USCA § 2041 (b)(1)(A); 26 CFR § 20.2041-1(c)(2).
34. 26 USCA § 2041(b)(1). Certain powers of appointment in favor of the donee granted before October 21, 1942, are also not general.
35. 26 CFR § 20.2041-1(b)(1).
36. *Id.*
37. *Id.*
38. *See* 26 USCA § 2041; 26 CFR § 20.2041-1(b)(1).
39. *See* 26 USCA § 2041; 26 CFR § 20.2041-1(b)(1).
40. *See* CRS § 15-14-736.
41. CRS § 15-14-724(2). This article does not address the income tax inclusion aspects of a power of attorney that grants an agent the authority to direct the principal's assets to those whom an agent has a legal duty to support.
42. *Id.*
43. CRS § 15-14-740(3).
44. *Id.*
45. *See* CRS § 15-14-714.
46. *See* CRS § 15-14-740.
47. CRS § 15-14-740(1).
48. *Id.*; 26 USCA § 2503(e).
49. 26 CFR § 20.2041-1(c)(1).
50. CRS §§ 15-15-101, -301(1), and -402.
51. CRS § 15-14-731.
52. CRS § 15-14-729.
53. *See* CRS §§ 15-14-719 and -731.
54. *See* 26 USCA § 401(a)(9). A review of the complex rules about the timing of withdrawals from these accounts depending on the identity of the beneficiary is beyond the scope of this article.
55. *See* CRS § 15-15-101(1).
56. CRS § 15-14-724(2). This article does not address the income tax inclusion aspects of a power of attorney that grants an agent the authority to direct the principal's assets to those whom an agent has a legal duty to support.
57. *See* CRS § 15-14-714.
58. 26 CFR § 20.2041-1(c)(1).
59. *See id.*
60. 26 USCA § 2041(b)(1)(A); 26 CFR § 20.2041-1(c)(2).
61. 26 USCA § 2041(b)(1).
62. A principal using the statutory form must provide these limitations in the "Special Instructions" section of the form. For other drafting suggestions, *see also* "Ancillary Documents—Financial" (Form 710 and accompanying notes on use), vol. 2, ch. 7 in *Orange Book Forms: Colorado Estate Planning Forms* (8th ed. CBA-CLE 2017).