CRITICAL POINTS TO CONSIDER BEFORE TRANSFERRING REAL PROPERTY TO A TRUST

Because of the cost and complexity of probate and the uncertainty about estate tax laws, the use of revocable and irrevocable trusts is on the rise. Often the asset used to fund the trust is real property. Unfortunately, there is often a lack of understanding of the implications and coordination between the property owner (both old and new), the estate planning attorney, the property and casualty insurance advisor and the mortgage holder.

Revocable Trusts and Title Insurance Issues
Title insurance protects owners of real estate, and mortgage lenders, against any losses if the title to real estate is determined to be defective. The insurance coverage is issued to and covers the named Insured. The narrow definition of Insured did not include the trustee or beneficiary of a revocable trust. Recognizing the problems inherent with such a limited definition, the American Land Title Association (ALTA) led the way to a change in 2006 to include “a trustee or beneficiary of a trust created by a written instrument established by the Insured named in Schedule A for estate planning purposes” as an Insured.

Quit Claim Deeds
For many years estate planning attorneys commonly used Quit Claim Deeds for clients to transfer real property to their trusts. The function of a quitclaim deed is to transfer the interest a purported owner of real estate may have in that property. Unlike a warranty deed, a quitclaim deed does not carry with it a guarantee that the title to the real estate is free and clear of any liens or encumbrances. The person conveying an interest in real estate with a quitclaim deed essentially is doing so in an "as is" condition. Because no warranty or guarantee is made regarding the actual state of the title when a quitclaim deed is used, some title insurers will not issue coverage. For this reason, attorneys now transfer ownership to trusts via warranty deeds.

Revocable Trusts and Mortgages
Most mortgages contain a “due on sale clause” which allows the mortgage holder to accelerate the loan upon a transfer of interest. However, in most cases the transfer of the property to a revocable trust is exempt under the Garn-St. Germain Depository Institutions Act of 1982. Under §341(d)(8) of that Act, codified as U.S. Code Sec. 1701j-3(d)(8), an exemption applies in the case of a real property loan that is secured by a mortgage on residential real property containing less than five (5) dwelling units. The exemption applies to a transfer of residential real property to a revocable trust if the grantor is a beneficiary of the trust.

Revocable Trusts and FHA/Fannie Mae/Freddie Mac backed loans
FHA underwriting guidelines state that natural persons who are United States citizens, permanent residents, nonpermanent residents, inter vivos revocable trusts and land trusts in some states are eligible to obtain FHA-backed loans. The lender must also ensure that the title insurance policy is issued to the trust. Most lenders will require a review of the trust document and/or certification by the trustee and an opinion letter from counsel stating that the trust
complies with applicable regulations and that the lender’s rights are not affected by the existence of the trust.

**Mortgages and Irrevocable Trusts**

Often irrevocable trusts are established for gifting purposes or spring into life after the death of the grantor (or the owner/testator of a testamentary trust). Irrevocable trusts are ineligible for many loans including FHA-backed loans and reverse mortgages (which were traditionally sold to Fannie Mae). Additionally, loans to irrevocable trusts do not qualify as “conforming loans”. Although whether a loan is “conforming” or not does not affect the deductibility of the interest, it often affects the interest rate. Thus, if a trustee of an irrevocable trust can find a lender that will issue a mortgage, it is often at a higher rate and a reverse mortgage may not be available.

**Effect on Creditors of Transfer to a Trust**

Couples and individuals are often given creditor protection for certain assets, such as the personal residence, or by virtue of the form of ownership. Before transfer to a trust, the parties must determine if this protection will continue.

**Homestead**

Some states give special creditor protection to a person’s residence. The transfer of a homestead to a revocable trust may affect its status. In a 2001 federal bankruptcy case (In re Bosonetto), the court held that Florida’s homestead exemption did not apply because the revocable living trust was not a natural person. The decision is not binding on Florida courts, but it does cause some uncertainty in bankruptcy cases involving those domiciled in Florida. Contrary to the federal bankruptcy court’s decision in the Bosonetto case, New Hampshire’s laws specifically state that an individual does not lose the homestead exemption by transferring his or her residence to a revocable living trust. See New Hampshire General Statutes, §480.9.

**Tenants by Entirety**

In 13 states, husband and wife hold title to property as “tenants by the entirety”. Because this form of ownership gives the spouses creditor protection not otherwise available to joint tenants or tenants in common, potentially destroying it by a transfer to one or more revocable trusts is an important decision.

Some states have statutorily remedied the risk by enacting provisions such as the one in Illinois which added to the Joint Tenancy Act as follows:

*Where the homestead is held in the name or names of a trustee or trustees of a revocable inter vivos trust or of revocable inter vivos trusts made by the settlors of such trust or trusts who are husband and wife, and the husband and wife are the primary beneficiaries of one or both of the trusts so created .... the estate created shall be deemed to be a tenancy by the entirety.*

The Illinois law also amended the Code of Civil Procedure as to seizures.

But, in states without such statutory provisions, changing the nature of tenants by the entirety property should only be undertaken after consideration of the potentially increased creditor risk.
Property Tax Exemptions
Many individuals receive state and local property tax exemptions on their personal residence for military service or other reasons. Whether these exemptions will continue to apply if the residence is transferred to a trust is another issue to consider before the transfer is made. The taxing authority may request a copy of the trust instrument in order to grant - or continue - the exemption. The trust should be sure to include any provisions necessary to qualify for the exemptions.

Insurance
Upon a change of ownership whether to a revocable or irrevocable trust, the owner should notify the property and casualty insurer. There are generally two coverage options: listing the trust as the “named insured” or as an “additional insured”. If the latter course is undertaken, the owner should be sure that both property and liability coverage is included. Lastly, the parties may wish to add the trust to any umbrella policy, if possible.

Conclusion
In summary, ownership changes must be carefully considered and properly addressed and structured. The components to successfully accomplishing the individual’s goals without unintended consequences require all parties to work together – the client, attorney, insurer, mortgage holder and agent. If any of the components are overlooked the results can be a problem.

ABOUT THE AUTHOR
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