

## FUTURE INTERESTS & THE LIFE ESTATE DEED

### DISCLAIMER

*This article is intended for informational purposes, only. It does not constitute legal advice. Nor is it a substitute for legal advice.*

In a separate article from this series we have discussed joint tenancy and tenancy in common as those two basic ways in which people can own property together. It is also possible as a matter of ownership of property, or titling of property, to create what are called future interests. In joint tenancy and tenancy-in-common, the owners have rights in the property at the same time, sometimes called concurrent rights. With future interests, the rights are usually successive, that is, one follows the other.

Let's take a simple example to start with. Mom and Dad are joint owners of a parcel of land. They decide that they want their son Paul to have that parcel of land after they die. They execute and record a real estate deed which transfers the land to Paul subject to their joint life estates. What has happened? Mom and Dad have transferred that parcel of land to Paul irrevocably; Paul owns it, but what he owns is a future interest. In law he is called a remainderman. Mom and Dad, having reserved joint life estates, are entitled to possess and control that parcel of land for as long as either of them lives. In the law, they are called life tenants. Paul therefore is not entitled to take possession of the property until after the last of his parents dies.

The law of future interests can become complicated. In general, future interests are first divided into two types, reversions and remainders. A *reversion* is a future interest retained by the person who is transferring the property. Let's say Bob owns a parcel of land and he transfers a life estate in that land to Ruth. At Ruth's death the parcel of land would *revert* to Bob, or, if Bob has died before Ruth, then to Bob's heirs. A *remainder* is a future interest in the person to whom the transferor is transferring the property, such as Paul in our first example. Let's take another example: Bob, the owner of a parcel of land, transfers by deed a life estate to Ruth with a remainder to Dylan. Bob here has retained no interest, so there is no reversion. Ruth has possession and enjoyment of the property until she dies and at her death, Dylan takes possession. Dylan, like Paul in our first example, presently owns a future interest, a remainder. (Should Dylan die before Ruth, Dylan's heirs will inherit the parcel of land at the time of Ruth's death.)

The law of future interests goes on into executory interests, springing or shifting executory interests, contingent remainders, possibilities of reverter, and powers of termination. A discussion of these future interests is both beyond the scope of this article and, in all likelihood, of limited use to the reader. It is, however, useful to know for purposes of our subsequent discussion that contingencies or conditions can be attached to future interests.

Future interests can be created in a testamentary (or time-of-death) transfer or they can be created during life, in what is called an inter vivos (between-the-living) transfer. The latter may be accomplished through a gift or as a sale.

### The Life Estate Deed

A life estate deed, in essence, is what Paul's parents used in our example. They transferred the land to Paul and reserved in themselves joint life estates. They will enjoy the property for the duration of their lives. They are entitled to the income from the property. They also have to pay the taxes. In legal terms, the parents have *dominion and control* over the property until the last of their deaths. At the last death, the parental life estate ends and Paul comes into possession and control of the property.

The life estate deed has been called a poor man's trust, which reflects the fact that it is an inexpensive estate planning tool. It may also be an efficient tool. There is no need for a probate to complete the transfer of the property to Paul, the remainderman. In addition, Paul receives an automatic step-up in basis for capital gains tax purposes. This is because the entire value of the parcel of land is typically included in the taxable estate of the parents. In other words, it qualifies as a time-of-death transfer. This is because Paul's parents, when they gave him the land, did not give to him all of their interests in the land – they kept life estates – which means that their gift to Paul was not complete for tax purposes. (This of course also means that a life estate deed is not a useful estate tax planning tool, that is, it is not useful for reducing the value of the parents' taxable estate. The value of the land that Paul's parents gave to him is included in their taxable estate. For estates that are fully protected from estate tax by the unified credit exclusion amount, currently \$5.34 million per person, this may make no difference.)

In certain circumstances, and subject to the deprivation of resources rules that govern Medicaid eligibility and asset recovery, a life estate deed may provide some protection to assets from the cost of the life tenant's long-term care. This may be one of the reasons farm and ranch families consider the use of life estate deeds. However, the complexity of Medicaid rules requires a careful analysis of the uses of the life estate deed.

So, what's not to like about a life estate deed, one might ask? A few things. Once the deed is done, so to speak, once it is executed and recorded, the parents cannot change their minds, unless Paul should agree. In other words, a life estate deed is irrevocable. It therefore violates one of the cardinal principles of estate planning, i.e. keep it flexible; things change, people change and a person would like to be able to change their estate plan to respond to those changes. After the deeding, Paul owns the property, subject to the parental life estates. This means that Paul has rights in the property; he has property interests that he can encumber (mortgage or pledge) or that may become subject to the claims of his creditors. This is a risk that some owners are unwilling to take; it is a shortcoming that takes some of the shine off the life estate deed as centerpiece of an estate plan.<sup>1</sup>

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<sup>1</sup> The remainderperson's creditors may be able to attach the remainder interest even while a life tenant is alive. For example, if Paul ran into financial trouble and one of his creditors obtained a judgment against him, that judgment could become a lien against the real estate that Paul, as the remainderperson, owns. However, it is unlikely that the creditor could force the sale of the real estate while the life tenant is alive in order to pay the remainderperson's debt provided the life tenant properly objected to the sale.

There may be ways to guard against such risks in a life estate deed itself. The parents might consider attaching conditions to the deed of the property to their children. For example, the deed might state that the property is being deeded to the children on express condition that they do not encumber the property so long as either parent remains living and that if they do try to encumber the property then ownership of the property reverts (comes back) to the parents, or perhaps transfers to another person. The deed might state that either a voluntary or an involuntary encumbrance would cause title to the property to revert to the parents. Or, instead of saying that the property reverts to the parents, the deed might expressly give the parents the power to terminate the transfer in the event of an encumbrance. Such a condition would protect the parents' life estate by preventing the children from mortgaging the property and, perhaps, by preventing the children's creditors from attaching the property.<sup>2</sup>

Language is critical in drafting these legal documents. The law is full of examples of poorly or unclearly drafted deeds, wills, agreements. It is important to get it right. It is critically important in using conditions in deeds that the language be legally precise.

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<sup>2</sup> It may also be the case that the remainderperson would not be able to find a lender willing to take a mortgage interest against the property while the life tenant is alive, knowing that a creditor's right to execute against the property is curtailed.