Planning Ahead to Protect the Home – Part I

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As an elder law attorney, I often work with retired clients who come in to have basic estate planning documents prepared – Wills, financial powers of attorney, healthcare powers of attorney, and advance medical directives. But such clients often have questions about what options are available to them to protect their life savings in the event one (or both) later needed long-term nursing care.

This concern is understandable, since for most middle-income seniors, the risk of needing long-term nursing care is overwhelmingly the greatest financial risk they face. With the statewide average cost of a nursing home in Pennsylvania currently over $107,000 a year (and with at least three nursing homes in Erie costing over $120,000 a year), such seniors could go through a significant part of their lifetime of savings (if married) or all of their lifetime of savings (if single) in just a few years – not because they did anything wrong, but simply because they had the misfortune to develop a long-term illness.

If my clients are in their 60s or 70s and in reasonably good health, with no foreseeable need for long-term nursing care, I rarely recommend that they begin asset protection planning because this typically requires them to start divesting themselves of their assets. My advice to such clients is to enjoy their retirement savings while they still have their health.

Nevertheless, I almost always discuss with them one asset-protection strategy that even younger, healthy retirees may want to consider – transferring their house to an irrevocable trust while retaining a life estate for themselves.

Why do this at all?

➢ <u>Protects the house</u>. The reason for doing this *at all* is to protect the house from the risk of later having to be sold and the proceeds used to pay for the cost of long-term nursing care. With a married couple the house would not be at risk as long as one spouse was still living at home – in the Medicaid jargon, if there was a "community spouse." But if one spouse died and the other needed long-term nursing care, or if both spouses needed such care, then the house would be at risk of being sold either during the client's lifetime to pay the nursing home or after death to pay the "estate recovery" claim of the Department of Public Welfare.

In order to protect the home from this risk, the client needs to transfer a sufficient interest in the property to someone else or to an irrevocable trust. However, even in these situations I rarely have my clients transfer the *entire house* outright. Once the home is owned entirely by one or more children, it is subject to various unavoidable risks, such as attachment by the child's creditors, the claims of a divorcing spouse (a potentially very aggressive form of creditor), bankruptcy, drug and alcohol problems, the child's death.

Protecting the security of my clients – especially their security in having a place to live – is very important, and that is why I rarely have my clients transfer their home entirely to a child or children.

Why do it this way? Having the parent transfer only a remainder interest while retaining a "life estate" in the house has a number of advantages over transferring the entire house.

- Avoids "Estate Recovery." First of all, while someone in a nursing home can own a home and still qualify for Medicaid, when that person dies the house will be in his or her "probate" estate and therefore subject to a claim by the Department of Public Welfare for all the Medicaid benefits he or she received. But if the parent had transferred the house and retained a "life estate," at the parent's death the life estate ends automatically and the house passes directly to the child or children (those owning the "remainder interest") without the need for a new deed and without going into the parent's estate. As a result, under current Pennsylvania law this protects the house from a Medicaid estate recovery claim.

- Protects the Client's Home. Second, by keeping a life estate the parent remains the owner of the home with the security of always having a place to live, without the risk of losing the home because of anything that might happen to the children: e.g., Debt, Divorce, Drugs, Disability, or Death.[1]

- Does Not Affect the Client's Standard of Living. Third, as noted above, in order for my clients to protect their financial assets from the risk of having to be spent down on their nursing-home care, they generally need to transfer them out of their name and control. But doing so generally means a reduction in their standard of living because with less money they have fewer options. However, transferring a "remainder interest" in their house has no effect on their standard of living – they continue to possess and enjoy their house just as they did before. They continue to pay the taxes, insurance and maintenance on the house, but for all practical purposes nothing has changed other than the names on their deed at the courthouse; their quality of life has not been affected.

- Creates Shorter Ineligibility Period. Fourth, while the transfer of a remainder interest is still a "gift" for Medicaid purposes that will result in a period of ineligibility if an application for long-term care Medicaid is filed in the following five years, since the period of ineligibility is based on the amount transferred, it will be a shorter period than if the entire home were transferred outright. By retaining a life estate, the parent has retained part of the value of the home, and only the portion remaining (the "remainder interest") is treated as the gift. (The value of the life estate is based on the parent's age at the time of the transfer. For example, at age 76, the life estate interest is worth about half the value of the house; at age 86, about a third; at age 93, only about a fourth.) Because every

[1] I am assuming in this discussion that they have decent, trustworthy children, but if not retaining a "life estate" would also protect my clients from the risk of their children kicking them out, selling the house and running off with the money – i.e., "Departure."

month of ineligibility for Medicaid represents a potential payment of one month of nursing home care ($6,500 to $10,000), reducing the ineligibility period represents a significant potential savings.

- Potential Tax Savings. Finally, although transferring the house while retaining a life estate will not avoid Pennsylvania Inheritance Tax at the parent's death, in many cases the children will have *less* tax to pay overall than if they had received the entire house outright and so avoided Pennsylvania Inheritance Tax. This seems at first counter-intuitive, so let me explain.

Many parents own houses that were purchased (or inherited) decades ago, when house values were much lower than they are now. As a result, the parents often have a "cost basis" in their house much lower than its current fair market value. It's true that if the parent transferred the house outright to one or more children, without retaining a life estate, then as long as the parent lived at least a year after making the gift that would eliminate Pennsylvania inheritance tax on the house. However, the children would take the house with their parent's low cost basis; this means they would likely have a lot of capital gains tax to pay when the house was sold. In many cases the children would end up paying more tax overall than if the parent had retained a "life estate."

For example, suppose the parent owns a house worth $100,000 that she purchased in 1963 for $15,000. If the parent transfers her entire house to her children, they take her "cost basis" in the house of $15,000. If the parent lives at least a year after making this transfer, at her death there would be no Pennsylvania inheritance to pay. But if the children then sold the house for $100,000 they would owe capital gains tax of at least 15% on $85,000, and so would end up paying income tax of *$12,750* or more. On the other hand, if the parent had retained a life estate when she transferred her house to her children, at her death there would be a 4.5% Pennsylvania inheritance tax due on the entire house value, or *$4,500*. But by paying that tax the children would get a "step-up" in cost basis in the house to $100,000, which means if they later sold it for $100,000, they would have no capital gains tax to pay. So the children in this case, by paying $4,500 avoided having to pay $12,750, meaning an overall tax savings of $8,250.

This article explains why transferring an interest in one's home can protect it from the risk of having to be sold to pay for long-term nursing care as well as the advantages of retaining a life estate over making a complete gift of the home. Next month's article will explain the advantages of doing this *sooner rather than later*.

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The content herein is for general informational purposes only and does not constitute legal advice. For specific questions you should consult a qualified elder law attorney.

Note*:* Working with the long-term care system we have in this country, seniors and their families need to understand that despite the restrictions in the Medicaid law, it is almost never too late to protect part or your remaining assets, even when facing an immediate crisis and with no advance planning. Whether you are 75 years old and living in your own
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home, or have an 85-year-old spouse in a nursing home, there are steps you can be taking now to preserve part – and often a very significant part – of your life savings otherwise at risk of being spent on your nursing care. But it is more true than ever that "time works against you." *Every day of delay in a crisis can result in $275 or more of irretrievable loss,* so it is important to contact a knowledgeable and experienced elder law attorney for advice sooner rather than later.

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