TRANSFER OF HOME TO CHILDREN – THE PROS AND CONS

By Lois G. Andrews, Esq. and James L. Young, Esq.

IMPORTANT NOTE: The purpose of this outline is to familiarize the reader with some of the various laws and considerations relating to transfers of property. However, since this is only a summary, since the laws change frequently and since each person's situation is different, planning should not be undertaken without the advice of counsel. The discussion in this article is applicable only to Connecticut. In compliance with regulations issued by the Internal Revenue Service, we inform you that any Federal tax advice contained in this communication, was not written to be used and may not be used by any person to avoid any penalties under the Internal Revenue Code.

Clients often ask their attorneys to transfer their homes to their children. Sometimes such a transfer is a good idea, but there are many issues surrounding such transfers that need to be carefully considered prior to making such a gift.

One reason some clients want to transfer their homes is to avoid probate. However, although gifting an asset during life can simplify the probate process if it is done as part of an overall plan, depending upon several factors the probate court fees may not change and the work required to settle your estate may not be significantly reduced. For the most part, the avoidance of probate is not a sufficient reason to gift a home.

Another common reason for wanting to make a transfer is to protect the home from the costs of long term care. Under Medicaid (Title XIX) rules, if you were to need assistance from the State for either home care or nursing home care, the transfer of your home (or of other assets) probably would result in a disqualification penalty if you were to need such assistance within 5 years from the date of the transfer.

The advantage to making a transfer is that it starts the clock running for that penalty, making it more likely that the house would be protected if you ever do need such assistance. However, there are many factors to consider before you will be in a position to know whether making such a transfer is a good idea for you, including risks you may not have in mind. Some of the issues you will want to consider are set out below.

1. Medicaid Issues

- Overview of Medicaid rules. If you need Medicaid assistance within 5 years from the transfer, you should assume the State will impose a penalty causing you to be ineligible for assistance. The penalty is calculated by dividing the amount of the gift by the average cost of nursing home care. For example, if your home is worth $250,000 and the average monthly cost of care is $10,000, a 25 month penalty would be imposed. The penalty would not start to run until you were otherwise eligible for benefits, which means that you would have no way of paying for your own care but nevertheless would not be eligible for help from the State for 25 months. Consequently, you could find yourself in the position of not being able to get the care that you need.

- There are several exceptions to the imposition of a penalty. The exceptions include the following situations:

  - Transfer to spouse;
  - Transfer to a child who has lived with you and provided sufficient care to keep you out of a nursing home for two years;
  - Transfer to a sibling who already has an ownership interest in your home and lives with you for at least a year prior to your institutionalization;
  - Transfer to a disabled child;
  - Transfer to a child under the age of 21;
  - Transfer made exclusively for purposes other than qualifying for Medicaid benefits;
  - Transfer intended to to be at fair market value
  - Transfer made for other valuable consideration. (Other valuable consideration is the provision of services or payment for services when the services rendered are of the type provided by a homemaker or a home health aide, and are essential to avoid your institutionalization for a period of at least two years, and are either provided by the transferee while sharing your home or are paid for by the transferee.

  Note that these exceptions are complicated and you should not assume that you will qualify for any of them without consulting with an attorney.

- <u>Warning! Possible Loss of Benefits</u>. Assuming you do not qualify for an exception to the transfer penalty, if a transfer is made less than 5 years prior to your need for State assistance, you probably will be able to get the care you need only if (1) your children transfer the home back to you, thereby eliminating the penalty, or (2) your children (or someone) pays for your care until the 5 year period has passed (if your children all agree and can be approved for a loan, this might be accomplished by them taking out a mortgage against the property and using the funds to pay for your care). Note that once a gift is made, unless you retain some legal interest in the home (perhaps by virtue of a life estate – see below) YOU NO LONGER HAVE ANY RIGHTS IN YOUR HOME AS YOU HAVE GIVEN IT AWAY. Also keep in mind that even if the children are willing to return the

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property, they may not be able to if they are experiencing financial or marital difficulties.

- Undue Hardship. It is possible that the State would grant assistance in spite of a transfer penalty based on a finding of undue hardship. However, undue hardship is very difficult to prove, and it may be very difficult to find a nursing home willing to take you as a patient if there has been a transfer.

- State Right to Sue. If the State does grant Medicaid in spite of imposing a penalty period because of a gift, the State has the right to sue those to whom you made a gift.

- Nursing Home Right to Sue. You should also be aware that effective October 1, 2013, a new law came into effect in Connecticut that allows nursing homes that provide services but are not paid for them, to sue persons who make or receive gifts which result in the imposition of a penalty period or denial of benefits, if the gift was made within two years of a Medicaid application. So if the giver of a gift needs benefits after making a gift, the one who receives the gift may find themselves being sued.

- Life Estate. It often makes sense to retain a life estate (also called a "life interest" or "life use") in the home when a transfer is made. The retention of a life estate would give you the legal right to the use of the property during your life, and also the obligation to pay real estate taxes and insurance and to maintain the property. Since a life estate includes the right to rent the property, if a life interest is retained and you were to need State assistance for medical issues, the State will have the right to require that the home be rented and the net proceeds be applied to your care, and it may apply pressure for the sale of the home.

- Power of Attorney. If you retain a life estate, someone should be given a power of attorney that would allow a mortgage to be taken out against the property in concert with your children, and to allow the property to be rented if you were no longer capable of managing your affairs. (It is important to have a power of attorney in place in any event.)

- Potential Collection against Life Estate. Under federal law, States can collect against non-probate assets (including life estates) for Medicaid benefits. So far Connecticut has not enacted legislation which would allow the State to enforce a lien against a life interest owned by a deceased recipient, but this could change.

2. Reverse Mortgage

- If a transfer is made (without retention of a life estate), the possibility of using a reverse mortgage to increase income is lost. A reverse mortgage is a loan which allows a person over 62 to borrow against the equity of his home and receive the borrowed funds as a lump sum or over a period of years or as a line of credit to be used as needed, thereby increasing the money available for living expenses. No payments are due on the mortgage until the owner dies or moves out of the home, although you may be required to make payments for taxes, and insurance, and for maintenance, and failing to do these things can put you in breach of the mortgage. Although reverse mortgages deplete the equity in the home rapidly and should not be used unless really needed, such mortgages can make the difference between being able to stay in the home and having to sell the home by providing funds to make repairs, pay taxes and/or provide a monthly income.

- If you retain a life estate, you still would be eligible for a reverse mortgage if you needed one. However, to get such a mortgage the children also would need to sign the mortgage, so you would not be able to get a reverse mortgage without the cooperation of the children.

3. Creditors

- Any interest transferred to a child is subject to that child's creditors. Some situations where a child's creditors could become a problem include:

    - If a child files for bankruptcy the property would be subjected to the jurisdiction and control of the bankruptcy court.

    - The property could be taken to satisfy debts of your children such as taxes, debts to the State for benefit programs received by the child, unexpected medical expenses of the child and debts incurred due to business difficulties or loss of employment, or simple overspending on the child's credit cards.

    - Personal Injury claims against a child could put the home at risk. If a grandchild is involved in an automobile accident while driving the child’s car, the claims could be huge.

    - Even if the child’s marriage appears stable, it could crumble later. The property you transferred to your child would be an asset of the marriage, subject to Court jurisdiction.

- If you retain a life estate the children's creditors could only attach to the children's “remainder” interest and you would still own the right to use the property during your life. However, such protection is not absolute and it is possible that the creditors could attempt to force a sale of the property to collect their claims.

- Power of Appointment. If you reserve the right to change the ultimate recipients of your house by retaining a “power of appointment” which you can exercise in your Will at your death, your children would not have a vested interest in the property during your lifetime and therefore, their creditors may not be able to collect against the property before your death. This right is known as a testamentary power of appointment. This is a sophisticated planning technique that should only be employed after consultation with experienced counsel.

4. Tax Issues

- Gift Tax. Both Connecticut and federal gift tax forms are required to be filed, but no tax will be payable unless total accumulated gifts exceed the “lifetime exemption” amounts, of $5,340,000 for federal purposes and $2,000,000 for Connecticut purposes (in 2014). Generally speaking, the making of the gift will reduce the amount of the lifetime exemption available at your death.

  If you retain a testamentary power of appointment, the gift is treated as incomplete for gift tax purposes when made and no gift tax returns will be required. However, if the house is sold during your life and the proceeds are distributed to your children, there would then be a completed gift and gift tax returns would be required. (Note that even though the gift would be incomplete for gift tax purposes, you would not have the right to take the house back once it has been deeded.)

- Capital Gains Tax. Loss of step-up in basis can result in large capital gains when children sell the asset.

  - On sale of property a capital gains tax is paid on the difference between the sales price and the "basis" of the property (usually the purchase price plus improvements). If property is transferred by gift, the recipient of the gift takes the same basis as the donor. On the other hand, if an asset is retained until death, the person who inherits the property gets a new basis equal to the value of the property as of the date of death (known as a “stepped-up basis”). Therefore, if the property is sold after death at the reported date-of-death value, no capital gains tax will be due. Consequently, for low basis property, if your estate is not likely to be subject to estate tax there may well be a substantial tax savings if property is included in the estate rather than passed by gift during life. In 2014, the amount that passes free of estate tax is $2,000,000 for Connecticut and $5,340,000 for federal purposes.

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Example: Home worth $260,000, with basis of $20,000 (*assuming a federal capital gains rate of 15% and a state rate of 5%*).

If gifted then sold:

Capital Gains tax (federal and CT)	$48,000
Total Tax	$48,000

If retained until death then sold:

Estate Tax	$ 0*
Capital Gains Tax	0
Total Tax	$ 0

**Assuming the total estate, including the total value of gifts made during life, is less than the federal and state estate tax exemptions.*

- The capital gains problem may be avoided if you retain a life estate and / or a testamentary power of appointment in the property since the retention of these rights should cause the property to be included in your estate for tax purposes. The inclusion in the taxable estate has the advantage of giving the property a new basis equal to the value of the property at the time of your death. Because of the new basis, if the children were to sell the property after your death, there probably will be less capital gains tax due than if the property had not been included in your taxable estate.

- Although retaining a life estate should avoid the capital gains problem if the house is sold after death, if the house is sold while you are still alive, capital gains taxes probably will be incurred since the $250,000 per person exemption for capital gains incurred on the sale of a primary residence would not be available to your children. Therefore, it usually is not a good idea to transfer your house if you anticipate selling the home prior to your death and your basis in the house is low.

- If you retain a testamentary power of appointment and then sell your house, the $250,000 per person exemption for capital gains may still be available to you. However, the law on this point is not clear.

- Another approach is to set up an irrevocable trust to own the home. (Please note, this is a very different trust than the more common revocable living trust. You cannot revoke, change or amend an irrevocable trust.) You could retain a life estate interest in the property when you give it to the trust, or rent the property from the trust. Either way you would not be a beneficiary of the trust. You will have gifted away your home, and you will no longer own it. You could however retain sufficient powers in the trust to be treated as the owner of the property for income tax purposes and to allow the trust property to be included in your estate for tax purposes at your death. That way if the home is sold prior to your death you could utilize your $250,000/person federal exclusion from capital gains and if the home is not sold prior to your death the property should receive a stepped-up basis at death so your children would pay less (or no) capital gains tax when the property is sold after your death. Such a trust has the additional advantages of providing a mechanism to manage the property (which is especially important if you have several children) and providing better protection from your children's creditors. However, utilizing an irrevocable trust is a sophisticated planning technique and is not suitable for many situations. Establishing an irrevocable trust is a complex affair, and you should make sure you understand the trust document thoroughly before taking such a step.

- <u>Real Estate Tax</u>.

  - A transfer (without retention of a life estate) can result in the loss of eligibility for real estate tax freezes, tax reduction and tax deferment benefits that may otherwise be available to veterans or senior citizens with limited incomes.

  - If you retain a life estate, such tax breaks may be retained. You should review these issues with the tax assessor in your town.

5. <u>Heirs</u>

- If a child predeceases you, his assets will pass to his heirs. Consequently, the gifted assets could end up in the control of your daughter-in-law or son-in-law or a grandchild with whom you do not have a close relationship. It is not unheard of for the child's surviving spouse to try to evict the parent from the home.

- Some protection from this situation is obtained by retaining a life estate. However, a child's heirs may be less cooperative in obtaining an equity loan or a reverse mortgage or returning the property to you to avoid a transfer penalty.

- Some protection may also be obtained by reserving a testamentary power of appointment.

6. Change in Circumstances

- If you retain a life estate in the home, and decide that the home should be sold to allow you to move to an assisted living facility or to purchase a different home

  - Capital gains tax may be payable

  - The children will be entitled to a large portion of the proceeds of sale or all of the proceeds if you have not retained a life estate

  - The children must agree to the sale

7. Psychological Issues

- Loss of control over assets can lead to feelings of dependency and insecurity since you do not know how your children will respond to your needs and desires.

- Money and self-interest can change a child's outlook. Even if the child remains trustworthy, if the child dies before you, the child's heirs may have different attitudes.

8. Miscellaneous Issues

- **Will this violate my mortgage, and allow my lender to call my mortgage due?**

  Answer: It might. Your mortgage may say that when you transfer title to the property your mortgage must be paid. (This is called a "due on sale" clause.) The Garn – St. Germain Act of 1982 allows lenders to enforce "due on sale" clauses but identifies a limited number of situations where such clauses cannot be enforced. The lender may not be able to call the loan if you are conveying title to your spouse or your children. Other exceptions may exist where you die and pass a house on to one of your heirs. If you have a mortgage on your home it is important that you provide it to us so that we can review it as to this issue. After we review the mortgage, we may ask you to contact your lender / mortgage holder and tell them what you intend to do, and ask them to give you some written assurances that making the transfer will not result in a calling of your mortgage loan, or raising the interest rate, or any other negative action.

- **Will my title insurance policy continue to provide insurance protection after I transfer title to the trustees of my trust?**

  Answer. To give the classic lawyer answer "it depends". If you have a title insurance policy, you should give it to us to review to see if any automatic coverage provisions are in the policy and will apply to your specific situation. (If you cannot find a copy of the policy, then provide a copy of the closing statement from when you bought the property, if possible.) If it is not clear that coverage will continue to exist after the transfer contemplated, then we recommend that the title insurance company be contacted, and asked if it will issue an endorsement to the policy to extend the coverage of the policy after title is transferred. The title insurance company may charge for this endorsement, and how much varies company by company, and exactly what needs to be done. It is possible a copy of any endorsement to the title policy may also be issued to the lender who holds a mortgage on your home.

- **Do I need to inform my hazard and fire insurance company?**

  Answer: Yes. You should inform your insurance company of what you are proposing to do, and make arrangements to obtain an endorsement to the policy to continue the coverage in favor of your children, yourself and your children, the trustees of your trust or yourself and the trustees, depending on the type of transfer that is to be made. In most situations there will not be a change in the premium amount, but you need to review this with your insurance company to prevent surprises later on. Also make sure to let your insurance company know if you are transferring only the real estate and house or also transferring your personal property. Make sure that insurance will continue for the personal property whether you are transferring it or not. PLEASE NOTE, that we understand the insurance company will send a copy of the endorsement showing the changes to your lender (since it is also an insured under most hazard insurance policies), so there is reason to think your lender will learn about the transfer in title through this notice. We also understand that some insurance companies respond to these requests quickly and expeditiously, whereas others do not. We suggest you find out how your insurance company will respond to such a request early on in the investigation of determining whether a transfer of your home is right for you or not.

- **By transferring the property am I putting at risk certain tax advantages I may have by virtue of the property having been designated as open space, or farmland (or other similar programs), or under other programs where tax benefits are obtained because I am elderly or a veteran?**

  Answer: You may be, depending on the nature of the transfer you are making. You need to tell us what you know about these things, and give us any paperwork you have that pertain to them. A title rundown of the property should be performed which will be an out of pocket expense incurred which we will pass on to you in addition to the legal fees which are due to us for our work. We will ask the title searcher to make inquiry of the town as to any tax benefits that are attached to the property. But we cannot guaranty that the title rundown will reveal all of these possible designations, so it is important that you tell us what you know about these types of programs and designations that the property may be under.

Conclusion:

The transfer of a home to children can be a useful planning technique. However, there are many reasons not to make such a transfer. It is important that you consider the implications before signing the deed.

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