The Risks of Bad Advice

Introduction and Overview

Herb Fineburg: Hello, Danielle and Max. Our next gathering of Trust Us on how to handle certain questions that clients raise.

Risks of Adding a Child to a Checking Account

Herb Fineburg: One of the ones that I read about recently was a national magazine was giving legal advice to the readers and it was suggested in the magazine by the writer who happened to be just a lay person who concluded that it is best to add a child to your checking account instead of leaving just the parent on the checking account. The author thought this is a way to avoid probate in whatever state mom died in. Today, we're going to talk about what are the implications of using these made up methodologies for estate planning instead of going to somebody who's informed and getting some good advice on how to handle it.

Herb Fineburg: Danielle, what do you see as a problem if one of the children is listed on the account and mom dies?

Danielle Friedman: So this falls under the category of just bad advice, because there's no one size fits all approach to estate planning and a number of issues arise if you add your child as a joint owner on the account.

Tax Implications of Joint Accounts

Danielle Friedman: On the tax side forgetting the other implications, but just from a purely tax perspective when someone dies you get a full step up in basis equal to the date of death value of the asset.

Danielle Friedman: So for example, if there's an investment account where mom bought stock at $100 and when she dies it's worth $100, 000 and the kids inherit it, their basis is $100, 000. So when they go to sell the stock, their capital gain is greatly reduced, if not eliminated. If mom adds the child to the bank account during her lifetime or to the investment account and the child is treated as a 50 percent owner, you lose that step up in basis with respect to the interest owned by the child.

Danielle Friedman: So when mom dies, only half of the account gets a step up in basis, which has huge tax implications for the heirs.

Inheritance and Gift Tax Consequences

Danielle Friedman: You also would have gift tax consequences if mom added child to an account as a joint owner. To the extent there was value in the account. She may be even making a taxable gift.

Danielle Friedman: I don't know if what her exemption is and the year that she's making the gift and adding the child to the joint account and lastly in certain states like in Pennsylvania where I practice you may have unintended inheritance tax issues or death tax issues. If mom was married, but added the child to the account for convenience purposes, but ultimately wanted to leave the account to her husband or someone else the child becomes the automatic heir of that account and in Pennsylvania, it would trigger an inheritance tax of four and a half percent.

Danielle Friedman: This type of advice really needs to be taken with a grain of salt because every situation is different and the unintended consequences are severe. Max, I talked about the tax consequences, but there's also real personal consequences, I would say and potential litigation that could arise from these types of situations that I know you've seen before.

Max McCauley: Absolutely.

Family Strife and Legal Issues

Max McCauley: So beyond exposing those individuals to unnecessary federal income tax or inheritance tax or gift tax. You also run into issues of family strife, where if one child was placed on the account and the other children didn't know about it or didn't agree with how the money was spent, you will often find the children making allegations of theft or in reality, theft might have occurred because somebody had access, unfettered access to the account as a signer.

Max McCauley: Family strife is a large issue, but beyond, there's another issue hiding in here that comes up often. And I've answered this question several times a year for the past five or ten years.

Adding a Child to Property Deeds

Max McCauley: And that is, should I add a child to the deed of my house? And that also has the same tax issues that you've identified, Danielle, and that the house might have, maybe it was a beach house, for example I can give you a good example of a beach house where the property would have been bought 30, 40, 50 years ago for $10, 000 and is now worth $2 million.

Max McCauley: When you add the child to the accounts, you have lost the step up in basis. If you just added one child to it equal to half of that fair market value. So you'd be paying, if you sold it, you'd be paying capital gains tax on half without the step up of basis, which can be a very expensive issue. The other issue that arises, again goes back to the family strife, in the same example, it was a beach house.

Max McCauley: It was bought for a few thousand dollars 50 years ago. The house isn't worth much today, but it's oceanfront property with a wonderful view, a $2 million lot. And the individual had three children and for convenience added just one of the children to the house. And when mom passed away, the daughter then was the sole owner of the house and refused to sell it and refused to share the property with the other two sisters.

Max McCauley: And so now that family of three, two sisters speak, but the third, who owns the house, has a piece of ground worth two million, a house that has no value, and the family has torn themselves apart. They walk by the sister and the house all the time, but they don't talk to each other anymore. And I've seen that firsthand.

Max McCauley: But, I think that is a question that I get routinely, and that is, for convenience or estate planning or sometimes people think this is a way to avoid and deal with Medicare or Medicaid planning by adding a child and it just doesn't work for tax reasons, it doesn't work for family reasons, it certainly doesn't work for Medicare or Medicaid planning because there's some look back rules and other rules that apply.

Max McCauley: Again, I routinely. Tell folks that's a bad idea to add anybody to an account or deed when you're talking about property that is appreciated substantially in value since it was acquired. Beyond all that, Danielle, there are better ways to handle this problem, correct?

Better Alternatives for Estate Planning

Max McCauley: Instead of just simply, for convenience, adding a name, how else could we accomplish this goal with proper planning?

Danielle Friedman: Sure. So for probate avoidance purposes, if that's the goal, put the asset in your living trust, or if it's a bank account or investment account that permits a beneficiary designation, designate your living trust as the beneficiary, or if you don't have a living trust, which you should designate the individuals that you wish to inherit the account as the beneficiaries. You've avoided probate.

Danielle Friedman: You may still have inheritance tax, but at least you've gotten a full step up in basis with respect to the asset that you're leaving. The other solution, for convenience sake is to have a power of attorney and I have had multiple clients who have powers of attorney that we've created for them that are excellent documents, but then they go to the bank and the bank does not feel like dealing with their legal department so they tell the client, just add your child or whomever you be named as your agent to the account as a signer on the account and then the client doesn't know any better. But then we learn of it when it's too late, when someone has died and the agent is actually on the account as an owner or a co-signer, which has the same effect, at least in Pennsylvania.

Danielle Friedman: And again, all these unintended consequences stem from that. You also have, your situation, Max, where there can be allegations of theft or wrongdoing. And if you have someone on a joint account, it's very difficult to argue that the account holder was doing something nefarious with money to which they had a right.

Max McCauley: That's the important point, right? That they actually, by adding the child to the account They now own the proceeds in the account, and they can dispose of those proceeds as an owner, as opposed to if they'd used the power of attorney.

Danielle Friedman: Then the agent, let's say the child is the agent under the power of attorney and they're acting on mom's behalf, but maybe they're doing something they're not supposed to do.

Danielle Friedman: The agent is a fiduciary, not only to mom, but also to the heirs of the estate. If the siblings of the agent under the power of attorney think that there was some sort of wrongdoing, they have a much better chance of succeeding in court. An agent under a power of attorney can be held to account, has to submit documents and an accounting to the beneficiaries of the estate.

Max McCauley: If you're on the account, you own it. If you're on the account, you own it and you can dispose of it how you desire, whether that is what mom wanted or not, or the parent.

Danielle Friedman: Absolutely. So definitely using powers of attorney, using living trusts, using beneficiary designations. Those are the way to go.

Danielle Friedman: Adding people to deeds may have realty transfer tax consequences, which we haven't touched on, but again, there's a number of ways that people could get tripped up if they don't consult with their estate planning attorney and rely on broad advice.

Conclusion and Final Thoughts

Danielle Friedman: Herb, do you have anything to add to that in your years of experience? What other pitfalls have you seen?

Herb Fineburg: I think all the ones that you highlighted, which again are income tax hazards. But more importantly, the informal handling of putting somebody's name on an asset, a brokerage account or a deed is dangerous.

Herb Fineburg: Oftentimes the parent is trying to add the person just for convenience, has no intention of, for example putting the house into the sole name of one of three children. But that's the legal effect of adding one child to a deed, one child to a brokerage account. You are then relying upon that child to say, Oh, mom was just doing it for convenience.

Herb Fineburg: I'm really here as your surrogate and whatever I get I will share with you. That takes a big step that requires a lot of cooperation and when doing that the whole concept creates issues of when that child gives 1/ 3rd to one sibling and 1/ 3rd to another sibling, there's gift tax consequences to that child.

Herb Fineburg: He or she is now making a gift. So the best route is to make sure when you add somebody's name, you indicate their capacity. Their capacity may be a co trustee. Their capacity may be an agent under a power of attorney. It shouldn't be, I'm adding Susan to this account or I'm adding Susan to this deed.

Herb Fineburg: That is just ripe for a dispute, false claims of stealing. Sometimes people do steal. So in that situation it's best to be safe to try to follow some of the many options you have for passing property conveniently.

Max McCauley: I agree, Herb. In my experience, I have never provided the advice to simply add the individual to the account or the deed.

Max McCauley: There's always been a better way to do it.

Danielle Friedman: Yeah.

Max McCauley: Always. For a variety of reasons that we've just discussed. But I have never once answered that question affirmatively, and that is to agree that a child should be added for convenience. It's just never been a scenario that's worked out factually. If it happens, it hasn't crossed my desk in 22 years of practice.

Danielle Friedman: Agreed. And again, there's so many solutions. We've named some of them. There are others like life estate deeds and things like that, depending on what state you live in. There's a number of alternatives, but I would just caution listeners, be wary of any estate planning advice that you read that is supposed to appeal to a mass audience because oftentimes you get more than you bargained for.

Herb Fineburg: Great. This has been very informative and useful for our listeners. So I look forward to the next topic on Trust Us.

Danielle Friedman: Yeah. We'll talk soon.

Herb Fineburg: Thanks.