Musings on Ownership, Part II

This is the second piece in a series of articles covering planning considerations relating to ownership of real property, starting with individual ownership and moving outward to discuss agents, trusts, the role of legal entities in ownership and income and estate tax planning matters relevant to investors holding significant real property investments. The first article covered ownership issues facing investors during life and can be accessed here: **Musings on Ownership, Part I**.

In presenting these articles, we hope to provide a basic education on issues faced by real estate investors and to provide a referral source to attorney resources in your state to the extent that you wish to explore estate and tax planning opportunities in more detail. As always, Asset Preservation, Inc. stands ready to facilitate your tax deferred exchange when you are ready to sell an investment property.

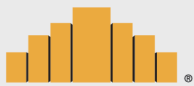
Even if nothing goes wrong with a real estate portfolio during the owner's life, the owner's death can present a serious challenge for those left behind. As a practical matter, death always results in a transfer of property from the deceased person to other persons or entities, but transfers at death can be simple and well planned or slow, complicated and costly. A transfer of real property at death may occur in two ways: (i) by operation of law, or (ii) through the administration of a legal entity called an "estate." A transfer by operation of law occurs where a decedent's death itself triggers a transfer of property without the involvement of a court or third party. With respect to real estate, the most common method for transferring by operation of law is a transfer of property from a deceased joint tenant to the surviving joint tenants who held title at the time of the decedent's death "as joint tenants with right of survivorship." Other examples of transfers by operation of law include a transfer via a contract provision called a "beneficiary designation" commonly used in life insurance contracts, retirement accounts and certain joint or pay-on-death accounts at financial institutions.

Joint Ownership

A transfer among joint owners that occurs at death is instantaneous and may be confirmed by the transferee on presentation of identification and proof of the joint owner's death. In the case of real estate, the surviving joint tenant merely records a declaration of surviving joint tenant to memorialize the transfer. Despite the instantaneous transfer and ease of administration, the surviving transferee may not be quick to pick up and exercise control over the property. Moreover, if a dispute arises concerning the validity of the deceased person's original intent to affect the transfer to the surviving joint owner, court proceedings may be initiated with associated delays and expense. This could happen if the deceased person's estate planning documents conflict with the transfer to the surviving joint owner. For example, a deceased father may have held title to a property with his son as joint tenants with right of survivorship, but his will leaves his entire estate to his spouse. Which instruction should control? Surprisingly, in the absence of undue influence or duress, the transfer by operation of law generally trumps the provision benefitting the surviving spouse in the decedent's will!

But even if there is no controversy, a transfer by operation of law is a blunt instrument insofar as the transfer is generally outright rather than managed for the transferee, may fail to integrate well with the overall estate plan or might have unintended results if the transferee dies before or near in time to the transferor. Consequently, while a simple joint tenancy is easy and inexpensive to implement, there are usually much better ways of reaching the desires estate planning result that would provide for alternative or contingent distribution arrangements depending upon the age, competence and composition of the decedent's transferees.

The second general category of transfers at death is through the administration of a legal entity call an estate. An estate can be a "probate estate" to the extent that the assets of the deceased are managed and transferred by a judge or a "trust estate" to the extent that management authority is exercised by a trustee under a trust arrangement made before the owner's death. The result of both procedures is the same insofar as a judge or trustee is given legal authority to marshal the assets of the decedent, pay the expenses of the decedent's death and to distribute or manage the property of the estate in accordance with the decedent's expressed wishes. Where they differ greatly is in the process by which these activities are carried out.



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Musings on Ownership, Part ll

A Willing Executor

Probate hails from a slower, simpler time. The person appointed by the court to administer the estate is called an "executor" if nominated under a will or an "administrator" if the decedent dies without a will. Either way, the prospective executor or administrator must give notice of the decedent's death to creditors and family members, petition the court for authority to serve as executor or administrator and, in the case of a will, petition a court to admit the will for probate. This process invariably takes time, sometimes several months. Even after the court's appointment of the executor or administrator, however, the executor or administrator may have to petition the court before taking significant transactions involving the assets of the estate, give notice to interested parties and obtain the court's approval before taking the proposed action. All of this happens in a public forum where relatives might intercede, object, challenge the will or otherwise cause confusion and delay. While there are abbreviated probate procedures that would enable an executor to obtain approval of specific actions to protect the estate, even these procedures involve the use of an attorney, the preparation of a petition to the court and the delivery of notice to interested parties. In the end, delays, public disclosure and expense are hallmarks of the probate process increasing the potential that something will go wrong when there is no person authorized to act or the where the executor is unable to respond quickly to manage the problem and mitigate the cost to the estate.

A Matter of Trust

Although there is a more formal legal definition of a trust, a trust is generally a private contractual arrangement between a "settlor" or "trustor" (the terms settlor and trustor are interchangeable and refer to the person who creates and transfers property to the trust), a "trustee" (a person or entity given authority to manage the property transferred to the trust) and a "beneficiary" (the person for whos benefit the trust property is held). The contract establishing the terms of the trust is referred to as the trust agreement or a declaration of trust. In some cases, a trust is treated as a separate legal entity apart from the trustor. A trust may be "revocable" if the trustor retains the right to modify or cancel the trust, or "irrevocable" if the trustor relinquishes the right to modify or cancel the trust. The question of whether a trust should be revocable or irrevocable depends upon the trustor's specific objectives, but revocable trusts are generally used to express and carry out the trustor's estate management and post death distribution objectives. Only after a revocable trust has been drafted to express the trustor's estate planning wishes does the client consider other trust arrangements to implement other, usually tax related objectives through an irrevocable trust.

Like a will, a revocable trust enables a property owner to provide specific instructions with respect to the transfer of property at death taking into account variables like the age, competence and composition of the decedent's transferees. Apart from the specification of beneficiaries, a revocable trust has several distinct advantages over a will. Unlike a will that has legal effect only at death, a trust is effective during the trustor's life. As a consequence, a successor trustee may be appointed in the trust document to act in place of the trustor in the event that the trustor is absent for an extended period or becomes incapacitated. This can be very important insofar as the ability of a successor trustee to manage the assets of the trust avoids the need for a general power of attorney or for a court's appointment of a conservator of the estate on the trustor's incapacity. Finally, any property held in the trust at the time of the trustor's death is generally not subject to the public probate procedures and can be administered by the trustee in accordance with the terms of the trust in a private and less formal manner. There are few formalities associated with the trustee's ability to act to preserve and protect the estate other than a strict fiduciary obligation to do so.

Thus a revocable trust, together with a power of attorney for property management, is usually prepared by an estate planning attorney to form the basis of the client's plan with respect to the distribution of property at death, but also to provide for continuity of management authority during the trustor's life in the event that "something should go wrong." Upon formation of the trust, title is transferred from the individual property owner to the trustee of the newly formed trust (usually the property owner in his or her capacity as trustee of the trust). An investor holding property in their individual name should give serious consideration to the formation of a trust as a means of protecting their property for themselves and their families.

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