

He Who Dies With The Most Toys...May Lose!

Titling Property - An Introduction

by Cal Brown, CFP

Different ways of holding property offer different benefits. The best approach is to examine the trade-offs, and choose the form that most benefits your family.

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he majority of married couples walk into our office holding most of their property titled either “Joint Tenants With Rights of Survivorship” or “Tenants by the Entirety.” By the time we have finished their estate plan, most have changed the method of titling. Why did these couples not own property in the way most beneficial to them?

Frankly, most of them had never thought through the various issues. No one had ever discussed the advantages and disadvantages of alternative methods of titling property.

The discussion that follows will give you a good idea of how you consider titling your property to best benefit your family and you. The titling of property involves legal concepts, of course, and as such you should discuss specific issues with your own legal advisor before taking any action.

This article, will provide you with an overview of some of the practical issues in asset titling for estate planning, however.

This discussion is cast in terms of a married couple because singles do not have

the same issues and have fewer choices they can make that will affect their estate outcome.

Different Ways of Owning Property

There are four primary ways of owning property:

- In your own name
- Tenants in Common
- Joint Tenants
- Tenants by the Entirety

Anyone may own property in his/her own name, and that concept is clear to most individuals. The other three methods of property ownership have various characteristics and differences. Here’s a short review of these three methods:

Tenants in Common: This ownership method allows two or more parties to own

property together, and has the following characteristics:

- Each owner (“tenant”) owns a specific percentage of the entire property. The property is not divided into parcels, with each parcel owned by one of the owners.

- An owner may sell his/her interest without the consent of the co-owners.

- An owner may will his interest. It does not pass automatically to the co-owner at death.

- The property may or may not pass through the probate process, depending on state law.

Joint Tenants: More formally, this method of ownership is called “Joint Tenants With Common Law Right of Survivorship.” It means the following:

- Each owner owns an undivided interest in the entire property.

- No owner may sell without the consent of the co-owner(s).

- A creditor may force the property to be sold to satisfy the debts of any of the owners.

- At the death of one owner, the surviving owner(s) instantly, automatically, and without the intervention of anyone owns the entire property.

- The property passes “by law” and does not go through the probate process.

It is quite common for unmarried parties to own property by this method.

Tenants by the Entirety: The formal name of this method of ownership is “Tenants by the Entirety With Common Law Right of Survivorship.” This is a special form of joint ownership just for married couples. It is the same as joint ownership, but with the following very significant difference: *the property cannot be sold just to satisfy the debts of one owner.*

Similar to Joint Tenancy, the consent of both owners is required to dispose of the property. However, “partition” (the court-dictated process of selling a property when the parties cannot agree as to its disposition) is usually *not* available for this type of property,

so there is no way around the joint consent requirement except death or divorce.

Benefits of the Various Methods

Here’s a list of some benefits provided by the various methods of owning property that many married couples would likely seek. Unfortunately, no one method provides all benefits. You must balance the benefit that each method provides against the benefits lost using that method, and choose the one which best meets your needs.

Possible benefits include:

- Protection from claims of creditors
- Lower estate taxes
- Not divided with spouse upon divorce

Protection from Creditors: Property owned in the form of Tenants by the Entirety (only available to married couples) cannot be sold to satisfy the debts of only one owner. Lenders know this, of course, and therefore they always require a spouse to co-sign a loan even if it is the debt of only the other spouse.

But, you can have liabilities from ways other than borrowing money. The most common liability is created from negligence.

“Any judgment obtained against you cannot reach any property you own in the form of Tenants by the Entirety.”

Suppose, for instance, you are involved in an automobile accident and are found to be responsible for damages resulting from death, disability, or property damage to another person. Any judgment obtained against you cannot reach any property you own in the form of Tenants by the Entirety.

Physicians in high-risk specialties who may be concerned about malpractice suits may want to hold property this way.

Minimize Estate Taxes: There are two areas to focus on here—the first involves the ability to use the current tax exemptions; the second concerns the ability to get “discounts” and have the property valued at less than the normal amount one would expect.

Under current tax law, every person can, upon death, leave unlimited amounts to their spouse; this is known as the Marital Deduction. In addition, in 2003 they can leave up to \$1,000,000 to others free of estate tax. This number, known as the “credit shelter exemption equivalent,” will increase to \$1.5 million in 2004.

Imagine the worst: In 2003, you and your spouse are killed in an automobile accident. Your children can inherit \$2 million tax-free if you have the right estate plan.

What is the “right estate plan?” Usually, it consists of something called a bypass trust. Using this common planning technique, the spouse that dies first leaves an amount equal to the “credit shelter exemption equivalent” in trust for the children. For simplicity, let us assume the 2003 figure, \$1 million. Any amount over \$1 million would be left to the surviving spouse outright.

The surviving spouse would receive income from the bypass trust, and could also receive some trust principal if needed, according to an ascertainable standard. This standard is typically phrased as “health, education, maintenance, and support.”

The \$1 million in the bypass trust, plus any growth, would pass tax-free to the children after the second spouse dies.

Here’s the catch: Each spouse must own \$1 million of property in his or her own name in order to be able to send it to the bypass trust at death.

The definition of “own name” is the key: most people tend to think if they own property jointly with someone else, when one person dies, the “other person’s half” is available to send to the bypass trust.

Unfortunately, this has generally not been true. However, according to the IRS and the courts, here is the latest status:

- Property held solely in your own name is, of course, no problem.

- If Tenants in Common is used, your portion of the property is definitely “in your own name.” You can sell or will your portion without the co-owner’s consent, so there is no problem here. Thus, it can easily be specified to be sent to the bypass trust and save estate taxes.

- Joint Tenancy has had its status revised somewhat, with the IRS relenting from a long-held position. The IRS now allows this titling to be interpreted as being “in your own name” when one-half is inherited by a spouse. This portion can be disclaimed by the surviving spouse and sent to the bypass trust to save estate taxes.

- What about Tenants by the Entirety (“TBE”)? Previously, TBE property could not be disclaimed. “The Taxpayer Relief Act of 1997” changed this—TBE property can now be disclaimed and your portion of the property will be considered “in your own name” so it can be sent to the bypass trust and estate taxes can be saved.

Thus, the creditor protection available from owning property as Tenants by the Entirety is no longer in conflict with planning to minimize estate taxes.

Protection from Division Upon Divorce:

Divorce is a fact of life in our society, unfortunately. It is quite unromantic to anticipate it in the choice of how to own property. Nevertheless, it is a consideration.

The issue arises because many states now have “equitable distribution” laws. These laws, in effect, say that it does not matter how property is owned—all property of both spouses is on the table for a fair division as determined by the court.

However, in some states there is an exception. Property owned before marriage or inherited during marriage is exempt from this division. It is as though it did not exist and stays the property of the original owner.

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There is a “kicker”, however. The property must *always* remain in the sole name of its original owner or inheritor, and must never be commingled by joint ownership. If you put that inheritance in a joint account with your spouse, it will be subject to division in case of divorce. Caution: Equitable distribution laws vary considerably and the above interpretation may not apply in all states.

Discounting

Another example of how titling can affect your estate plan is in obtaining discounts.

Suppose you inherit one-quarter of a business (say, a certain number of shares of its stock) from an old friend. The professional preparing the tax return for the estate will not simplistically value that interest at one-fourth of the value of the entire business. This portion can be assessed at a much lower value because it is not easily marketable. This is known as discounting the value.

Now, suppose you inherit the same interest from your spouse or brother. Historically, the IRS has insisted that interest inherited from relatives is not available for discounting. However, after a string of defeats in tax courts, the IRS has abandoned this position. Now, fractional interests inherited from family members can be discounted.

This means that it may be better for a surviving spouse to inherit a partial interest in a property rather than the whole property.

For example, if a couple owns two pieces of real estate, they could own them using two alternative methods:

- They could each own one of the properties, or,
- They could own both properties jointly as Tenants in Common.

If the first method is used, no discounting is available when the property passes from the decedent. But if the TIC method is used, the portion inherited could be discounted when the property passes from the decedent.

With discounting, property is passed to the bypass trust at a discounted value to qualify for the estate tax exemption, but has a much higher ultimate value. (Here’s how it works: At the first death, the kids get half the property from Dad, but it is held in trust for Mom’s use. The value of the property can be discounted so that, for example, one-half of a \$1 million property could be valued at, say, \$300,000 instead of at \$500,000. When Mom eventually dies, the kids get the remaining half from her, also at a discount. Thus, the estate tax value of passing the property to the kids is only \$600,000. Yet, the actual value of the combined halves is \$1 million.)

If the heir was another individual who was left one-half at the first death and one-half at the second death, the value for estate tax purposes would be lower than the combined value of the two halves because of the discounting.

This technique offers major tax savings. But its use must be carefully coordinated with the overall estate plan. The value of the discount must be calculated independently. Seek counsel before assuming you may apply a discount to any property you own.

Conclusion

The laws concerning titling property as well as estate taxes are constantly changing. You need to make sure the information you have is the latest and most accurate.

An estate plan can succeed or fail on the proper titling of property. The documents costing so much to prepare can be rendered worthless if property is not re-titled consistent with the plan and the documents.

Not only must you make the proper decisions regarding joint ownership, but if there is a trust involved, property must be re-titled to the trust. Joint ownership may render trusts and wills useless as tax planning devices, according to attorney Richard Boardman. He further states that “neglect of proper funding defeats 90% of estate plans.”

In order to make sure your estate plan will accomplish your distribution and tax reduction desires, there must be follow-through with respect to titling. Otherwise, he who dies with the most toys will lose a great deal to the wrong Uncle!