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Trusts & Estates Forum

The Meaning of Life (Estates)

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The life estate is probably one of the most commonly used methods of securing a right of occupancy or income from real estate, but, like the meaning of life, it is also one of those most taken for granted by attorneys. Too many practitioners seem ever ready to prepare a deed with a reserved (or granted) life estate without really thinking (and unfortunately sometimes without knowing) about the numerous potential tax and legal ramifications. For instance, is it the life tenant or the remainderman who has the right to partition the property? Or neither? Can a creditor of the life tenant obtain possession of the property? If the property is the life tenant's principal residence will the proceeds of a sale be subject to the \$250,000 capital gains tax exclusion? Would the results be the same if the life estate was granted to the life tenant by a third party? And on and on. Seems somewhat complicated for a "simple" life estate, but that's life.

Perhaps there is one thing that is simple about a life estate – the life tenant's "estate" (the right of possession, rents, or "profits" from the property) lasts for the duration of the measuring life, but that is about the extent of its simplicity. Black's Law Dictionary (7th Ed.). From there, the

questions begin. Occasionally, some questions can be answered by an examination of the language creating the life estate, since that is what governs, if in fact the language contains anything more than the pure grant, such as words creating a special limitation upon the life estate, or prohibitions on alienation of the life estate. Restatement Property §112 and §124. Otherwise, one must look to common law, accepted treatises, case law, and state statutes.

The Right to Partition

A good illustration of the uncertainty that can arise, if not addressed in the language creating the grant, is the question of the right to partition. Under common law, a sole life tenant does not have the unilateral power to partition or sell the property, although the power to sell the life estate itself is permitted as discussed below. Restatement Property §126(2). A number of states have provided by statute that unless otherwise stated in the language governing the grant, a sole life tenant may petition the probate court to order a sale of the property. See, e.g. Mass. Gen. Laws ch. 241 §1, and Ch. 183 §49. After the sale the proceeds are reinvested, providing income to the life tenant, or such other “just and equal” partition as the court may order. Batchelder v. Munroe, 335 Mass. 216; 139 N.E.2d. 385 (MA 1957).

Interestingly, the rule is quite different where there are concurrent life estates. In that event, a life tenant does have the right to partition (unless prohibited by the grant) and force either a physical (legal) division of the property or a sale. Restatement Property §125, comments a and d. For instance, Y deeds property to X, but granting joint life estates to H and W. Either H or W may bring a petition to partition the property to separate their life estates, as long as the joint life estates are not held as tenants by the entirety. Remaindermen generally do not have the right to partition since they do not have a possessory interest, but a seeming contradiction to this rule is where one person has a life estate in an undivided share of property and another person holds a fee simple interest in the rest. In that event the fee simple owner has the right to partition the property.

Transferring a Life Estate

Even though a life tenant may be prohibited, whether by restrictions in the grant language or under local law, from partitioning the property, this does not mean that the life tenant is prohibited from transferring her life estate. Peterson v. Picardi, 15 Mass. L. Rep. 343 (2002)(transfer of life estate in buildings and surrounding property). Typically, a life interest is freely transferable with or without consideration, although, except in rare cases, it is unlikely that it would be easily marketable to a third party, since the third party's rights would be summarily cut off on the death of the life tenant. For that rare case, see Castello v. Commonwealth of Revenue, 391 Mass. 567, 462 N.E.2d 322 (1984)(life estate in trust sold for \$24,000 a year for life). Of course, the age and health of the life tenant impacts upon marketability. In re Buckley, 218 Mass. 354, 105 N.E. 979 (1914)(infirm life tenant's interest of little or no value); Evenson v. Minn. Dept. of Human Services, 489 N.W. 2d 256 (Minn. 1992) (Fair market value of ninety year old's estate for life valued at zero). Of course, it could have value to a creditor of the life tenant, because the life tenant's exclusive right to possession, rents, and profits could provide a ready source of funds to satisfy the life tenant's debt. Accordingly, unless the life tenants were husband and wife who held their joint life estates as tenants by the entirety, a judgment creditor of a life tenant could through a court order take possession of the property and either sell the life tenant's interest or simply rent the property and apply the net proceeds to satisfy the debt. Restatement Property §147.

Life Tenant's Responsibilities

The life tenant's interest in the property is not without responsibility. It is well settled that the life tenant is responsible for payment of the real estate taxes on the property, as well as reasonable maintenance and repairs, and interest on any outstanding mortgage on the property. Spring v. Hollander, 261 Mass. 373, 158 N.E. 791 (1927); Restatement Property §129. If the life tenant fails to make these payments and the remainderman makes them in order to protect his interest in the property, he would thereby have a lien against the life tenant's interest. If the lien is of a substantial amount, the remainderman could foreclose on the lien and cause the life estate

to be sold to satisfy the lien, causing the life tenant to lose the life estate to the extent of the value of the lien. Restatement Property §130, comment d. Of course, the grant language could limit or release the life tenant's responsibility for these payments, but then a serious practical problem will arise – who will make the payments? Although the responsibility may be shifted to the remainderman, what if he doesn't pay it?

The life tenant could pay the expenses (if she has the funds) that she has been excused from paying and then have a lien against the remainder interest, or if no one pays it, the property could ultimately be lost through a forced sale for taxes and other expenses. In that event, the net proceeds would be invested to provide income for the life tenant. Spring v. Hollander, 261 Mass. 373, 158 N.E. 791 (1927). These potential problems make it clear that adequate arrangements should be made for maintenance of the property and expenses during the life tenant's life, either in the grant language or by outside financial arrangement, such as a funded trust.

Of course, if the interest of the remainderman could be arbitrarily taken away, he is not likely to advance any funds for taxes or expenses. This would be the case, for instance, where someone, such as the life tenant, has a special power of appointment over the remainder. A grantor/life tenant would consider this arrangement where she wants to divest herself of the property but retain the right to change the ultimate owner as well as the right of occupancy. This approach has been recommended where the property consists of the grantor's principal residence and the grantor/life tenant wishes to transfer the home and yet still take advantage of the Internal Revenue Code (IRC) §121 capital gains exclusion on the sale of one's residence. The gain on the sale would be taxed to the grantor because the retained power of appointment renders the gift incomplete. See, Alexander A. Bove, Jr., *A Creative Strategy For Protecting the Home for Medicaid Purposes*, 24 Est. Planning 1 (January 1997).

Life Estates and Taxes

The tax implications of the “simple” reserved life estate can be every bit as involved as the legal ramifications discussed above. Let’s break them down into the categories of the three main taxes – gift, income, and estate taxes.

Gift Taxes

When an outright transfer of a remainder interest is made and the grantor reserves a life estate, the grantor makes an irrevocable gift of the present value of the remainder, which is subject to a federal gift tax. In fact, under IRC Chapter 14, unless the interest retained by the transferor meets certain specific requirements (termed a “qualified interest”), then the transferor will be treated as having made a gift of the entire value of the property, without reduction for the retained life estate. IRC. §2702(a)(2)(A). If the interest is a qualified one, the value of the gift of the remainder interest may be calculated using the applicable IRS tables pursuant to IRC §7520 and §2031 based on the age of the grantor at the time of the gift (and applicable discounts, if any). Remember, however, that if the grantor reserves a power of appointment over the remainder, there will be no gift for gift tax purposes. Sanford’s Estate v. Commissioner, 308 U.S. 39 (1939); Treas. Reg. §20.2511-1(b). Note also, that for gift tax purposes, since the gift is one of a future interest (the remainderman does not get possession until the life tenant’s death), the IRC §2503(b) tax-free annual exclusion (\$11,000, indexed for inflation) is not available. Finally, the uniform basis rules of IRC §1015 would allocate a proportionate amount of the donor’s basis to the remainderman. And, the basis would be increased by any gift tax paid if the cumulative gifts exceed the transferor’s applicable exemption amount. IRC §1015 (d).

Income, Depreciation and Capital Gains

Since the life tenant has the exclusive right to “possession, rents and profits” from the property, any income realized, such as rents, will be taxed to the life tenant. Further, if the property is generating rents, the life tenant may take depreciation deductions, but here the law gets a little

confusing. The general rule is that for property held outright and free of trust, the life tenant is allowed to depreciate the property as if she owned the whole of it. IRC §167(d). The problem is that there is an exception to the general rule where the remainder interest is held directly or indirectly by a “related person” (to the life tenant), in which case no depreciation deduction is allowed. IRC §167(e)(1) incorporating IRC §267(b) and (e). Accordingly, since the typical deed with a reserved life estate usually grants the remainder interest to a family member, depreciation deductions would not be allowed in most cases.

If the life estate property is sold during the life tenant’s lifetime, and if the life tenant’s interest meets the requirements for the IRC §121 capital gains exclusion, then the life tenant can apply the exclusion to the proportional interest relating to her life estate but not to the remainder interest. The remainderman will pay a tax on his share of any capital gain, based on the proportionate share of the life tenant’s basis in the property that relates to the remainder interest. Rev. Rul. 84-43, 1984-1 C.B. 27. To illustrate, say that Jennifer transfers her home to her son, Jeremy, retaining a life estate. Jennifer’s basis in the home is \$50,000, and the value of her life estate at the time of the gift is 60% of the property value. Later the home is sold for \$300,000 and Jennifer meets the IRC §121 requirements for the capital gain exclusion. Because Jennifer is now older, at the time of the sale the value of Jennifer’s life estate has decreased to 50% of the value of the proceeds or \$150,000. Her basis in the sold life estate is 60% x \$50,000, or \$30,000, so Jennifer’s (tax-free) gain is \$150,000 (her share of the sale proceeds) less \$30,000 (her share of the basis), or \$120,000. Jeremy’s basis in his share of the gain is 40% x \$50,000, or \$20,000, so Jeremy’s taxable gain is \$150,000 less \$20,000, or \$130,000. Note that although the value of the life estate decreases with time and the value of the remainder increases correspondingly, the basis in the hands of the life tenant and the remainderman is fixed at the time of the gift, unless subsequently changed by further investment or improvement to the property. IRC §1015 and §1016. Note, too, that if Jennifer had sold a remainder interest to Jeremy IRC §121 would not apply since Jennifer and Jeremy are related parties. Treas. Reg. 1.121-4(e)(2)(ii)(B).

Occasionally, life estates come about through transactions other than gifts. They may, for example, be the result of a “split purchase” where one party purchases a life estate in newly acquired property and the other party purchases the remainder, or where one party already owns property and another party purchases a life estate in that property. In both instances, IRC §2702

comes into play, and unless certain exceptions apply a gift will result in the amount of the entire value of the property (less consideration). IRC §2702(a)(2). The former case, however, provides an excellent opportunity for tax planning where a “new” piece of property is to be purchased by members of a family, where one party, typically the parent, purchases a life estate in the property, and the other party, typically a child, purchases the remainder interest. If carefully and properly carried out, typically by using a trust, it can result in a transaction that succeeds in removing substantial sums from the life tenant’s estate at no gift tax cost.

Estate Taxes

As for estate taxes, it is well settled that where a person transfers property but reserves the right to use that property for her life (e.g. a life estate), the full value of the property will be included in the estate of the grantor/life tenant on her death and will receive a corresponding step-up in basis in the hands of the remainderman up to the fair market value at date of death. IRC §2036(a) and §1014(b)(9). An interesting twist on this concept, however, can produce just the reverse result. As explained above, if a person purchases a life estate and another person purchases the remainder with his own independent funds, no part of the purchased property is included in the estate of the life tenant on death. Magnin v. C.I.R., T.C. Mem., 2001-31 (February 12, 2001). It is extremely important to understand that such a split purchase must be carried out within precise guidelines and is not for the uninitiated. (BINGO!!)

Where the life tenant is not the original grantor, such as where one spouse owns the property alone and deeds it to another person, but grants a life estate to the other spouse, the property would be neither in the estate of the grantor spouse nor the estate of the life tenant spouse, since neither spouse has retained any interest in the property. The problem with this arrangement is that the remainderman will lose the basis step-up at death, but this may not matter if the property is vacation property that is not intended to be sold by the family.

Where a decedent devises property to one individual for life, and another receives the remainder interest, the “stepped-up” date of death tax basis is allocated between the two partial interests. Treas. Reg. 1.1014-5(c).

Conclusion

As can be seen, the “simple” life estate can have far-reaching legal and tax ramifications, many of which are never contemplated by the parties and, sometimes, even by practitioners. Its simple concept and ease of implementation places the life estate in the same tempting, but potentially troublesome, category as joint tenancy and powers of appointment, and as demonstrated in this discussion, life estates, like life itself, should not be taken (or given) for granted.

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