KOWALCZYK, TOLLES, DEERY & HILTON, LLP

ESTATE PLANNING QUARTERLY

TO TRANSFER OR NOT TO TRANSFER: ADVICE FOR CONSIDERING TRANSFERRING CLIENTS' HOMES TO CHILDREN

As Advisors, almost every one of us has at one time or another, given advice to a client to transfer their home to their children. Traditionally, this was a great method to preserve and protect the home in the event the parents required long-term nursing home care. I still encounter these transactions in my practice. What was once a good idea, however, has been convert ed into something approaching malpractice.

In 2006, the Medicaid Law was changed, and that change seriously altered how the penalty on a transfer was assessed. In the good old days, when someone transferred their home to their kids, the penalty on that transfer would begin immediately. If luck held, when the parents went into the nursing home, the home would be protected. The problem now is that the penalty does not begin until the parents are actually in the nursing home and apply for Medicaid.

Moreover, the lookback is now five years, making it even more difficult to plan ahead. If the transfer occurred less than five years before the parent applies for Medicaid, the result could be a penalty that exceeds the five years.

When a married couple is involved, and one spouse goes into the nursing home, the home is still exempt. So if the parties transferred their home to their children three years prior to one of the parents entering the nursing home, the result is the children have to transfer the house back to the parents to exempt it. That assumes that the children can and will do so.

Let's get to the real good stuff. What if one of those children dies, gets divorced, files bankruptcy gets sued for a debt or kills someone in a car accident? The result, the home you wanted to protect by transferring it, is again at risk. The possibilities for trouble with children are great, and the more children the client has, the more the trouble.

We cannot forget the ever-present tax issue. When the parties transfer a home to their children and the home is sold while the parent is still alive, there is a capital gain to the children on that portion not attributable to the parents' life estate. That capital gain can often exceed the cost of proper planning in the first place. For example, if a couple were to buy a home in the 1950s for $20,000 and transferred it to their children in 2009, and that sold it 2010 for $125,000, assuming no improvements in the property, there would be a $105,000 gain on the property. The IRS (assuming parents are 80 years old) would allocate approximately 80% to the residuary beneficiaries and 20% to the parent. Where the parent would receive a homestead exemption on the sale, the children do not. Therefore, in this example, the transfer to the children and the ultimate sale would result in approximately $12,000 of capital gains tax (15% tax rate). This cost far exceeds the cost of doing a trust in the first place.

The Solution: When planning to protect a home for parents, the proper solution, at least under the conventional rules of Medicaid, would be to use an irrevocable trust. With the use of an irrevocable trust, you avoid the complicated issues of children dying, filing bankruptcy, divorcing or being sued. Furthermore, because the Medicaid trust is a grantor trust, any sale would result in the use of a homestead exemption by the parent and would eliminate capital gains. They would also be able to maintain the all-important STAR Exemption.

Normally, the cost of a trust, anywhere from $2,500 to $5,000, would be offset by the control the parent would retain, as well as elimination of potential problems and the capital gain tax. If the house needed to be given back to the parents, the parents would have enough control to get it back without worrying about the children refusing to do so.

So, a warning to all who continue to advise clients to transfer homes to children, be aware of the potential risks, as there are many, and the upsides are few. Consider saving your clients a great deal of pain by using a trust rather than a direct transfer.

USING TRUSTS FOR SMALL BUSINESS SUCCESSION PLANNING

Many of our clients have one great asset, their small business. It is the source of both their income and their retirement. The hope for many is to find a way to either pass it to the children or sell it and retire. What can get in the way of both of these happy events is the untimely death of the owner.

The business is often only valuable while that person is alive and well and running it. Without the owner, the business might be in chaos. In order to avoid ensuing chaos, the owner needs to have something in place to minimize the problems. Most estate plans, particularly will-based plans, fail to fully account for the small business owner.

A trust is used in cases where a small business owner is concerned about a crisis. In order to effectuate proper control of a business, a trust may establish a "Business Management Trust" upon disability or death of the Grantor. This trust will have both separate Trustees and separate guidelines to operate the business. It may include parameters and directions to operate or even sell the business by persons who have that specific knowledge and understanding of how that business or finances work. It will also allow the remainder of the trust assets to be managed by a family member separately.

The advantage of the Business Management Trust should be obvious, to keep the business operating so it can be profitable, or so it can be sold.

Along with the use of good estate planning is the need for good disability, business interruption, key man and cross-purchase insurance. These various insurances can keep a business operating and saleable in a time of crisis.

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We have been very busy thanks to all of you. Please let me know if I can help you with your personal estate planning needs.

UPCOMING TOPICS:

- Planning for the Disabled.
- Life Insurance and Medicaid Planning.