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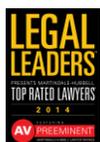
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The Trouble with Joint Tenancy

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 that 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 upon 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 that 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 that 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 override 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 its 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 as to whom or how his or her assets will ultimately be distributed.
- With joint tenancy, spouses effectively lose their right to a \$5,000,000 (indexed for inflation) federal estate tax exemption.
- In Arizona and the other eight community property states, joint tenancy may expose assets to capital gains taxes that could have been avoided.
- When the joint tenants aren't husband and wife, gift taxes and/or gift tax returns may be due.
- Joint tenancy exposes one joint tenant to the financial risks, liabilities, and other potential problems suffered by other joint tenants.

Let's take a close 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. However, the benefit is limited. Joint tenancy does alleviate the need for probate when the *first* owner dies. But when the second 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 there are more Americans in second marriages than in first marriages. Spouses in subsequent marriages typically have 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 would normally choose ownership strategies that will help them ensure that 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 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 next to his wife, were disinherited while his estate went instead to children whom he’d never met.

THE \$5,000,000 QUESTION

As an estate-taxation planning device, joint tenancy is a disaster. The federal government allows individuals to pass up to \$5,000,000 (indexed for inflation) of their assets estate-tax-free. Married couples get a combined exemption of \$10 million. But to capture these exemptions, you must plan properly. joint tenancy gives you no opportunity to do that. Instead, it effectively eliminates one of the two \$5,000,000 exemptions a married couple would otherwise be entitled to claim.

For a surviving spouse, the estate tax issue may be of little concern. Through the *Unlimited Marital Deduction*, the federal government lets spouses pass assets to one another at death estate-tax-free. However, when the survivor dies, estate taxes can loom large, dramatically reducing the legacy the couple thought they were leaving behind.

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

When Marjorie Cummings' husband — and joint tenant — died, she immediately inherited his half of their estate, valued at \$2,000,000. Thanks to the Unlimited Marital Deduction, Marjorie owed no estate taxes on the assets she inherited from her husband. Fifteen years later, however, when Marjorie died, her estate had grown in value from \$4 million to \$5.5 million. And estate taxes became due. Using Marjorie's \$5,000,000 (The rate applicable after 2012) exemption, her taxable estate was reduced to \$500,000. After estate taxes of \$200,000 were paid, Marjorie's son and sole heir inherited just \$5,300,000 of the original estate valued at \$5.5 million. With just a little planning, however, Marjorie and her husband could have eliminated any estate taxes sheltered up to \$10 million from estate taxes. That would have eliminated any estate taxes.

When non-spouses hold property in joint tenancy, estate taxes take an even larger bite out of the deceased's estate. For example, when one of the joint tenants dies, the entire value of the asset is included in his or her estate.

If the survivor contributed to the acquisition of the asset, the survivor must prove how much was contributed, or show that the asset was acquired through inheritance or as a gift, before he or she can keep a share of the asset out of the deceased's estate.

With the entire asset included in the estate of the first joint tenant to die, the full burden of estate taxes must be paid by his or her estate, even though the asset now belongs to someone else.

Dean Mitchell and Janine Wright decided that they would skip the formality of marriage, even though they were as committed to each other as any other married couple could be. Together as joint tenants, they bought a home for \$300,000. When Dean died several years later, the home was valued at \$800,000. The full value of the home was included in Dean's estate for tax purposes, even though Janine now owned it outright. As a result, Dean's estate would be liable for taxes on an asset it no longer owned.

CAPITAL GAINS EXPOSURE

Couples who live in one of the nine community property states — Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Wisconsin and Washington — 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 at which you sell it. The difference is your capital gain, 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 sold 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.

Arizona 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, considering them to be gifts, not estate planning strategies. That's why many Americans are shocked to discover 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 may become due, and the donor — the person presumably making the gift — will usually be liable for the taxes. (Under extreme circumstances, however, the donee — the person receiving the gift — may become liable.) How much of a gift tax is due and when it is due depends upon the asset.

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 may 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 up to \$14,000, indexed for inflation, to one individual — and to as many individuals as you want — with no gift taxes due. Gifts in excess of that \$14,000 are applied to a lifetime exemption of \$5,000,000.

So, in many cases, the mere fact that you've added someone's name as joint tenant to your checking account or real property won't actually require you to part with cold hard cash. Even if your gift falls within the exemptions described above, however, you must still report it on your federal gift tax returns. Otherwise, penalties will be assessed that may in the long run cost you more than the gift taxes you failed to report.

Rebecca Waters was nearing 70 and in frail health. Because she was concerned illness might make her unable to attend to her affairs, she added her daughter Susan to 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 that 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. Although Rebecca's gifts to Susan were applied toward her lifetime exemptions, the IRS levied penalties and interest on the taxes Rebecca failed to report.

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 young, 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 upon 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 that 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 with a spouse. 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 such options as the revocable living trust. With a revocable living trust, you can:

- Control exactly how your estate is distributed — including who your heirs 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.
- Retain complete control over your assets while you live.
- Put your legacy out of the reach of your heirs', creditors, ex-spouses 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.

GETTING STARTED TODAY

Although it might sound as if all these benefits come only through considerable expense and trouble, nothing is further from the truth. An attorney who provides living trust-centered estate planning services will be able to help you achieve all these goals without the bother you might expect, and certainly without the bother you or your heirs will eventually encounter if you own your property in joint tenancy.



For fifty years, the attorneys at Morris Hall, PLLC (MH) have provided quality estate planning documents for our clients. Helping our clients protect their assets for those they love has been our goal from the very beginning. We are recognized throughout the Southwest for our expertise in educating individuals about the importance of proper estate planning. We do this through various speaking engagements and public seminars. We also strive to keep our clients up-to-date through frequent communication like e-newsletters, complimentary reviews and phone calls, and more advanced seminars.

At Morris Hall, we focus on protecting families from the expense and delay of probate and minimizing tax consequences. We also implement basic and advanced estate planning strategies for clients, and assist in the administration of our clients' estates upon death or disability. Since we practice estate planning exclusively, we are able to answer the complex questions and concerns consumers have about estate planning.

MH is staffed with experienced attorneys and paralegals who are trained in the complex areas of trust administration, probate and tax law. Our firm's aim is to help you understand the basic principles of estate planning and why each individual needs a plan. We have helped thousands of individuals secure their assets. By taking advantage of the services that Morris Hall has to offer, you can be assured that your legacy and your family will be protected.

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The American Academy of Estate Planning Attorneys is a member organization serving the needs of attorneys committed to providing their clients with the best in estate planning. Through the Academy's comprehensive training and educational programs, it fosters excellence in estate planning among its members and helps them deliver the highest possible service to their clients.