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## Life Estate Ownership of Real Estate (Advantages and Disadvantages)

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A transfer of real estate (including, but not limited to, a personal residence) from individual or joint ownership to a Life Estate form of ownership is an estate planning device used to avoid probate of the property that also offers the possible advantage of protecting the residence in Medicaid situations. The transfer is accomplished by a simple Deed. Transfer to the Life Estate ownership form avoids some of the significant disadvantages of an outright gift of the property to the heirs (frequently the children of the owner).

With a Life Estate form of ownership of real estate there are two separate categories of owners of the property:

### **Life Tenant Owner:**

The Lifetime Owner of the property with absolute and exclusive right to use of the property during their lifetime, which expires automatically upon the death of the last to die of the Life Tenant(s). The Life Tenant can be one individual or there can be joint Life Tenants. The Life Tenant remains responsible for real estate taxes, insurance, and ordinary maintenance costs related to the property. The Life Tenant is entitled to all income from the property in the event that the property is rented. In the event the Life Tenant no longer wishes to reside at the property, or if they are unable to reside there, the property can be rented and the rental income is the rightful property of the Life Tenant. Even if the property is a multi-family dwelling, all rental income is payable to the Life Tenant Owner.

### **Remainder Owner:**

The Remainder Owner(s) automatically become owner(s) of the subject real estate immediately upon the death of the last to die of the Life Tenant Owner(s). The Remainder Owner has no right to use of the property or income from the property during the Life Tenant's lifetime. The Remainder Owner is not responsible for payment of taxes, insurance, or maintenance of the property during the Life Tenant's lifetime. The Remainder Owner may be one individual, or more than one person.

### *Example:*

Life Tenants: John and Mary Elder (75 years old, married)

Remainder Owners: John, Jr., Sally and Tom (3 adult children of John and Mary)

### **Advantages:**

**1. *Simplicity and Low Cost to Establish:*** Life Estate ownership is accomplished simply by signing and recording a new Deed signed by the present owner(s) of the property. Legal fee for the Deed preparation is \$175.00, plus cost of recording the Deed, which is \$125.00 in Massachusetts. There is an additional charge if you are unable to provide us with a copy of your present Deed and we have to obtain it for you from the Registry of Deeds, or if you require a title search to confirm current exact ownership of the property.

**2. *Avoids Probate:*** Upon the death of the last Life Tenant Owner the property automatically belongs to the Remainder Owner(s), without any requirement of probate for the real estate. This is extremely advantageous (especially where there

is little or no other probate property). Thus, costs and delays of probate are avoided when the property is owned in the Life Estate ownership form.

**3. *Simplicity of Clearing Title to Real Estate:*** In order to clear title to real estate owned in the Life Estate ownership form after the death of the Life Tenant(s), a death certificate for each Lifetime Owner must be recorded at the Registry of Deeds, together with a simple affidavit stating that the deceased Lifetime Owner did not have assets valued at more than the Estate tax limit (there is no Federal Estate tax for date of death in 2010, with Federal Estate tax beginning January 1, 2011 to be imposed on gross Estates valued at \$5.0 million dollars or more. In Massachusetts Estates valued at \$1.0 million dollars or more are subject to Estate tax, regardless of year of death). This is a simple and low cost method of clearing title that can be completed immediately after the death of the last Life Tenant Owner, or at any convenient time prior to a sale of the real estate. If the real estate had to pass through the probate process because it was not owned in the Life Estate ownership form then title generally would not be cleared until the probate process was completed (usually about 1 year after death).

**4. *Estate Taxes - No Consequence:*** If the deceased Life Tenant Owner(s) has assets with a value of more than the Estate tax value (there is no Federal Estate tax for date of death in 2010, with Federal Estate tax beginning January 1, 2011 to be imposed on Estates valued at \$5.0 million dollars or more. In Massachusetts Estates valued at \$1.0 million dollars or more are subject to Estate tax) at the time of their death, an Estate tax return would have to be filed and Estate taxes paid before title to the real estate would be clear. Whether or not the real estate is owned in Life Estate ownership form has no effect on whether or not Estate taxes must be filed.

**5. *Life Tenant's Right to Occupancy is Protected Regardless of Risks, Debts, or Actions of Remainder Owners:*** The Remainder Owner's problems cannot effect the Life Tenant's absolute and exclusive right to use and occupancy of the property during the Life Tenant's lifetime. The Remainder Owner(s) may experience certain

hardships (such as: financial difficulties - bankruptcy; marital problems - divorce, lawsuits - personal injuries or other types of lawsuits, etc.). However, these problems cannot affect the Life Tenant's rights to the property. However, if the parents (John and Mary Elder in our example) had gifted their real estate outright to their three (3) children, rather than retaining a Lifetime interest, then these same types of problems for John and Mary's children would place John and Mary at risk of losing their home. Thus, the Life Tenant form ownership protects John and Mary's home from their children's problems, unlike a gift of the home to the children, which would place John and Mary's home at risk.

**6. *Income Tax Advantage to Heirs upon Death of Life Tenant:*** Where real estate owned in Life Tenancy form is not sold until after the death of the Life Tenants, the heirs (Remainder Owners) get the full benefits of a stepped-up income tax basis for capital gains purposes. (***Note: the step-up in tax basis does not apply where date of death of life owner occurs in Year 2010, thus, this advantage does not apply to Year 2010 date of death***). Assuming the step-up in tax basis is applicable in the year of death and by way of example, if John and Mary Elder had purchased their home thirty (30) years ago for \$50,000.00 and put \$50,000.00 in improvements into the property over the years, then their tax basis is \$100,000.00. Assume they transfer the property from the two (2) of them to the Life Tenancy ownership form at some time prior to their deaths, and then at the time of their deaths the property is valued at \$400,000.00. The Remainder Owner(s) would have a tax basis of \$400,000.00 in the property. If the Remainder Owner(s) then sold the property after the death of the Life Owners for Fair Market Value (F.M.V.) of \$400,000.00, they would have no capital gains tax consequence. However, had John and Mary Elder gifted the same real estate to their children during John and Mary's lifetime (instead of transferring it to the Life Estate Ownership), in our example the children would then have a \$300,000.00 gain to report (with a capital gains tax (State and Federal combined) estimated at between \$60,000.00 to \$100,000.00, depending on tax rates in effect at the time of the sale of the property by the children.

**7. Medicaid Planning:** Under current law, a property owned in Life Estate form of ownership is, in most cases, protected from Medicaid claims once more than sixty (60) months passes after the date of transfer to the Life Estate ownership form. (By example, John and Mary Elder transfer their personal residence to a Life Estate by a Deed in October 2010, with their children named as Remainder Owners, John then requires long term care in an institution in November 2016 and applies for Medicaid. Assume John has no other assets besides the home (which he owns as a Life Tenant Owner), under current law he would qualify for Medicaid since it has been more than sixty (60) months since the transfer to the Life Estate form of ownership. Had the property remained in John and Mary's name with no transfer to the Life Estate ownership form, the full value of the real estate may be subject to Medicaid liens to pay for John's and/or Mary's care.)

### **Disadvantages:**

**1. Medicaid:** There is a sixty (60) month Medicaid disqualification period, commencing from the date of the transfer of the property to the Life Estate ownership. Therefore, if a Medicaid application appears to be imminent, the transfer to the Life Estate ownership form is not recommended. However, if you are in relatively good health and believe the Life Estate form of ownership otherwise makes sense for your Estate plan, the sooner you accomplish the transfer to the Life Estate form of ownership, the sooner that the five (5) year disqualification period will pass. Additionally, the Medicaid laws now allow an applicant to cure a disqualifying transfer. Therefore, if you found yourself in the unfortunate situation of having transferred the property to a Life Estate ownership form and then become ill soon afterwards and require long term care, the disqualification may be cured by transferring the real estate out of the Life Estate ownership form and back to yourself individually. However, be aware that all owners must agree to sign a new Deed to transfer the property back. (See No. 3 below). The transfer back to you from the Remainder Owner cures the disqualification problem.

### **2. Income Tax Consequence on Sale of Real**

**Estate during Lifetime of Life Tenant:** If the property were to be sold during the lifetime of the Life Tenant, the Life Tenant would not get the full income tax exemption available upon the sale of a personal residence that would otherwise have been available to them if they were the sole owners of the real estate at the sale date. One possible way to avoid the disallowance of the income tax exemption upon a sale of the personal residence, may be a short term rental of the property, rather than a sale during lifetime, if the Life Tenant no longer wishes to reside at the property for a short period of time. (However, in order to preserve the personal residency tax exemption, the Life Tenant would have to prove the property was his/her personal residence for 2 of the last 5 years). The rental income could be used to pay taxes, insurance, and maintenance of the property, and any excess income would be payable to the Life Tenant. If a sale were absolutely necessary during the lifetime of the Life Tenant, then the Life Tenant would get a personal tax exemption, but not the full value of their \$250,000.00 per person exemption for sale of a personal residence, however, the Remainder Owner(s) would get no exemption as a sale of a personal residence. Thus, any capital gains due would likely be due from the Remainder Owner's proportionate share of the sale proceeds. IRS tables determine the respective ownership interest in the property for purposes of calculating taxes depending on the age of the Life Tenant at the time that a property is held in the Life Estate form of ownership is sold. By example, if under IRS tables the Life Tenant is considered a fifty percent (50%) owner, then their fifty percent (50%) portion of the profit upon sale would be exempt from capital gains tax up to the \$250,000.00 limit, however, the Remainder Owner's fifty percent (50%) share of the profits would be subject to capital gains tax at applicable tax rates. In our earlier example of a \$300,000.00 profit, then \$150,000.00 attributable to the Remainder Owner(s) would be subject to capital gains tax. Assuming a twenty percent (20%) to thirty-three and one-third percent (33-1/3%) tax rate (State and Federal combined), the tax to the Remainder Owner's share would be between \$30,000.00 and \$50,000.00. While this is a substantial tax, it may be totally avoided (depending on year of death and applicable tax laws in effect at that time), if the prop-

erty is not sold during the Life Tenant's lifetime. Additionally, while \$30,000.00 to \$50,000.00 is a significant tax payment, keeping the property in the form of individual ownership rather than Life Tenancy would expose the full \$400,000.00 value of the property to Medicaid claims, so the risk of a possible tax payment (that may possibly be totally avoided) is generally considered to be worthwhile. In all likelihood, any risk of possible capital gain taxes would be outweighed by the potential Medicaid benefit in the event of catastrophic illness, and remember the tax may be totally avoided (depending on tax law in effect in year of death), if a sale of the property is postponed until after the death of the last to die of the Life Tenants. A short term rental of the property during the Life Tenant's lifetime usually makes more sense than a sale, since it is generally worth the effort to continue ownership of the property and rent it in view of the tax savings that may be achieved if a sale during Life Tenant's lifetime can be avoided. However, if you believe a sale of the property is very likely or imminent in the near or not so distant future, you probably should not consider a transfer of your real estate to a Life Estate as part of your Estate plan at this time.

**3. All Owners (Life Tenants and Remainder Owners) must Sign to Sell or Mortgage the Property:** All of the owners must agree to sign a Deed in order to sell the property or sign a Mortgage in order to Mortgage the property during Life Tenant's lifetime. So long as all owners agree to sign the Deed and/or a Mortgage, then a sale or mortgage can be accomplished without any problems. Sometimes a Life Tenant Owner views this as a disadvantage (due to their loss of sole control over the property) therefore, careful consideration should be made in choosing the Remainder Owner(s) so that the Life Tenant can be sure to rely on the Remainder Owner(s) to follow the wishes of the Life Tenant. In our John and Mary Elder example, if John and Mary were unsure they could rely on all three (3) of their children to agree to a possible future sale or mortgage against the

property, then John and Mary should consider this and name as Remainder Owner(s) only those individuals whom John and Mary believe would act in John and Mary's best interests.

**4. Irrevocable Transfer:** For all practical purposes, the decision to transfer the property to a Life Tenancy form of ownership should be considered irreversible. However, keep in mind if all owners (Life Tenants and Remainder Owners) agree, a change could be made, although it may not be recommended due to income tax consequences or Medicaid planning reasons.

In summary, a transfer to the Life Estate form of ownership has many advantages including protecting the Life Tenant's rights to use and occupancy of the property without concern about the effects of the Remainder Owner's debts and obligations, avoiding probate, possible income tax advantage upon a sale of the property after death of Life Tenant, and partial or full preservation of the value of the property for a Medicaid recipient, once five (5) years passes after the date of the transfer. The disadvantages are the five (5) year Medicaid disqualification period, income tax consequence in the event of sale of the property during lifetime, and the loss of sole control over decisions to sell and/or mortgage the property. Nevertheless, many individuals find the Life Estate Deed is a cost effective estate planning device that works for their particular personal situation and that the advantages outweigh the disadvantages.

Other options to protect the personal residence from Medicaid liens are extremely limited; certain Long-Term Care insurance policies prevent Medicaid liens, but premiums may be cost prohibitive. However, it is a good idea for all individuals to look into the purchase of Long-Term Care insurance to determine if it may be worthwhile for their situation. If eligible and affordable, Long-Term Care insurance is possibly the best Medicaid planning tool available under the current laws.

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