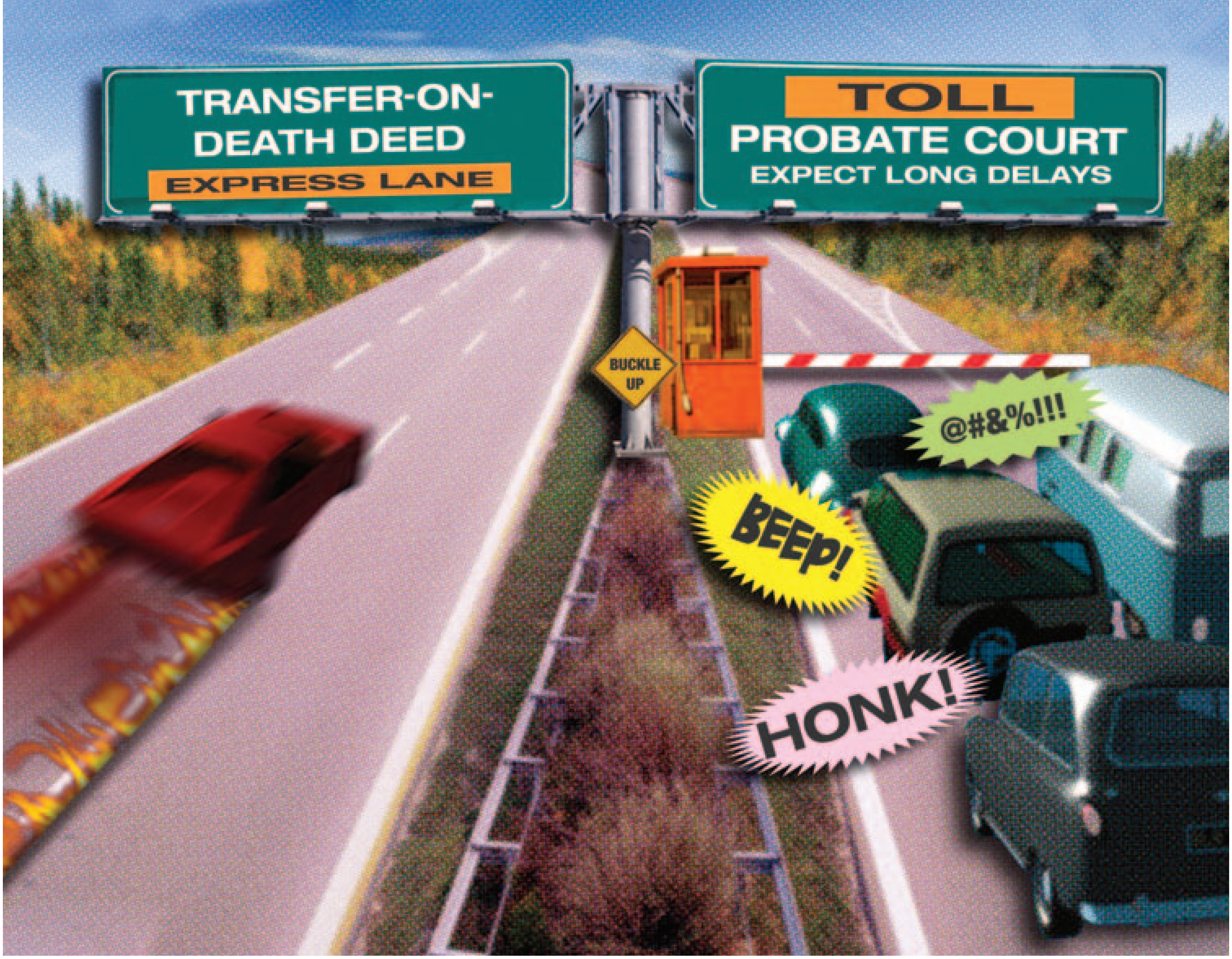

Andrew O. Alcala

The Significance of the Transfer-on-Death Deed

By Michael A. Kirtland and Catherine Anne Seal

In the world of estate planning attorneys, the debate over the advantages and disadvantages of the probate process, normally juxtaposed against the use of revocable trusts, seems never-ending. This article is not designed to enter that fray, but rather to examine one aspect of the debate, the growing trend toward the recognition of the transfer-on-death deed. Nine states now recognize transfer-on-death deeds: Arizona, Arkansas, Colorado, Kansas, Missouri, Nevada, New Mexico, Ohio, and Wisconsin. Without aligning with those in favor of, or opposed to, the probate process, this article discusses the use of transfer-on-death deeds (referred to in some states as "beneficiary deeds") and their advantages and pitfalls in modern estate planning.

The concept of transfer-on-death deeds is directly comparable to the use of pay-on-death or transfer-on-death

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accounts at banks or with brokerage houses. Most state transfer-on-death statutes are based on the Uniform Nonprobate Transfers on Death Act, promulgated by the National Conference of Commissioners on Uniform State Laws in 1989. Under transfer-on-death deed laws in the nine states recognizing such post-mortem transfers, the owner of real property is permitted to designate by deed, during the life of the owner, a beneficiary of the real property, and, on the death of the owner, the property passes to the beneficiary without the need for probate. Typically, by recording a death certificate, and possibly an affidavit, the beneficiary becomes the new owner of the property. See, for example, Colo. Rev. Stat. § 38-31-102.

Adding a Current Owner to a Deed: Tax and Other Negative Consequences

Probate is relatively inexpensive and straightforward in states that have adopted the Uniform Probate Code, but such simplicity is not the norm in all states. The result has been a plethora of probate avoidance techniques, both simple and complex. Typical of probate avoidance techniques is the addition to the deed of the intended beneficiary during the lifetime of the grantor. This technique is commonly seen in the use of joint tenancy deeds. With the continued aging of the American population, attorneys practicing estate planning see more and more aging parents adding their adult children's names to deeds as joint tenants with right of survivorship with the parents, as a method of avoiding probate, for convenience, and because the aging parents or the children incorrectly perceive that adding the adult children to the deed protects the land from Medicaid recovery. Many flaws exist, however, in the use of joint tenancy with right of survivorship for these purposes.

For individuals adding adult children as joint tenants to transfer property at death without probate, tax and other unintended consequences can arise. Execution of a deed creates a completed gift in most states and in all states no later than at the time of recordation. Such a completed gift results in the imposition of federal gift tax to the extent that the gift exceeds the annual gift tax exclusion amount, currently $12,000 per year per grantee. 26 U.S.C. § 2503. For the vast majority of individuals, this is not an issue because, in addition to the annual exclusion, there is a lifetime applicable exclusion amount of $1 million. 26 U.S.C. § 2505. Any amount gifted over the annual exclusion amount, however, results in the use of a portion of the individual's lifetime exclusion amount. For wealthy individuals, this may or may not be a desired outcome when the totality of all gifts made is considered. Too often, no federal gift tax return is filed for such transfers, which can result in the imposition of penalties and interest in addition to any tax due.

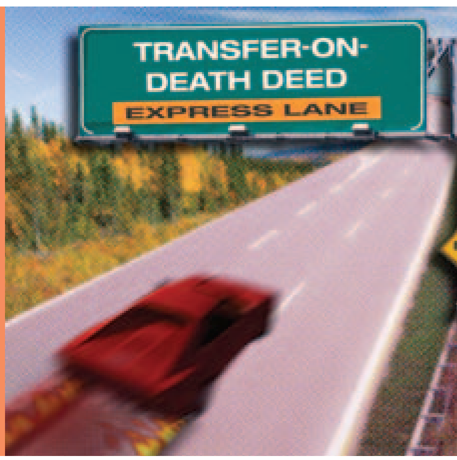
Although the federal estate and gift taxes are reaching fewer people with the recent and scheduled increases in the exclusions and exemptions, adding the name of another joint tenant to a deed still has consequences for capital gains taxation. When an individual makes a gift to another person during the grantor's lifetime, the capital gains tax basis of that property in the hands of the new owner remains unchanged. Should the individual choose to sell the property, the capital gains tax will be determined based on the grantor's tax basis in the property. Contrast this result with what occurs under a transfer-on-death deed, when the transfer is deemed to occur at the grantor's death and the grantee receives a step-up in basis. 26 U.S.C. § 1016.

In addition to tax consequences, other unintended liabilities can occur as a result of adding the name of an adult child as a joint tenant. Because the addition constitutes a completed gift, the ownership interest of the child vests at that time. Should the child become involved in a lawsuit, most typically a divorce, a tort action, or a bankruptcy proceeding, the real property on which that child's name has been added is subject to those legal proceedings.

In the case of the adult child's divorce, the value of the child's interest in the property may be considered in the determination of the division of marital assets. In community property states, this may result additionally in the court considering the property to be a marital asset, resulting in the divorcing spouse having an undivided one-half interest in the child's share of the property. In the case of a tort by the child against a third party, resulting in the award of damages, the property jointly held with the parent is subject to attachment to pay the damage award. Although many states exempt homestead property from attachment, it is likely that the interest owned by the child would not be considered homestead, as it is the parent, not the child, living on the property. At least in theory, the property could be ordered to be sold to satisfy a judgment. The same is true in a bankruptcy proceeding against the child. Although the family members may think of the property as belonging only to the parent, in fact the child holds an interest in the property that could be used to satisfy creditors' claims. In the unusual, but not uncommon, case in which the child dies before the parent, the same is true: the child's creditors may be able to attach the property to satisfy claims in the deceased child's probate.

Even more sinister, perhaps, is the case of the adult child whose name is placed on the house, and then the child pledges the property as collateral. Two potential difficulties arise in this situation. First, if the child fails to honor the debt, the creditor may attach the child's interest in the property. Second, should the parent decide to use the property as collateral, he or she may be unable to borrow against the property because it is already encumbered or because the child refuses to cooperate in the loan process. In either event, the owner who adds a child's name to the deed as a joint tenant may be deprived of access to the equity in what often is the most valuable asset of an elderly individual, the home.

Another common variation on the adult child being added to the deed as a joint owner is the addition of the unmarried partner. For economic reasons, it is not unusual for older individuals to live together in an intimate relationship but not marry. In so doing, economic benefits such as Social Security and pension benefits, either from their own work efforts or from benefits received as a surviving spouse, can be maintained, enhancing the income and lifestyle of the individuals. The couple may wish to see themselves in a committed relationship but not want their retirement benefits to diminish as the result of remarriage. For this reason, they may choose to stay unmarried yet intermingle their assets, including real property. By placing the partner's name on the real property without considering the legal consequences, negative results can occur.



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Unfortunately, growing older does not shield anyone from entering into personal relationships that do not last. But if the owner of real property adds the name of a partner to his or her deed as a joint tenant, that constitutes a completed gift. In the event the relationship ends before death, it is not unusual for the partner whose name was added to the deed to insist on being compensated before being willing to execute a subsequent deed that removes his or her name from the deed. As with any divorce-type situation, the positive feelings that existed at the time the property was deeded into joint ownership no longer exist. The departing partner may not be willing to remove his or her name voluntarily from the deed or may demand excessive compensation.

Even assuming a positive, continuing relationship between unmarried individuals, health and long-term care issues may develop that can significantly affect the innocent addition of a partner to a real property deed. Should the partner's health deteriorate to the point where long-term care in an assisted living facility or nursing home is required, the financial cost of such care is expensive. For many elderly individuals, the cost of such arrangements quickly uses up the available cash of the institutionalized individual. If governmental benefits are required in the form of Medicaid nursing home financial assistance, all available assets must be expended except for a nominal amount. If the couple is married with one of the spouses continuing to live in the community setting, the house is generally exempt from being considered in determining the Medicaid eligibility of the institutionalized spouse. 42 U.S.C. § 1396p. If the couple is unmarried, however, such a spousal exemption is not available, and the value of the institutionalized individual's interest in the jointly owned property will be considered in determining Medicaid eligibility. For most elderly individuals living together, this was never in mind when the partner's name was added to the deed as a joint tenant. Under the Deficit Recovery Act of 2005 (DRA 2005), 120 Stat. 4, Medicaid eligibility rules have been significantly altered and made more restrictive. Among the changes was the extension of the so-called look-back period for uncompensated transfers of assets (such as adding someone's name to a deed) from three years to five years. 42 U.S.C. § 1396p. In addition, the imposition of a disqualification period (also known as a "penalty" period) has been modified so that the period of disqualification from Medicaid eligibility, which used to begin running at the time of uncompensated transfer, now only begins to run when the individual applies for Medicaid long-term care assistance. 42 U.S.C. § 1396p. The result is that anyone who adds the name of another individual to his or her deed (other than a spouse) within five years of applying for Medicaid assistance will be ineligible for a lengthy period of time beginning on the date the person would otherwise be eligible for Medicaid assistance. (The exact disqualification calculation depends on the value transferred and the average cost of nursing home residency in a particular state, which can vary widely.) Under the Medicaid law in effect before DRA 2005, the penalty period might easily have expired before application for Medicaid assistance. Under the new law, it will not even begin to run until the application date.

Because of these various issues and the strong desire to avoid probate, the concept of a transfer-on-death deed has been implemented in a growing number of states. Although the specifics of the transfer-on-death deed laws vary from state to state, they share certain essential features. The owner or owners of real property can execute a deed naming a grantee-beneficiary. At the time of the owner's death (or in the event of multiple owners holding rights of survivorship, the last surviving owner's death), the property vests in the grantee-beneficiary.

The documentation of the transfer of ownership as a result of death is typically completed by recording the death certificate in the county where the property is located. In some jurisdictions, an affidavit also must be filed.

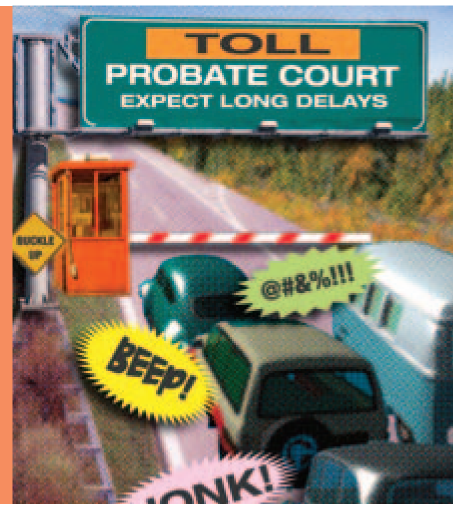
To avoid the problems of so-called pocket deeds, which are executed but not recorded, the statutes require the transfer-on-death deed to be recorded. See, for example, Ariz. Rev. Stat. § 33-405. In most states, the deed must be recorded before the grantor's death; see, for example, Nev. Stat. § 111.109(6). This requirement ensures that no "deathbed transfers" can take place. A deed not recorded before death would simply be void.

All existing transfer-on-death deed statutes permit the grantor to revoke or amend the deed without the consent of the grantee-beneficiary. When the purpose of devising the property to a particular heir is in recognition of the efforts of an adult child or other individual to care for the grantor, the transfer-on-death deed ensures that the grantee-beneficiary will not cease his or her efforts to care for the grantor. Rather, because the grantor can change the deed at any time, the incentive remains to continue caring for the grantor.

Because the grantee-beneficiary has no ownership in the property before the death of the grantor, the beneficiary has no ability to borrow against the property, nor is there any interest that can be attached as the result of a bankruptcy, divorce, or other judgment. The property ownership remains solely in the grantor, who is free to do with the property as she or he wishes. No unintended liens, foreclosure, or other divestment of interest in the property against the grantor can occur as the result of the independent actions of the grantee-beneficiary.

To prevent abuse of the transfer-on-death deed as a creditor avoidance technique, most states have included in their statutes a variety of protective provisions. Each state has included a provision that timely filed creditor claims against the estate of the grantor may attach to the transfer-on-death deed property. As is common with real property transfers at death, the typical statute requires that any outstanding mortgage on the property runs with the property and liability thereby transfers to the grantee-beneficiary. See, for example, Colo. Rev. Stat. § 15-15-407. In addition, some statutes include provisions that on divorce any transfer-on-death provision in a deed benefiting the former spouse is thereby automatically revoked. See, for example, Mo. Rev. Stat. § 461.051. Finally, in an effort to prevent misuse and abuse of the deed, the statutes often require specific language to be displayed prominently on the deed indicating that the interest does not pass to the grantee-beneficiary until the death of the current owner and notice that the deed may be revoked at any time. See, for example, Colo. Rev. Stat. § 15-15-404.

The question of eligibility for Medicaid during the grantor's lifetime should not be confused with the question of estate recovery after the grantor's death.



Medicaid and Transfer-on-Death Deeds

A frequently discussed question during the enactment of transfer-on-death deed legislation concerns the status of the property in the event that the grantor should attempt to qualify for Medicaid assistance, most typically Medicaid nursing home assistance.

Under Medicaid qualification rules, both before and after enactment of the DRA, individuals who apply for Medicaid assistance must disclose any transfers of assets within a specified period of time before completing the application for benefits. Although the DRA changed this so-called look-back period, the question remains whether execution of a transfer-on-death deed constitutes a transfer as defined under the Medicaid rules, or whether such real property is to be considered an available resource for Medicaid qualification purposes. If the execution of the deed is considered a transfer, it would trigger a disqualification period, depending on the value of the property. Logically, as the grantor still retains full control and enjoyment of the property, including the right to revoke the transfer-on-death deed, sell or transfer the property, or encumber it with debt, the mere execution and recordation of a transfer-on-death deed should not be deemed a transfer and should not change the status of the asset for purposes of Medicaid. The one state statute to address the issue, Colorado's statute, reaches the opposite result, however, declaring the grantor ineligible for Medicaid assistance while the grantor has a transfer-on-death deed in existence and transforming the property into a countable resource. But to lessen the transfer-on-death deed's effect on an unknowing grantor, the law further allows the grantor to "unwind" or revoke the deed without the imposition of a disqualification period. Colo. Rev. Stat. § 15-15-403.

The question of eligibility for Medicaid during the grantor's lifetime should not be confused with the question of estate recovery after the grantor's death. To ensure that transfer-on-death deeds cannot be used to avoid Medicaid recovery, some states have specifically so provided by statute. See, for example, Nev. Rev. Stat. § 111.109(9).

Problems and Solutions: Effective Planning and the Use of Transfer-on-Death Deeds

As with many estate planning techniques, the transfer-on-death deed cannot be contemplated in isolation from an overall approach to estate planning. As with any client, the attorney asked to draft a transfer-on-death deed should inquire into the motivations for such a deed. This is especially important if the client is elderly and has been brought to the attorney's office by an adult child, other relative, or a friend who also will become the grantee-beneficiary under the deed. The potential for undue influence must be taken into account. Although in hindsight this may seem a classic undue influence scenario, it may not immediately present itself as such to the attorney. Careful discussion about the motives and intentions of the current owner should be included to ensure the client understands the consequences of his or her actions in creating a transfer-on-death deed. It is not at all unusual for a client to latch onto the concept of this deed as a way of avoiding the "horrors of probate," because a close friend or neighbor has such an instrument or because such a person, no better informed than the client, recommended such an instrument. Inquiring about the goals of the client and educating him or her on the available alternatives remains an essential step in the estate planning process.

All states that have enacted transfer-on-death deed legislation permit the revocation of the deed at any time. Consider, however, that the elderly client is much more likely to suffer an incapacitating event than is common in the general population. Once incapacitated, through dementia, stroke, or other incapacitating event, no competent party may exist to revoke the deed because of changes in family circumstances or because of the need to qualify the individual for Medicaid assistance. The attorney drafting the estate plan that includes a transfer-on-death deed should ensure that a durable power of attorney exists, with specific provisions to permit the revocation of a transfer-on-death deed. Without such a power of attorney, a single transaction conservatorship may be the only alternative to permit the revocation of the deed and subsequent qualification for Medicaid. Such a proceeding, though provided for in virtually every state, is much more expensive and cumbersome than execution of a well-written durable power of attorney permitting transfer-on-death deed revocation.

The transfer-on-death deed is especially effective for an individual whose only substantial asset is the home in which he or she lives.

Effective Use of the Transfer-on-Death Deed

Transfer-on-death deeds are not a panacea for all estate planning issues. But when carefully considered, they can be an effective instrument for the elder law and estate planning attorney. The transfer-on-death deed is especially effective for an individual whose only substantial asset is the home in which he or she lives. Even in probate-friendly states, where the only reason for the opening of a probate estate would be for the transfer of real property, either because of a lack of assets or because, when all other assets are jointly held with right of survivorship or as pay on death accounts, the transfer-on-death deed permits the completion of the nonprobate transfer of assets for such estates. Although many states have a small-estate transfer procedure to avoid full probate proceedings, the dollar limit of such small-estate proceedings varies widely. In Alabama, for example, a small-estate proceeding is limited to estates of $3,000 or less, too small for virtually any estate, and the statute cannot be used for real property in any event. Ala. Code § 43-2-692. At the other end of the spectrum, California's small-estate procedure has a $100,000 limit. Cal. Prob. Code § 13100. Even in larger but still modest estates in which joint tenancy is not the appropriate ownership method, or in which the real property is not intended to go to a spouse, the transfer-on-death deed can avoid the need for probate. Most typically such a situation would be one in which the spouse is of a second marriage and the intent of the grantor is to keep the family home in the grantor's lineage. Also typical would be a situation in which the grantor's spouse in a second marriage might have tax, creditor, child support, or other legal issues, which would indicate that placing the name of the spouse on the real property would be unwise and subject the property of the grantor to creditor or IRS claims and liens.

Family dynamics are complex even in the best of families. This is especially true when one adult child has taken up the responsibility to assist a parent with his or her daily living needs so as to permit the parent to continue to live in the home rather than having to enter an assisted living facility or nursing home. Often this adult-child caregiver has sacrificed his or her own employment opportunities to care for the elderly parent. Because of such sacrifice, the parent may wish to benefit the child to a greater extent than would be proportional to the other children/beneficiaries in the parent's estate plan. Nevertheless, it is also often true that the parent may not wish to reveal to the other beneficiaries of the estate such disproportional benefit to the caregiver child. The transfer-on-death deed permits the grantor to place the real property outside probate and thus eliminate the need to reveal in the will that the caregiver child has been disproportionately benefited. Although the objective observer may note that such disproportionate benefit will be revealed at the time of death anyway, it may be important to the grantor that it not be revealed during his or her lifetime to facilitate harmony within the family. In addition, the grantor may believe that making such a disproportionate transfer within the will may invite a will contest. Although such contests are difficult to prosecute, the mere threat may cause the intended beneficiary/caregiver child to abandon that which the grantor intended them to have for the assistance provided during the grantor's lifetime.

In today's society, in which nontraditional relationships are much more common than in times past, for both same-sex couples and unmarried heterosexual couples, the transfer-on-death deed can avoid the litigated issue of adding the partner as a joint tenant to a deed to property purchased solely with the assets of one party. The transfer-on-death deed permits this tangible acknowledgment of the commitment of the couple by placing the partner on the deed as a grantee-beneficiary rather than a co-owner. An unmarried couple, regardless of sexual orientation, does not enjoy the benefits that a married couple does in the event the relationship ends. The result is often expensive and difficult litigation to determine the property rights of the parties in the real estate. Although not a substitute for a co-habitation agreement, the transfer-on-death deed eliminates what is often the most contentious aspect of the breakup of a nonmarital relationship.

In Uniform Probate Code states, revocable trusts are less common than in other states, such as California and Arizona. This is so because of the relatively uncomplicated and inexpensive probate procedures in the Uniform Probate Code. Yet, even in Uniform Probate Code states, and especially elsewhere, revocable trusts are set up specifically to ensure effective transfer of assets, quite often because of controversial relationships or because the individual may own real property in multiple states. But the costs of drafting, funding, and administering a revocable trust may seem prohibitive for small estates. Most typically, the individuals' real property assets were the impetus for the creation of the revocable trust in the first place. Certainly, it is not uncommon for a revocable trust to fall into disrepair, through neglect, time, and changes in circumstances, even after the most careful and effective initial drafting by the attorney. When real property is the main, or perhaps even the only, asset of the revocable trust, the transfer-on-death deed provides a less expensive and much less cumbersome asset transfer procedure.

Conclusion

Simplification of peoples' lives is an essential, though oft forgotten, purpose of government. Rightly or wrongly, many people see the avoidance of probate as an essential goal in their lives, believing it to be an expensive vestige of an antiquated and byzantine real property transfer system. The enactment of a transfer-on-death deed statute provides an alternative to probate, as well as to many other problematic methods of property transfer, benefiting clients and simplifying the real property transfer system. In a growing number of states such transfer-on-death deeds are providing an inexpensive alternative to probate, as well as providing protection for the elderly client against unintended burdens against his or her real property. ■

When real property is the main, or perhaps even the only, asset of the revocable trust, the transfer-on-death deed provides a less expensive and much less cumbersome asset transfer procedure.