A Closer Look at Life Estates, Long Term Care Planning & Reverse Mortgages

By:

Leo J. Cushing, Esq., CPA, LLM
Cushing & Dolan, P.C.
Attorneys at Law
24 School Street, Suite 300
Boston, MA 02108
(617) 523-1555
lcushing@cushingdolan.com
www.cushingdolan.com

August 2007

WILMINGTON
187 Ballardvale Street
Suite A180
Wilmington MA 01887
T: 978-988-1222
F: 978-988-1223

WESTBOROUGH
276 Turnpike Road
Suite 228
Westboro MA 01581
T: 508-870-1666
F: 508-870-1818

NORWOOD
520 Providence Hwy.
Route 1 - Suite #10
Norwood MA 02062
T: 781-278-9901
F: 781-278-9911

CHESTNUT HILL
1330 Boylston Street
Chestnut Hill, MA 02467
T: 617-264-7999
F: 617-264-4445

I. The Threat of Long Term Care

- 43% of persons age 65 and over will spend some time in a nursing home.

- The average stay in a nursing home is 408 days with 31% being less than one month and 11% extending beyond three years.

- Nursing homes cost as much as $100,000 per year in Massachusetts. (The average is $89,790 per year)

II. When to Consider a Life Estate

- The home is a non-countable asset if the equity in the home is less than $750,000. (Deficit Reduction Act of 2005, enacted February 8, 2006, “Act”).

- Prior to February 8, 2006, there was no limit on the amount of home equity and the Act provides that a “reverse mortgage can be used to reduce the individual’s equity in the home.”

- If countable assets are less than $2,000 (in the case of an individual) or $101,640 (in the case of a married couple), the MassHealth applicant will be eligible for Medicaid.

- The state will be paid back out of the estate unless the applicant had long term care insurance in an amount of $125 per day for at least two year’s beginning on the date of admission to a nursing home.

- This can be avoided by transferring the home to the children (or to an irrevocable trust for the benefit of the children) and the parent keeping a life estate.

- If the home is sold before death, the state must be paid back and the balance of the sale proceeds will remove the nursing home resident from Medicaid.

III. What is a Life Estate?

- A life estate is a type of home ownership
- The life estate owner (“life tenant”) has the absolute right to use, occupy and enjoy the property until death. (You can’t be thrown out and the property can’t be sold without your consent.)
- The life tenant must pay all the bills associated with home ownership (property taxes, insurance, utilities and the like) and gets all income tax deductions.
- The children are known as “remaindermen.”
- In reality, the transfer is a gift that is not really completed until the death of the life tenant.
- The children do not have any responsibility or liability for home ownership.
- Consider giving the property to a Medicaid trust for the benefit of the children to protect the property from the children’s spouses and creditors.

IV. Medicaid Benefits

- The value of the transfer is based upon the value of the remainder interest and thus reduces the penalty.

- There is now a five-year look-back period.

- The penalty is determined by dividing the value of the transfer by the average cost of nursing home care, currently $256 per day or $7,680 per month.

Example:

- Consider the case of an individual whose home has an assessed value of \$303,500. At age 75, the life interest portion using Table 90 CM is .60449 of \$303,500 (or \$183,462.71).

- The remainder interest is \$120,038. The penalty is only 15.6 months. (\$120,038 ÷ 7,680) rather than 39.5 months (\$303,500 ÷ 7,680)

- This life estate also avoids estate recovery and will provide the heirs with a “step-up in basis” upon death so that a post sale death will not give rise to any capital gain tax to the heirs, provided the sale price is equal to the fair market value on the date of death and the property is sold shortly after the date of death.

- As the individual ages, the value of the life estate decreases. For example, at age 87, the life estate portion is worth .25638 of the fair market value. Assuming the assessed value of the property has increased to \$850,000, the life estate would only be worth \$217,923, much less than the maximum allowed of \$750,000.

V. Why Consider a Reverse Mortgage?

- Reverse mortgages are becoming more popular than ever and for good reason. A reverse mortgage allows an elder to convert the equity in his or her home to an income stream by eliminating the wide spread problem of being house rich and cash poor without selling the home. While reverse mortgage programs vary, the fundamental objective is usually the same and that is to provide the elder with cash flow to maintain a dignified quality of life and to eliminate payments on mortgage debt.

- Consider the case of an elder with a small $100,000 balance on a mortgage with equity in the home and the home is worth $330,000 and an assessed value of $305,500. Assume no basis or cost for simplicity.

- The current mortgage payments are almost $1,000/month since the mortgage payments were based upon the original loan at the time the loan was transacted. As a result, virtually all of the elder’s social security and pension is being used to pay the mortgage leaving little money for quality of life events and financial independence.

VI. Using a Life Estate Will Not Disqualify an Individual from Obtaining a Reverse Mortgage

- FHA allows the property to be held in a life estate in lieu of a fee simple, under certain conditions. In fact, the guidelines issued the largest provider of reverse mortgages State:

  "A life estate is an interest in real property allowing the owner of the life estate to use and enjoy the property during his or her lifetime. On the death of the owner of the life estate, his or her rights in the property cease, leaving fee simple title to the property and the holders of the interest of the property. HUD permits mortgages to be insured if the borrower's interest in the property is a life estate. However, to encumber fee simple interest in the property, the borrower and all holders of any future interest in the property, must execute the mortgage at closing. Holders of future interests do not execute the note or loan agreement."

- The guidelines state that a reverse mortgage would not be permitted if the remainder interest is held by an income only irrevocable trust, but this problem can be solved simply by having the trustees of the trust make a distribution of the remainder interest to individual beneficiaries.

- A distribution of the property from the trust will represent a completed gift of the remainder interest valued at the time of the transfer (since the income only irrevocable trust usually is considered an “incomplete gift” for gift tax purposes). Unless the value of the remainder exceeded $1,000,000, there will be no gift tax consequences.

- The property can be sold during life. If the property is sold during life, a portion of the proceeds must be paid to the holder of the life interest for the value of his or her property interest. The amount is to be determined based upon the relative values of the life interest versus the remainder interest using Table 90 CM.

Example:

At age 86, Borrower is admitted to a nursing home. The reverse mortgage note provides that the loan is due if the Borrower ceases to use the property as their principal residence. (Some notes are ambiguous. Others provide failure to physically occupy the home for 12 consecutive months because of physical or mental illness.) Instead of bringing Borrower home for a night, assume the property is sold for $850,000 when the Borrower is age 87 and the balance on the note is $200,000.

VII. Computation Allocation of Sale Proceeds if Property is Held in a Life Estate.

Sale Price	$850,000	
Broker's Commission (5%)	$ 42,500	
Net Sales Price	$807,500	(after sales commission and expenses)
Life Estate Rate	.25638	(from 90 CM Table)
Borrower Proceeds	$207,026	(life tenant)
Children's Proceeds	$600,474	taxable at 15% long-term capital gain rate

VIII. Determination of amount "at risk" for nursing home with Reverse Mortgage

Borrowers proceeds	$207,026	
Loan Repayment	$200,000	(Borrower's portion)
Amount at risk	$ 7,026	

IX. Determination of amount "at risk" for nursing home if no life estate was used at the time of the closing.

Borrowers proceeds	$807,500
Loan Repayment	$200,000
Amount at risk	$607,500

To protect some of this:

- Consider the reverse half-a-loaf (if it works at all) will save $272,500 if the nursing home costs $9,000/month net of Borrower's social security and transfer $607,500.
  - Tentative penalty is 79 months (607,500 divided by $7,680)
  - Give back (cure) $335,000 – new penalty is 35 months (607,500 – 335,000 = 272,500 divided by 7,680)
  - The money returned will be paid to the nursing home to cover the penalty period (335,000 divided by 9,000/month = 37 months)

- The failure to use a life estate costs the family $327,974.

  $600,474
  $<u>272,500</u>
  $327,974

- Life estates cannot be done after the Reverse Mortgage since there is a due-on-sale clause.

X. Tax Considerations:

If property is sold during life that is subject to a life estate, the portion payable to the life tenant is eligible for the $250,000 income tax capital gain exclusion, while the remaining portion would not be eligible so that the remainderman would need to pay capital gain taxes on their share.

Introduction to
Cushing & Dolan, P.C.
Real Estate Settlement Services

- Established in 1984, by Leo J. Cushing, Esq., CPA, LLM, in Boston as a tax and business law firm.

- Expanded into residential real estate conveyancing in 1987 with the addition of Kevin N. Dolan, Esq.

- Cushing & Dolan offers five convenient locations in Massachusetts:

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    Fidelity National Title
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- Largest Massachusetts agent for First American in 2005.

- Preferred title insurance agent status with major title insurers.

- 24 hour turn-around on all refinancing (titles conducted by in-house staff)
  - 5 day turn-around for purchases
  - Closings will be conducted “almost” anywhere and “almost” at any time
  - Free draft of Homestead – customer pays recording fee
  - 10% off Owner’s Title Insurance for first time homebuyer’s
- Advanced technology:
  - Doc Star Scanning System.
  - All closing documents scanned and stored electronically moving toward paperless office.
- Signed closing documents can be delivered electronically or on disk in addition to paper file
- Lawyer to Lawyer <u>Purchase</u> Program (“LTL”) with Owner’s Title Insurance
- Your lawyer will be paid the legal fee for conducting the closing.

- We takes care of all the back-room work, including title examination, obtaining payoffs, preparation of HUD-1, scheduling, copying, funding, transmittal and issuance of title insurance

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  – Special relationship with title insurers

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Educational seminars for real estate brokers – What Every Real Estate Professional Needs to Know About Probate, Estate & Gift Taxes, Income Taxes and Capital Gains

- Is a License to Sell required if the owner is deceased?
- What are the rules relating to obtaining a license to sell?
- Is there an estate tax lien against property owned by a decedent?
- How is the estate tax lien released?
- Is there a federal estate tax lien?
- What are the Massachusetts and federal estate tax filing thresholds?
- When are estate tax returns due?
- How is gain determined by the seller in the case of inherited property?
- Does property have to be inherited in order to obtain a step-up in basis?
- How do you determine the basis of property inherited by a surviving spouse rather than children?
- Time limits on rental of vacation property.
- If the taxpayer’s home is sold does the taxpayer have to reinvest the proceeds?
- What is a life estate?
- Can property held in a life estate be sold?
- Does the life tenant have to pay a capital gain tax on his portion?
- How do you determine basis? How are life estates created?
- Is the property subject to a Medicaid lien or estate recovery?

- What are the tax rates for married couples and single individuals for 2006?
- What about the tax on dividends?
- How do you compute depreciation and depreciation recapture?
- How do you compute tax on depreciation recapture
- Do like kind exchange rules save on taxes?

Medicaid Update:

- Massachusetts Exemption is Really $2,000,000 and is not $1,000,000
- Current Medicaid Numbers
- New Massachusetts Uniform Principal and Income Act
- The Tortured History of the Deficit Reduction Act

Summary of the Act Provisions

- Lookback Period is extended to 5 years from 3 for all transfers!
- Beginning Date of penalty is date of nursing home admission.
- Annuities.
- Notification Requirements.
- Hardship Waivers.
- Income First Rule Required.
- Disqualification for Assistance for Individuals with Substantial Home Equity.
- Requirement to Impose Partial Months of Ineligibility.
- Inclusion of Transfers of Certain Notes and Loans.
- Inclusion of Transfers to Purchase Life Estates.
- Default effective date.
- Comparison of Private Pay, Medicaid & Medicare Payments.
- Take a second, third and fourth look at long term care insurance!
- A Closer Look at Life Estates – Long Term Care Planning and Reverse Mortgages
- When does a reverse mortgage reduce the equity?
- Value of a Life Estate
- Using a Life Estate Will Not Disqualify an Individual From Obtaining a Reverse Mortgage
- Purchase a life estate in another’s home