How Titling Property can affect your Estate Plan

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The myriad options presented to homebuyers when titling real estate have significant tax, asset protection, and estate planning consequences. Failing to consider these issues often results in unanticipated taxes, liability, fees, and headaches. This article discusses a variety of potential pitfalls that should be considered when purchasing or re-titling property.

First Pitfall: Failure to plan for Probate

The way homebuyers title real estate determines whether a probate will occur. You might ask, what is Probate and why should I be concerned about it? When people talk about Probate, they are referring to the court-supervised administration of estates. Under California Probate Code §§10800 and 10810, probate fees for the each of the attorney and personal representative are 4 percent on the first $100,000, 3 percent on the next $100,000, 2 percent on the next $800,000, and so on. These fees are calculated on the gross (not the net) value of the estate.

For instance, let's say that Jim, who is not married, dies owning one asset, a house worth $1,000,000 with a mortgage of $500,000. Jim's house is titled in his name alone. Jim's will leaves the house to his three children, one of which is named as personal representative. The probate fees here would be as follows: $23,000 to Jim's attorney (plus any "extraordinary fees") and $23,000 to the personal representative (if he/she decides to take a fee). The minimum fee for this probate is $23,000, however it could easily rise to $46,000 or more. As noted above, these fees are calculated without taking into account the $500,000 mortgage, because the fees are

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charged on the gross (not the net) value of the estate. As you can see, Jim's estate does not have enough liquid assets to cover the expense of the probate!

How can Jim avoid probate fees? First, he could establish a revocable trust and transfer the property to himself as trustee. In that case, the asset would not have to pass through a probate procedure, because it would be transferred directly by a successor trustee. However, Jim needs to make sure that his trust is fully "funded" at the time of his death. Otherwise, a probate might still be required. Often, trust documents appear to be valid on their face, but the underlying assets have not been funded to the trust. Jim should seek an attorney's counsel in order to ensure that his trust is funded and remains that way.

What if Jim never establishes a revocable trust? Could he get by with joint tenancy? If Jim were married, he could avoid probate at the death of the first spouse by owning his real property as in joint tenancy with his spouse. Joint tenancy means that two (or more) people own property in equal shares. On the death of either person, the entire interest automatically passes to the remaining owner, and probate is avoided. Of course, on the death of Jim's spouse, the real estate would still be subject to probate. In addition, titling property in joint tenancy without consideration of whether the property is separate or community may result in unintended tax consequences (see below). Also, Jim might benefit from some estate tax planning, which may be better facilitated when planning with trusts. Ultimately, ownership of the property in a funded revocable trust while giving full consideration to the real estate's community property status and estate tax issues will give Jim the best protection.

<u>Second Pitfall: Listing your Child on the Deed</u>

What if Jim owns his property jointly with one of his children? The idea of listing a child on a deed as a joint tenant often appeals to parents. This approach appears to offer a simple, cheap way to transfer property on death, avoid probate, and perhaps even avoid taxes. However, adding a child to the title of your house could result in disastrous consequences, both during life and at death. At the end of the day, it is rarely advisable to take this "shortcut."

First, owning a home in joint tenancy exposes the parent to liability for the child's actions. For instance, the child's gambling habit or addiction may put the real estate at risk. Or, say that the child is involved in a car accident. In such case, the court could place a judgment lien on the child's interest in the property. This is true regardless of whether the parent's sole intent was to facilitate a transfer of real property at death.

Second, naming a child on the deed often frustrates a parent's overall estate planning objectives. A parent may want their children to live in a home as long as they are under age 18, or for the home to be sold and the proceeds distributed equally among multiple children. Alternatively, a parent might wish for one child to have the family home, but the other child to be compensated with liquid or business assets. A will or trust may provide exactly how property should be distributed, or empower a trustee with discretion to distribute such property. As parents often forget, however, a joint tenancy interest passes outside of the terms of one's will or trust. While a will may clearly provide for equal distribution, this makes no difference as far as the joint interest is concerned. As a result, one child may get an inheritance boost, while another may wind up with a smaller proportionate share of the estate.

Third, and perhaps most important, adding a child's name to a property can result in disastrous gift and estate tax consequences. If the child has not contributed an equal amount of money as the parent when purchasing a home, the parent could be liable for a gift tax in the year the home was purchased or transferred. Later, after the parent dies, the entire value of the home will be included in that parent's estate for estate tax purposes unless it can be established that the child contributed to the purchase. In view of both the gift and estate tax consequences of holding property with a child, it is rarely advisable to pursue this approach!

Third Pitfall: Failure to consider Basis Step up

The way in which homebuyers title property affects the basis "step-up." What does "step-up" in basis mean and how does it affect me? Generally speaking, when property is sold, capital gains are recognized on the difference between the basis (the purchase price) and the sales price. At death, however, the basis of an interest passing by will or trust to a surviving spouse "steps up" to the value as at the date of death. As a result, the sale of property after a full basis step-up often results in substantial capital gains tax savings.

However, married persons may only receive a partial basis "step-up," limited to one half of an appreciated property at the death of the first spouse to die, if the property is not held as community property. By contrast, both halves of an asset held as community property will receive a full step-up upon the surviving spouse's death. In general, therefore, community property is usually the best form of ownership when property has a low basis or will most likely appreciate in the future. An attorney can assist married couples in determining whether property is community or separate.

Before running to the title company, remember that numerous other factors, not all of which are discussed in this article, should also be considered. These factors include: whether the property has depreciated in value such that a partial step-down in basis would be desired; whether more advanced strategies such as bypass trusts would warrant titling property as tenancy in common; or whether the property will be held in a revocable trust. This does not even touch the family law issues involved, or some of the more nuanced asset protection rules. Because so many factors are involved when titling property, it is advisable for individuals in California to consult with an attorney about how property should be held, while keeping in mind the goals of (a) basis "step-up" for California and Federal income tax purposes; (b) probate avoidance for the entire transferred interest; (c) the marital deduction for estate tax purposes; (d) asset protection and (e) minimizing liability.

Please feel free to contact our office at (650) 329-9500 if you would like more information.