**Attorney Timothy P. Crawford, CPA, CELA*, CAP****
wanted to share this information with you.

# Use of the Personal Residence Exclusion In Medicaid Planning

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Many of us refer to the Personal Residence Exclusion as the tax free sale of a home. The reason a home can be sold tax free is because of the Personal Residence Exclusion for the sale of a principal residence available under Section 121 of the Internal Revenue Code.

## LENGTH OF OWNERSHIP AND OCCUPANCY

The taxpayer must use and own the property as the taxpayer's principal residence for 2 out of the last 5 years. Special rules apply if an owner has been institutionalized. If a taxpayer becomes physically or mentally incapable of self-care, and the taxpayer owns and uses the property as his principal residence for periods aggregating at least one year out of the last five-year period, then the taxpayer is treated as using the property as the taxpayer's principal residence during any time during the five-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a state or political subdivision to care for an individual in the taxpayer's condition. §121(d)(7).

## OLD RULES – NEW RULES

Many of us are familiar with the old rules, which were changed on May 7, 1997. Under the old rules, a taxpayer could take advantage of the tax free sale of a principal residence only once in a lifetime. In addition, the taxpayer had to be over the age of 55 in order to take advantage of the rule.

Under the new rules, a taxpayer of any age can take advantage of the tax free sale. The taxpayer no longer has to be over the age of 55. In addition, one could take advantage of the rule every 25 months. It is no longer a once in a lifetime opportunity.

A common planning technique is for a person to sell their principal residence on a tax free basis. They then move into their cottage, which they have owned for years, and convert it into use as their principal residence. Then they sell the cottage on a tax free basis 25 or more months later.

Under the old rules, you had an opportunity to postpone the tax under Section 1034 on what otherwise would have been a taxable sale. Section 1034 no longer can be used. However, there is generally no need for it as for most people, the sale can be done on a tax free basis.

For our friends on the East Coast and the West Coast, there still could be a tax due on the sale. There is a limitation on the exclusion from gross income of the gain realized on the sale of $250,000 of gain for a single person, and $500,000 of gain for a married couple filing a joint return where both husband and wife qualify for the exclusion. For very expensive homes being sold with a low tax basis there could be a gain in excess of $250,000/$500,000, and thus, a portion of the gain would be subject to tax.

## ASSET PROTECTION PLANNING

When people are planning to protect their home so it does not need to be sold to pay for nursing home care costs, a common bad technique is for a parent to give the home to their children. Obviously, if the home has been given to the children, there will be a period of ineligibility caused by this gift which will be treated as a divestment for purposes of determining eligibility for Medical Assistance. However, I generally recommend against this solution as the children generally will not be living in the property, and thus, will not be eligible for a tax free sale of the property. Many times the parents have owned this same home since the 1950's. At the time of the transfer of the home to the children by gift, the children will have the same tax basis as the parents had in the home. This generally will be a very low tax basis. Thus, when the children subsequently sell the home, either during the parent's lifetime or after the parent's death, they would end up with a large capital gains tax to pay at the time of the sale. Sometimes, however, a home is given by a parent to a daughter who will live in the home. Thus, the daughter may be able to qualify for the tax free sale status in the future.

Another technique that is used in asset protection planning is to gift away to the children a remainder interest in the parent's home while the parent retains a life

estate. At mother's death, the children will receive a step up in basis to the full fair market value of the property that existed on the date of mom's death. We also have to remember, that for deaths occurring after 2009, the current tax law provides for no step up in basis on a retained interest, and thus, the tax burden for the children would continue for sales occurring after deaths in that situation. A sale during lifetime of the property will result in the children being required to pay a capital gains tax attributable to the gain on the sale of the remainder interest.

To avoid the children being required to pay a large capital gains tax on the sale of the remainder interest, Attorney Timothy P. Crawford recommends the use of the parent retaining a Special Power of Appointment. If a Special Power of Appointment is retained, then the IRS gift tax law states that the transfer of the remainder interest is an incomplete transfer. Therefore, you have the argument that at the time of the sale of the remainder interest during mother's lifetime, that it is mother's sale and not the child's sale. Mother would take the position that she is selling her principal residence. If mother is selling her principal residence, then it should be a tax free sale.

I refer to the Special Power of Appointment as the "Right To Change Your Mind Agreement"™. Many clients like to have the power to change their mind as to which of their children or grandchildren will receive the property at their death. By reserving this "Right To Change Your Mind", mother can protect her children from losing the remainder interest in the event of the child's bankruptcy or divorce. If mother has given to her daughter a remainder interest, but has kept the right to change mother's mind, then, when daughter dies and transfers her remainder interest to the daughter's husband, mother would have the right to change her mind and redistribute the property to the daughter's children (mother's grandchildren). These advantages, in addition to the tax advantage, should force you to consider using a "Right To Change Your Mind Agreement"™ (Special Power of Appointment) any time you would consider using a life estate.

PRACTICE TIP

Wherever you would consider using a life estate/remainder interest solution to protect the parent's home, you may want to consider combining the life estate solution with a "Right to Change Your Mind Agreement"™ (Special Power of Appointment).

SPECIAL RULES

Q. What happens if my husband dies?

A. An unmarried individual whose spouse is deceased on the date of the sale of the property is treated as owning and using the property as a personal residence during the period for which the deceased spouse owned and used the property before death. Section 121(d)(2).

Q. What if I get sick and must move out of my home?

A. If the sale of the residence is due to a change in the taxpayer's health, a taxpayer who does not otherwise qualify for the full exclusion is entitled to a proportionately reduced exclusion amount under Section 121(c).

Q. What if the property is owned by my trust?

A. The requirement of ownership of the property is satisfied not only if the residence is owned directly by the taxpayer, but also under certain circumstances if the residence is owned by a trust. If a residence is owned by a trust, for the period of time that a taxpayer is treated, under the grantor trust rules, as the owner of the trust or the portion of the trust that includes the residence, that taxpayer is treated as owning the residence for purposes of satisfying the two year ownership requirement. Section 1.121-1(c)(3)(i).

SUMMARY

I have provided you this information to help you solve some of the tax problems that exist when you are trying to do planning to protect the client's home from being sold to pay for nursing home care costs.

**"Those Who Plan Ahead Win.**
**Those Who Don't Plan Ahead Lose."**

This article is for informational purpose only and is not intended as legal advice. It is recommended that you call Timothy P. Crawford for a free conference to discuss your situation in more detail. Attorney Crawford can be reached at 1-262-634-6659. Please refer to this article when you call.

*Attorney Timothy P. Crawford is a Nationally Board **C**ertified **E**lder **L**aw **A**ttorney (**CELA**). He has been Board Certified by the National Elder Law Foundation which has been approved as the Sole Certifying Organization for Elder Law Attorneys by the American Bar Association.

**Timothy P. Crawford was invited to join the **C**ouncil of **A**dvanced **P**ractitioners (**CAP**) of the **N**ational **A**cademy of **E**lder **L**aw **A**ttorneys (**NAELA**) in August of 2005. **CAP** is a small group of premier elder law attorneys, all of whom have been members of NAELA for at least 10 years, are certified as elder law attorneys by the National Elder Law Foundation, and are AV rated by Martindale Hubbell, a service that provides an independent rating of the quality of attorneys, as one of the top attorneys in the nation.

Attorney Timothy P. Crawford has been selected as a **Fellow** of NAELA. **Fellow** is the highest honor bestowed by the Academy. Selection as a **Fellow** signifies that his peers recognize the lawyer as a model for others and as an exceptional lawyer and leader.

Attorney Timothy P. Crawford has a superb rating of 10 out of 10 with A V V O.

A V V O has awarded to Attorney Timothy P. Crawford the A V V O Client's Choice Award.

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**"Helping Families in Wisconsin for Over 40 Years to Protect Their Assets from Nursing Home Care Costs"**

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