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Elder Law Attorney

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Message from the Chair

Ordinary people can do extraordinary things. You and I are ordinary people but as members of the NYSBA Elder Law Section we are doing extraordinary things.

The Section has initiated a series of state-wide *pro bono* senior clinics. **Ami S. Longstreet,** Chair-Elect of the Elder Law Section, is spearheading this *pro bono* project. District Delegates **Alfreida B. Kenny, Pauline Yeung-Ha, Amy S. O'Connor, Deborah A. Slezak, Anne B. Ruffer, Donald W. Mustico, T. David Stapleton, Jr., Gayle L. Eagan, Michel P. Haggerty, Richard A. Weinblatt, Howard F. Angione** and **Batya S. Levin** and Executive Committee members **Ronald A. Fatoullah** and **Frances Pantaleo** are working to set up senior clinics within each Judicial District of New York State so that older adults can seek the advice of legal counsel on Elder Law-related issues.

Several of the Districts have already experienced their first *pro bono* clinic. Third District Delegate **Amy S. O'Connor** advised me that the Albany clinic was very successful and that 12 attorneys provided 52 separate consultations on the day of the clinic. The response to the Albany clinic was so overwhelming that seniors had to be turned away and were referred to a *pro bono* clinic scheduled in Schenectady for the following week. As I write this message I am waiting to hear how other Districts' *pro bono* clinics fared. Once the first round of clinics is complete, we will evaluate our successes and failures to determine how to better offer the clinics a second time. The goal of the project is to provide three clinics within each District on an annual basis. The District Delegates will be seeking volunteers to provide the legal expertise for the upcoming clinics. If you are interested in participating in this project contact your local District Delegate. Ordinary people can do extraordinary things.

The Elder Law Section has undertaken some significant legislative initiatives. The Section, with the help of Compact Legislation Co-Chairs **Howard**

Inside this Issue

NYSBA

Income Only Trusts: A Simple Solution to Ensure Marketability of Title When Reserving an *Inter Vivos* Special Power of Appointment

By Salvatore M. Di Costanzo

I. Introduction

Planning to preserve the homestead in anticipation of requiring medical assistance for chronic care has always been at the forefront of our practices. Notwithstanding the importance of such planning, we are often confronted with clients who may be reluctant to surrender control of their assets, particularly the homestead to a child, and as a result of such reservations, it becomes difficult for clients to "pull the trigger" on arguably sensible planning. Counterbalancing the client's issues of control are the dire consequences the client may face if he or she does no planning at all.

The focal point of this article is the use of a special power of appointment in the context of real estate transfers and its impact on marketability of title.[1] Its use has commonly provided solace for the parent who cringed at the thought of irrevocably transferring their house to their children. This ability to alter a child's inheritance is powerful (no pun intended) and to that extent exudes a certain amount of authority and control over the children (and their behavior). However, this power creates a conundrum for the practitioner. On one hand, the reservation of a special power of appointment fulfills the parent's goal of maintaining control over the ultimate disposition of the property, but in doing so, it also creates a title issue which may eventually cloud title.

II. Definitions

A power of appointment gives an individual the right to dispose of certain property that is not legally owned by such individual. The New York Estates, Powers and Trusts Law (EPTL) defines a power of appointment as "an authority created or reserved by a person having property subject to his disposition, enabling the donee to designate, within such limits as may be prescribed by the donor, the appointees of the property or the shares or the manner in which such property shall be received."[2]

The donor is the person who creates or reserves the power of appointment.[3]

The donee is the person to whom a power is given or in whose favor a power is reserved.[4] If the donor reserves the power of appointment unto himself, for instance, in a deed retaining a life estate, the donor is also the donee of the power of appointment.

The appointee is the person in whose favor a power of appointment is exercisable.[5]

The appointive property is property which is the subject of a power of appointment.[6]

III. Varieties of Powers

A power of appointment may be classified as general or special.[7] A power of appointment is general to the extent that it is exercisable wholly in favor of the donee, his estate, his creditors or the creditors of his estate.[8] If a decedent holds a general power of appointment at death, the value of such property covered by a general power of appointment is included in the decedent's federal gross estate.[9]

All other powers of appointment are special.[10]

Property transferred by a donor subject to the donor reserving a special power of appointment will render the transfer an incomplete gift for federal gift tax purposes, and thus, the value of the property will be included in the estate of the donor at death. In the case of real property, (1) the reservation of a life estate in a deed or (2) the right to use and possess real property transferred to an irrevocable trust also renders the value of the property or trust includable in the estate of the decedent at death. Thus, the use of a power of appointment should not be solely for tax purposes.[11] As indicated above, it is generally used to maintain control over the ultimate disposition of real property or shares in a trust.

Property covered by a special power of appointment (or a general power of appointment that is exercisable solely for the support, maintenance, health and education of the donee within the meaning of Sections 2041 and 2514 of the Internal Revenue Code) is not subject to the claims of creditors of the donee of such power nor the payment of the donee's estate and administrative expenses.[12]

As to the time of exercise, a power of appointment may be (i) presently exercisable, (ii) testamentary, or (iii) postponed.[13] Whether a power is presently exercisable, testamentary or postponed is important because if a power is considered general and presently exercisable, the property covered by the general power of appointment is available to the donee's creditors.[14]

A power of appointment is presently exercisable if it may be exercised by the donee, during his lifetime or by his written will, at any time after its creation, and does not include a postponed power.[15] A lifetime exercise must be by written instrument (e.g., a deed).[16]

A power of appointment is testamentary only if it is exercisable by written will of the donee.[17]

A power of appointment is postponed if it is exercisable by the donee only after the expiration of a stated time or after the occurrence or non-occurrence of a specified event.[18]

Property covered by a general power of appointment (unless such general power of appointment is exercisable solely for the support, maintenance, health and education of the donee within the meaning of Sections 2041 and 2514 of the Internal Revenue Code) which is presently exercisable, or of a postponed power which has become exercisable, is subject to the claims of creditors of the donee of such power and the payment of the donee's estate and administrative expenses.[19]

IV. Uses of a Power of Appointment

Powers of appointment are commonly utilized in the context of Medicaid planning in a deed or *inter vivos* trust.

Prior to the signing of the Deficit Reduction Act of 2005 (the DRA) on February 8, 2006[20] the use of a deed reserving a life estate coupled with the donor's reservation of a special power of appointment was a preeminent Medicaid planning technique for clients wishing to (i) transfer real property for purposes of planning for Medicaid eligibility and (ii) maintain a certain degree of control over the ultimate disposition of the property. Although arguably an irrevocable income only trust offers more planning advantages than a deed reserving a life estate coupled with a special power of appointment, clients frequently opted for the latter because of the three-year look-back period which applied to the transfer of a remainder interest as opposed to the trust which carried with it a five-year look-back period.

A deed reserving a power of appointment is analogous to a deed with no grantee. Only after the power of appointment is exercised or terminated, or after the donor dies, will the grantee become ascertainable.[21] It is the power to giveth and then taketh away.

The impact on marketability of title resulting from the use of a deed retaining a life estate and special power of appointment is only beginning to surface as titles to such properties begin to transfer.

V. Title Issues

Illustrative Example

Client A has two children, Sally and John, but only transfers a remainder interest in Blackacre to John while reserving a life estate and a special power of appointment to appoint the remainder interest in Blackacre to his issue. Client A may exercise the power of appointment by deed or in his Last Will and Testament; thus it is presently exercisable. The deed creating the special power of appointment is duly recorded within a reasonable period after execution. Client A is the donee of a special power of appointment and thus has the power to divest John of his interest in Blackacre.

A. Legal Interests of the Donor and Grantee

In the illustrative example, Client A has the current right to the use and possession of the property, and as such, Client A has an estate in possession. Section 6-4.1 of the EPTL defines an estate in possession as "an estate which entitles the owner to the immediate possession of the property."

John has a future estate vested subject to complete defeasance. Section 6-4.9 of the EPTL defines a future estate vested subject to complete defeasance as "an estate created in favor of one or more ascertained persons in being, which would become an estate in possession upon the expiration of the preceding estates, but may end or may be terminated as provided by the creator at, before or after the expiration of such preceding estates." If Client A does not exercise his special power of appointment, John will receive the property at Client A's death in fee simple absolute.

B. Priority of Title

The existence of a power of appointment creates a title quandary when one considers Section 10-5.4 of the EPTL in the face of the recording statute. Section 291 of the Real Property Law (RPL) is the race-notice statute in New York which provides that between two good faith purchasers, the first to record his deed will have superior title, free of any claims by the second to record. But wait! Read Section 10-5.4 into the equation and see what you get.

Section 10-5.4 of the EPTL, more commonly referred to as the priority statute, finds its roots in an 1822 case, *Jackson v. Davenport*.[22] EPTL 10-5.4 states, "[T]he interest of the donee of a power of appointment, and of any appointee thereunder, has priority with respect to real property subject thereto, as against creditors, purchasers or encumbrancers, in good faith and without notice, of or from a person having an estate in such property, **only from the time at which the instru-**

ment creating the power is duly recorded" (emphasis added).

At the risk of being repetitive, it is important to extract the elements of Section 10-5.4. They are:

1. A donee or an appointee of a power of appointment;
2. has superior title;
3. over good faith creditors, purchasers or encumbrancers;
4. if the deed creating the power is duly recorded.

Assume *arguendo* that Client A decides that he does not want Blackacre to pass to John but rather to Sally, who by the way also promised Client A that he would never be admitted to a nursing home. Client A exercises his power of appointment by executing a subsequent deed in favor of Sally. Sally does not record the deed. After Client A dies, John attempts to sell Blackacre to a third party under the impression that he owns Blackacre outright.

Since the original deed creating the power of appointment was duly recorded, Sally has superior title over John, regardless of whether Sally records her deed. Equally frightening is that the title officer working in connection with the transaction from John to a third party has no idea about the deed to Sally or any other unrecorded deed (or multiple unrecorded deeds) for that matter. It is a title nightmare.

VI. Using Irrevocable Income Only Trusts

Practitioners have craftily attempted to impose conditions on the donor's exercise of the power intending to preserve marketability of title. Common examples of additional provisions placing conditions on the manner in which a donor can validly exercise a power of appointment include (i) a requirement that the deed exercising the power of appointment be recorded within a certain period of time after its execution by the donor, or (ii) a requirement that the deed must be recorded during the donor's lifetime, or (iii) if the power was exercised in the Last Will and Testament of the donor, a requirement that a notice be recorded in the County Clerk's office within a stated period of time after the donor's death. All of the above pose practical dilemmas, but more importantly may run afoul of the no additional formality language of EPTL 10-6.2(a)(2). Section 10-6.2(a)(2) reads, "Where the donor has directed any formality to be observed in its exercise, in addition to those which would be legally sufficient to dispose of the appointive property, such additional formality is not necessary to a valid exercise of such power." Where a deed contains conditions necessary to exercise a power of appointment, EPTL 10-6.2(a)(2) suggests that such requirements may be disregarded, and thus, you are back to square one.

Believe it or not, something good may have come out of the DRA. With the look-back period now being five years for all transfers, the use of an income only trust to protect the homestead has achieved greater popularity and has in effect superseded the deed retaining a life estate and special power of appointment as a preferred Medicaid planning strategy for those who are not in immediate need of chronic care. Perhaps more importantly, the use of a special power of appointment in an irrevocable trust rather than a deed may solve the title quandary.

Once title passes to the irrevocable trust, the trustee of the trust has an estate in possession. Similar to reserving a special power of appointment in a deed, the trust can be drafted so as to provide the creator with a special power of appointment to change the beneficiaries' shares of the trust property. From a Medicaid eligibility perspective, the use of a special power of appointment will not render the principal of the trust available to the creator.[23]

Generally, if the creator exercises his special power of appointment, it is done via a written instrument delivered to the trustee of the trust during the creator's lifetime. It appears that once title is transferred to the trustee of the trust, the creator's exercise of a special power of appointment has no effect on marketability of title since the power will not be exercised by a subsequent deed and since there is no subsequent deed, the title company need look no further than the original deed transferring the property to the trust. Whether the creator exercised his special power appointment and altered the disposition of the trust property is an issue between the trustee and the trust beneficiaries. Title, however, will undoubtedly be vested with the trustee.

VII. Conclusion

Prior to the enactment of the DRA, practitioners frequently advised clients to transfer a remainder interest in their primary residence to their children while reserving a life estate and special power of appointment. The reservation of a special power of appointment allowed the grantor to maintain control over the ultimate disposition of the property; however, its use may potentially cloud marketability of title. With the enactment of the DRA, practitioners are turning to irrevocable income only trusts since the look-back period for all transfers is now five years. In doing so, title is vested with the trustee and the creator's exercise of a special power of appointment to change the ultimate disposition of the trust property has no impact on marketability of title.

Endnotes

1. The author would like to thank Lawrence B. Lipschitz of Lawyers Title Insurance Corporation for sharing his thoughts and written material on this power of appointment. For an in-depth discussion of the impact on marketability of title resulting from the retention of a special power of appointment in a deed, *see* Lawrence B. Lipschitz, *Deeds with Reserved Powers of Appointment: Do the Benefits Outweigh the Pitfalls?* New York Counsel to Lawyers Title Insurance Company (1996); *see* Lawrence B. Lipschitz, *Powers of Appointment*, NYSBA Elder Law Attorney, Vol. 9, No. 2 (Spring 1999); *see* Marvin Bagwell, *Powers of Appointment, A Predicament Involving Death and Taxes*, N.Y.L.J., July 14, 2004, at 5 col. 2.
2. EPTL 10-3.1(a).
3. EPTL 10-2.2(a).
4. EPTL 10-2.2(b).
5. EPTL 10-2.2(c).
6. EPTL 10-2.2(d).
7. EPTL 10-3.2(a)(1).
8. EPTL 10-3.2(b).
9. 26 U.S.C. § 2041.
10. EPTL 10-3.2(c).
11. 26 U.S.C. § 2036.
12. EPTL 10-7.1.
13. EPTL 10-3.3(a).
14. EPTL 10-7.2.
15. EPTL 10-3.3(b).
16. EPTL 10-6.3.
17. EPTL 10-3.3(c).
18. EPTL 10-3.3(d).
19. EPTL 10-7.2.
20. Pub. L. No. 109-171.
21. *See* Lawrence B. Lipschitz, *Powers of Appointment*, NYSBA Elder Law Attorney, Vol. 9, No. 2 (Spring 1999); *In re Stewart*, 131 N.Y. 274, 281 (1992); and the Practice Commentaries by Margaret Valentine Turano under EPTL 10-3.1 in *McKinney's Consolidated Laws of New York Annotated*.
22. *Jackson v. Davenport*, 20 Johns. 537 (1822).
23. *See In re Irene Spetz*, Index No. K1-2001-000778 (Sup. Ct., Chautauqua Cty. Jan. 15, 2002).

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