

## TRANSFER OF HOME TO CHILDREN – THE PROS AND CONS

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***IMPORTANT NOTE: The purpose of this outline is to familiarize the reader with the various laws 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 making a transfer, including risks you may not have in mind.

### **1. Medicaid Issues**

- If you need Medicaid assistance within 5 years from the transfer, the State probably 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 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.

- Assuming you do not qualify for an exception to the transfer penalty, if a transfer is made less than 5 years prior to the 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 pay the nursing home until the 5 year period has passed (this might be accomplished by taking out a mortgage against the property). Note that once a gift is made you may encounter serious legal obstacles if you try to force the children to pay for your care or to gift the assets back, and even if the children are willing to return the property, they may not be able to if they are experiencing financial or marital difficulties.
- It also 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 difficult to prove, and it may be difficult to find a nursing home willing to take you as a patient if there has been a transfer. In addition, if the State does grant Medicaid in spite of the penalty period, the State could sue the children for return of the gifted assets.

- 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 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 probably would insist that the home be rented and the net proceeds be applied to your care, and may apply pressure for the sale of the home.
- If you retain a life estate, someone should be given a power of attorney that would allow a mortgage to be taken out against your retained life interest and would allow the property to be rented if you were no longer capable of managing your affairs.
- Under federal law, the State can collect against non-probate assets 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 annuity mortgage to increase income is lost. A reverse annuity mortgage is a loan which allows an elderly person to borrow against the equity of his home and receive the borrowed funds over a period of years or for life 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 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 the child could put the parent's house 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 some creditor protection is achieved since the children's creditors could only attach to the children's 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 force a sale of the property to collect their claims.

### 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 \$1,000,000 for federal purposes and \$2,000,000 for Connecticut purposes (in 2009).
- 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 2009, the amount that passes free of estate tax is \$2,000,000 for Connecticut and \$3,500,000 for federal purposes. The amount passing free of Connecticut estate tax will increase to \$3,500,000 in 2010.

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)	<u>\$48,000</u>
Total Tax	\$48,000

If retained until death then sold:

Estate Tax	\$ 0*
Capital Gains Tax	<u>0</u>
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 can be avoided if you retain a life estate in the property since the retention of the life estate causes the property to be included in your estate for tax purposes. Although the inclusion of the property for estate tax purposes would not result in estate tax if your estate is not large enough to trigger estate taxes, such inclusion would increase the probate court fee. Nevertheless, it generally is an advantage to have the property included in your taxable estate since the probate court fees are relatively small (approximately 1/3 of 1%), whereas 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 should 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.

- Real Estate Tax.
  - A transfer (without retention of a life estate) can result in the loss of eligibility for real estate tax freezes, tax reduction and tax deferral 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.

## 5. Heirs

- 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 void a transfer penalty.

## 6. Change in Circumstances

- If you 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 will be payable
  - The children will be entitled to a large portion of the proceeds of sale
  - 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. Title Issues**

- If you decide to make a transfer, it is important to have the title to the property checked to make sure that the title is held the way you think it is and that all of the property is included in the description in the deed.
- A transfer can also affect benefits you may have under a title insurance policy. Since your policy will only cover your interests and not your children's interests, the title policy may no longer provide protection.
- If you have given a mortgage to a lender on the property, the mortgage probably includes language allowing the lender to require that the balance be paid immediately if the property is transferred.

### **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.