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How To Fix An Expensive Estate Planning Mistake

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In last week's article, we went over the wealth transfer from generation-to-generation and how proper estate planning can be crucial. That is why the generation of people with ages in the range of 70 to 90 is prime for taking advantage of proper estate planning techniques. Many of them were the first in their families to attend college and obtain advanced degrees. They worked hard and many did not have designs on retiring in their fifties or sixties when they were much younger. The other thing they prominently did was stay put. This generation usually stayed in one job with one employer. They bought a home, raised a family and then retired while still in that same home. They bought those homes when the average price across the nation was around $10,000. Today, those same homes would sell for $250,000 and a whole lot more depending on the location. Because of the long term capital gains in these types of homes, we will show why putting a beneficiary on the deed of your family home isn't an efficient estate planning strategy, and other proper techniques that can be used for an efficient primary home transfer.

A lot of people in this same generation are wisely looking pass their assets on to their heirs, usually their adult children and grandchildren. They have named them as beneficiaries on their trusts, investment and retirement accounts, life insurance and a few other things that we would typically call an asset. What about the home? That's right, they call it a home, not a house. It's where they raised us and where we played with our friends. It sounds kind of cold to call it an asset doesn't it? But when that home is transferred from one generation to the next before the homeowner passes away, a capital asset is exactly what the IRS will call it.

Given that the fair market value for nearly any home held by the same owners for four or five decades would easily have risen on the order of a couple hundred thousand, you would be talking about a substantial tax bill. This represents a considerable cost to what might otherwise be considered a somewhat modest estate. There is certainly more than one way to pass a residential home to heirs without tripping this expensive capital gain tax bill. Given that, why do so many people gift their homes or a partial interest in their homes to heirs before their passing? In many instances it is because they put the probate court cart before the estate planning horse.

An awful lot of people fear probate court like the grim reaper. They don't want prying eyes to have a look at what their estate holds, or they are of the belief that probate court costs will deduct many thousands of dollars (or more) from their assets before they reach the heirs. Neither of these premises hold much validity. As for the prying eyes, nobody really cares what's in anyone else's estate. And those exorbitant probate costs....they generally only run about three to five percent in most states and only apply to those assets that are probated. All of the assets that go to a named beneficiary generally do not pass through probate court.

Another reason that some elderly people look to remove, or gift, most of their assets from their estate during their lifetime is in order to become Medicaid-eligible. This is, generally, a poor financial planning approach. There are a myriad of rules regarding look-back periods and many other issues that can cause this plan to backfire harshly.

This is where a little estate planning forethought can be highly beneficial. A home can be placed into a living trust and this step extracts it from the estate at the time it is transferred to the trust. The home can then be sold in the future, after the original owner's passing, and the proceeds distributed to the heirs. This approach mostly accomplishes what an outright gift does, but alleviates many of the snags of a gifting strategy. A home held in a living trust also still receives the step-up in basis benefit for capital gains purposes at the death of the original owner.

It is also possible to use a traditional life estate deed so that the home can continue to be used by the original owner while living, but upon their passing, the life estate is terminated and the home transfers to the named heirs. Here again, a full step-up in basis occurs at the death of the original owner. There are other considerations when using a life estate deed. The owner does not maintain full control of the property after executing the life estate deed. While they can live in the home, they cannot sell the property, nor can they refinance it or take any other form of a mortgage or debt against the property. This type of deed is a legal transfer of the home at the time it is executed.

What could be better than a traditional life estate deed? The fanciful sounding Lady Bird Deed is also what amounts to an enhanced life estate deed. With this type of deed mechanism, the original owner can still live in the home for their remaining years, but also maintain full control of the property for purposes of selling and refinancing. Under the Lady Bird Deed arrangement, the property will still transfer to the heirs.

It is always worth consulting qualified financial and estate planning advice and guidance. The transfer of a home held for decades is no different. A few thousand dollars spent on putting a proper plan in place will always look like a bargain compared to tens of thousands of dollars on a tax bill.