THE TROUBLE WITH JOINT TENANCY

AMERICAN ACADEMY | OF ESTATE PLANNING ATTORNEYS

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Although Joint Tenancy offers some short-term conveniences, in the long run it poses a host of problems that can cost you and your loved ones many times the expense and headaches you thought you were avoiding.

For the vast majority of American couples, "till death do us part" also means, "till death do we hold property in Joint Tenancy."

It happens almost automatically. When you and your spouse open a checking account, buy a car, purchase a home, or acquire just about any other asset you can think of, the first — and usually only — impulse is to put the title in both your names as Joint Tenants.

Married couples aren't the only ones relying on Joint Tenancy. This ownership strategy is widely used by friends, life partners, parents, and their children, among others. It's an ownership method so pervasive, many consumers often say they know of no others.

Why is Joint Tenancy so frequently employed? Ironically, otherwise well-informed consumers choose Joint Tenancy because they've heard it is a cost-free replacement for a will and that it avoids probate. These consumers focus on the fact that at the death of one of the owners, Joint Tenancy — or more precisely, *Joint Tenancy with Right of Survivorship* — immediately passes full ownership of an asset onto the surviving Joint Tenant by operation of law. So, yes, it does circumvent probate and avoid the need for a will. At least for the moment.

What all too many Americans unfortunately overlook is the fact that Joint Tenancy only *temporarily* avoids probate. It also brings with it a slew of problems that more than make up for any short-term convenience it provides. In fact, Joint Tenancy can end up costing you — and your loved ones — many times the expense and headaches you thought you were avoiding.

Here Are Just a Few of the Disastrous Consequences:

- Joint Tenancy may avoid probate at the first death. But upon the death of the surviving Joint Tenant, the entire estate will have to pass through probate.
- Joint Tenancy means that the first person to die loses all control over to whom or how his or her assets will ultimately be distributed.
- With Joint Tenancy, spouses effectively lose their right to a double federal estate tax exclusion.

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- Depending on the state in which you reside and the state in which the joint tenancy property is located, Joint Tenancy may expose assets to capital gains taxes that otherwise could have been avoided.
- When the Joint Tenants aren't husband and wife, gift taxes may be due.
- Joint Tenancy exposes one Joint Tenant to the financial risks, liabilities, and other potential problems created by the other Joint Tenant.

Let's take a closer look at each of these areas and how they may affect you.

PROBATE, AFTER ALL

Frequently called the "Poor Man's Will," Joint Tenancy is often used as a replacement for wills and as a tactic for avoiding probate. But this is only half the story. Joint Tenancy does alleviate the need for probate when the first owner dies. But when the second/last owner dies, the entire estate goes through the often costly, time-consuming, and nightmarish probate process.

After 30 years of marriage, Gene and Marjorie Cummings had accumulated the usual trappings of married life. The home they bought 25 years ago for $100,000 was now worth $500,000. When they added in the value of their autos, furnishings, and cash accounts — all held in Joint Tenancy — they were slightly amazed to discover their estate was worth $1.5 million. When Gene died suddenly, Marjorie immediately became the sole owner of their $1.5 million estate by operation of law, circumventing the probate courts. But upon her death 15 years later, the entire estate — now worth over $2 million — was subjected to probate.[1]

LOSING CONTROL

Today more Americans are involved in second marriages than in first. And often, remarriage means that either one or both of the partners has children from a previous marriage. Whenever a parent holds property in Joint Tenancy with a spouse, children are effectively disinherited. That's one reason why parents with children from a prior marriage *should rarely*, if ever, own property in Joint Tenancy with a new spouse. Instead, remarried parents should choose ownership strategies that will help them ensure their children are well provided for in the event of their death.

Even when children from a prior marriage aren't a factor, you may want to think twice about whether you want to give up total control over how the fruits of your life's work are

[1] This example and the others used throughout this brochure are fictional and are used for illustrative purposes only.

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distributed at your death. Since many widows and widowers will eventually remarry, there's a strong likelihood that someone your spouse may marry in the future will be the ultimate beneficiary of your estate. For some people, that's of little concern. But most of us would rather see our assets benefit a relative, friend, or favorite charity, rather than some stranger we've never met.

Jerry and Raine Symington had been married 23 years when Jerry died of a stroke. The Symingtons had no children, but Jerry had a niece and nephew who were dear to him. At his death, ownership of all Jerry's assets passed to Raine, his surviving Joint Tenant. A few years later, Raine remarried a man with two children of his own. He outlived Raine and inherited all of her assets, which his own children ultimately inherited from him. In the end, Jerry's niece and nephew, the two people Jerry loved most next to his wife, were disinherited while his estate went instead to another man's children whom he'd never met.

A TAXING ISSUE

As an estate taxation planning device, Joint Tenancy is not optimal. As the death of the first tenant, there may be little concern. Through the Unlimited Marital Deduction, the government lets spouses pass assets to one another at death estate tax-free. However, when the survivor dies, estate taxes can reduce the legacy the couple thought they were leaving behind. Why? At the death of the survivor, the value of the entire property is included in the survivor's estate. If the sum of all of the survivor's property is less than the amount that can be passed free of estate tax, this may not be a problem. This amount is $5 million for federal tax purposes, indexed for inflation (this amount is temporarily doubled for years 2018-2025). However, many states have a separate state estate or inheritance tax which kicks in at a much lower level.

CAPITAL GAINS EXPOSURE

Couples who live in one of the nine community property states — Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin — pay a high price when they put assets in Joint Tenancy rather than owning them as community property. In these states, using Joint Tenancy can actually expose your estate to costly capital gains taxes. Here's how.

The capital gains tax, that often-debated revenue generator for the federal government, is a tax levied against your profit when you sell an asset. To determine the amount of capital gains against which the tax will be applied, you deduct your *cost basis* in the asset — meaning your investment in it — from the price it fetches when you sell it. The difference is your capital gains, and that's the sum which will be used to compute your capital gains tax. For instance, if you bought rental property for $125,000 and sell it later for $200,000, you would owe capital gains taxes on $75,000.

The federal government provides a capital gains tax break on assets in a person's estate. Called a *step-up in basis*, it simply means that when you die, the government will consider your heir's *cost basis* in an asset to be its current market value, not your original purchase price. So, if the rental property you originally bought for $125,000 is worth $200,000 when you die, your heir's cost basis would be $200,000. If your heir sells it for that price, no capital gains tax will be due.

A very taxing situation occurs, however, when you live in a community property state but hold title to an asset in Joint Tenancy with your spouse. Instead of getting that *step-up in basis* on the entire sum — as your survivor would if the asset were community property or owned outright by you — the government allows him or her only half the *step-up in basis*. That means when the asset is sold, more of the profit will be subject to costly capital gains tax.

California residents, Nick and Sandy Worthington, had an admirable art collection, with pride of place going to an acclaimed Matisse. It was one of the first pieces they bought, paying $50,000 for it several years ago. When Nick died last year, the painting was appraised at a whopping $500,000! Unfortunately, Nick and Sandy had placed ownership of the painting in both their names, as Joint Tenants, rather than owning it as community property. That meant the painting received the favorable step-up in basis treatment on only half its value. So, much to Sandy's dismay, instead of a cost basis of $500,000, she now has a cost basis of only $275,000. If she were to sell the painting today, $225,000 of her profit would be subject to capital gains tax, an expense she could have avoided completely if she and Nick had titled ownership of the painting differently.

JOINT TENANCY AND GIFT TAXES

So far, we've focused primarily on the impact of Joint Tenancy and married couples. But frequently, Joint Tenancy is used as a method of ownership between non-spouses. For instance, friends often buy property together. An aging relative will often make a younger relative a Joint Tenant on property or cash accounts. Parents make their children Joint Tenants with them on everything from cash accounts to cars to the family home.

Unfortunately, the government takes a dim view of these transactions, sometimes considering them to be gifts, not estate planning strategies. That's why many Americans are shocked to discover that the step they've taken to avoid wills and probate will in the long run cost them many, many times more money than it saves. Let's look at some examples.

When a non-spouse is added to the title of property as a Joint Tenant, the government deems it to be a gift. Gift taxes will become due, and the *donor* — the person presumably making the gift — will usually be liable for the taxes. (Under extreme circumstances, however, the *done* — the person *receiving* the gift — may become liable.) How much gift tax is due and when it is due depends on the asset.

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For example, elderly relatives commonly add a younger relative or an adult child to their checking accounts, savings accounts, and other cash accounts as a convenience. As long as the new Joint Tenant withdraws money strictly for the use of the original Joint Tenant, no gift taxes are due. But if he or she withdraws money for personal use, the original Joint Tenant will have to pay gift taxes on that amount.

The gift tax situation is even more dire when real estate is involved. At the time a new Joint Tenant — who is not the spouse of the original Joint Tenant — is added to the title of real property, the government considers a gift to have been made. Gift taxes will then be due on the portion of the property the new Joint Tenant receives. For example, if a father decides to add his son as his Joint Tenant on his personal residence, the government will consider that the son has been given a gift equal to half the home's value, and demand the father pay gift taxes accordingly.

Of course, there are some exemptions available for gifts. Each year you may give away up to the annual gift exclusion, $18,000, indexed for inflation, per individual — and to as many individuals as you want — with no gift taxes due. Gifts in excess of that amount reduce the gift and estate tax exclusion.

So, in many cases, the mere fact that you've added someone's name as Joint Tenant to your checking account or real property may not actually require you to part with cold hard cash. Even if your gift falls within the exclusions described above, however, you must still report it on your federal gift tax returns.

Rebecca Waters was nearing 70 and in frail health. Because she was concerned that illness might make her unable to attend to her affairs, she added her daughter Susan onto her bank accounts and home as Joint Tenant. Susan used the money for her mother's benefit, until Susan's car broke down and needed costly repairs. Rebecca insisted her daughter use her funds to pay for them. When tax time came around, Rebecca never thought once about reporting on a gift tax return the cash Susan withdrew for her own use or the "gift" of half Rebecca's home. But a tax audit of Rebecca's return a few years later uncovered these omissions.

EXPOSURE TO RISK

When you own property with a Joint Tenant, each of you owns half of the asset. That means you effectively lose control of half the property. Whether your Joint Tenant is your spouse or someone else, the implications of this exposure to loss are frightening. For example, half of your asset held in Joint Tenancy could be lost as a result of:

- Your Joint Tenant's bad debts, back taxes or bankruptcy
- Your Joint Tenant's divorce
- Lawsuits or damage awards filed against your Joint Tenant

More than exposure to risk, Joint Tenancy also deprives you of the day-to-day autonomy and control in managing your own asset. Consider, for example, that property is held in Joint Tenancy with someone else:

- You may have to obtain your Joint Tenant's consent before you sell, pledge as collateral, or engage in any other transaction involving your property.
- You may have to obtain the approval of your Joint Tenant's spouse before you can dispose of your property.
- Your asset may fall under the jurisdiction of your Joint Tenant's living probate, if your Joint Tenant becomes incapacitated through illness or injury.
- If your Joint Tenant is a child, your shared property may be the subject of guardianship hearings.
- If your Joint Tenant is a child, you run the risk that his or her financial inexperience, emotional immaturity, or the inevitable mistakes that are part of the growing experience, may have a disastrous financial impact on your shared asset.

Liquid assets — such as cash accounts — can be depleted by your Joint Tenant without any safeguards to protect you.

ALTERNATIVES TO JOINT TENANCY

Early on we said that Joint Tenancy is so pervasive, many people are hard-pressed to think of an alternative. Fortunately, there are several. For instance, you can own property solely in your own name. Or you and another person can own property as *tenants in common*. If you live in a *community property state*, you can elect that ownership option. Or, in some states, you can seek the special creditor protection spouses receive under *tenants by the entirety*. Each of these options avoids some of the pitfalls of Joint Tenancy.

However, none of them — and that certainly includes Joint Tenancy — is a replacement for the thoughtful estate planning that a qualified estate planning attorney can provide you. In fact, all the objectives you might try in vain to achieve through Joint Tenancy can be achieved much more effectively through an option such as the Revocable Living Trust. With a Revocable Living Trust, for example, you can:

Control exactly how your estate is distributed — including who your beneficiaries will be, when they will receive your legacy and how they will receive it.

Ensure that children from another marriage — or children who have special needs — will receive fair treatment from your estate.

- Reduce your estate taxes or eliminate them completely.
- Take advantage of all other tax breaks to which you might be entitled.

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- Retain complete control over your assets while you live.
- Put your legacy out of the reach of your heirs' predators, creditors, and others seeking a piece of your estate.
- Choose when, where, and how you will make gifts to friends, family, and worthwhile organizations.
- Enjoy peace of mind in the knowledge that you can make provisions for your care should injury, illness, or some other incapacity make you unable to do so for yourself.

For current estate tax, gift tax, & income tax figures, please visit our website at *www.ourfirm.com* or contact our office at **(###) ###-####**.

ABOUT THE ACADEMY

This report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive Membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services.

The Academy expects Members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects. To ensure this goal is met, the Academy provides over 40 hours of continuing legal education each year. The Academy has also been recognized as a consumer legal source by *Money Magazine*, *Consumer Reports Money Adviser* and Suze Orman in her book, *9 Steps to Financial Freedom*.

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