Deeding Property to Avoid Probate – Bad Idea

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January, 2018

Following the holidays there are a number of clients who come to see me and ask to have their children added to their property for the purposes of transferring such property at their death. In essence, they are looking to avoid probate. What they don't realize is that such changes are fraught with potential consequences. Once the consequences are explained, almost all of my clients elect not to make the change. Here are some of those consequences.

In many of these cases, the property which is having the children added are vacant lots. The major issue with doing this are capital gain taxes. The IRS has established a rule that when an owner adds another to their property without proper payment for such property, the recipient of the gift takes the property at the base value of what the donor paid for it. What this means is, if Mom and Dad purchased the property back in 1980 at $5,000.00 and the children are added to the property in 2017, they take ownership at the original value of $5,000.00. Upon the death of the surviving parent, should the children elect to sell the property, any amount over $5,000.00 will be subject to Federal capital gains tax (depending on whether it is short or long term). Therefore, if the property is sold at $30,000.00, a $25,000.00 capital gain tax will be charged to the children.

Can this be avoided? Of course, but it means that the surviving parent needs to convey the property via their Will or Trust instrument to the children. Doing so gives the children a step-up in basis in the value of the property. Therefore, if the property is sold following the death of the surviving parent, the value of the property receives a step-up in basis to the fair market value of the property at death or 6 months following such death. The sale of property at $30,000.00 has no capital gain impact, assuming it is the fair market value at death or 6 months after death. Given today's tax rates you just saved your children $5,000.00 in taxes.

In a minority of situations, the surviving parent desires to have the children added to their homestead property which presents an even greater problem because the value of the property is greater than that of a vacant lot. However, what many people do not realize is, if the homestead property is subject to a mortgage, the IRS considers the transfer to the children as a sale subjecting Mom and Dad to the capital gain rules of the Treasury Department. Even more important, because the children are generally not permanent residents of the homestead, they would fail to qualify for the $250,000.00 exemption for purposes of reducing their capital gain taxes at the point of selling the property.

Although a gift tax consequence exists when transferring property, such consequences do not affect a majority of persons. Upon placing your children onto a deed to avoid probate, a gift has occurred. If the value of the property is greater than $14,000.00, notification to the IRS is required. However, you are entitled to a $5.49 million-dollar exemption before any gift tax is imposed. It's just the aggravation of having to report it that creates the consequence.

What about the protection from creditors provided by Article X, Section 4 of the Florida Constitution? That level of protection could be lost when adding the children to your property. The protection against creditors is provided to those Florida citizens whose property is considered their permanent residence. When the children are added to Mom and Dad's deed and are not permanent residents of the homestead property, any judgments against the children are enforceable against the homestead at the point of its sale. Thus, if child A has a judgement against them for $100,000.00, and the property is sold with a profit of $100,000.00, child A and all of the other persons listed on the deed will receive zero profit. However, had Mom and Dad simply placed child A on their Will or Trust instrument as a recipient of their homestead, the children would have received their share of the $100,000.00 without having child A's judgment affect their share.

What if the property is part of a homeowner's association? In many situations, the addition of any person to a deed may require that the added person be approved by the association. This is especially true when the community has a 55+ age restriction. Failure to get approval can result in violations subject to fining or worse, having the transfer set aside.

Finally, another issue to consider is the potential for a partition action. This can occur when one of the children becomes angry and wants out of the joint tenancy with Mom, Dad and the other siblings; but, also wants their share of the value of the property. They can do this by simply filing a law suit under the premise of partitioning the property. When this occurs, the court enters into the picture and enforces the property's sale on the court house steps. Nobody wins in this situation and families are generally torn apart.

As you can see, simply adding a child to your property may seem like a good thing to do; but, it is loaded with consequences from taxes to judgments. Before you commit to adding your children to your property, go see the lawyer of your choice and discuss the options, in the end, your children and you will be much happier.