MarketWatch

How to give your home to your adult child tax-free

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Published: Oct 19, 2019 11:03 a.m. ET

In order for the transaction to work properly, you have to plan ahead — here's a rundown of your options

Getty Images

Before the days of income and estate taxes, adult children often just moved into the family home after their parents died. Unfortunately, it's not that simple anymore.

There are several ways to give a home to your child. And a few are tax-free. But to get the best tax results, you've got to plan ahead. Here is a rundown of your options.

Stay put

If you plan to live in your home until you die, and your estate is below the unified federal estate gift and estate tax exemption amount ($11.4 million for 2019), this is your best strategy. When you die, your home's tax basis will be stepped up to fair market value as of the date of death. So you and your heirs will escape capital-gains tax on all the appreciation that occurs up to that date. And, because the value of your estate is below the estate tax exemption, your heirs will owe no federal estate tax. They are free to move into the house, or sell it and keep the cash while owing little or no tax to the Feds (thanks to the basis step-up rule). If they do move into the house, their tax basis for calculating the gain or loss on subsequent sales will be the home's fair market value at the time of your death.

This is a much better strategy than gifting your house to heirs while you continue living there. Why? Even if you pay a market-rate rent to your child, the IRS might argue the home's full date-of-death value still belongs in your taxable estate. The only sure way around this problem is with a qualified personal residence trust, which is explained later in this story.

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Outright gift

If you are moving out of your home, you can give the property to your child today. However, you will probably have to dip into your unified federal gift and estate tax exemption ($11.4 million for 2019). Here's how it works.

First, offset the amount of the gift by using your $15,000 annual gift-tax exclusion. Remember it is $15,000 per donor per donee (gift recipient). So if you and your spouse make a joint gift to both your child and his spouse, you can offset $60,000 of the home's value (4 x $15,000) for gift tax purposes. Then, as long as the net figure is less than $11.4 million or $22.8 million for a married couple for 2019, you won't owe any current gift tax (unless you made very substantial gifts earlier that used up part of your exemption).

There are two drawbacks to this strategy. First, your child's tax basis on the home will be your presumably low cost for the property, which increases the odds he or she will owe capital-gains tax on a later sale. Second, you've whittled down your unified federal gift and estate tax exemption (the exemption is reduced dollar for dollar by gifts in excess of the $15,000 annual exclusion amount).

On the plus side, you at least get any future appreciation in the home's value out of your taxable estate.

Sale for a bargain price

If you sell a home to a perfect stranger for less than fair market value (FMV), you've simply made a bad deal. The IRS doesn't care. When you sell to a relative, however, it's a different story. You will be treated as making a gift equal to the difference between FMV and the sale price.

For example, if your house is worth $700,000 and you sell it to your child for $350,000, you just made a gift of $350,000. Of course, you can use your $15,000 annual gift exclusion to whittle this down. The net amount of the gift then goes against your unified federal gift and estate tax exemption ($11.4 million for 2019). However, that's OK if the property is expected to appreciate, because the sale successfully removes all future appreciation from your taxable estate.

For income tax purposes, you subtract your tax basis in the home from the $350,000 sale price to calculate your gain or loss. Any loss is nondeductible. If you have a gain, it's probably eligible for the $250,000 (for singles) or $500,000 (for married couples) home sale gain exclusion. However, your child's tax basis in the home will be only $350,000, which increases the likelihood that he will owe capital-gains tax on a later sale.

Full-price sale with seller financing

Instead of making a bargain sale, consider making an installment sale for full market value instead. As you will see, this can still meet your primary objective of transferring the home to your child in a way he or she can afford — probably with better tax consequences.

Here's the deal. You sell the property to your son or daughter for a relatively small down payment and carry a note for the balance of the purchase price. Let's again say the house is worth $700,000 and your child can afford to pay $70,000 down. So you take back a note for $630,000. Make sure it's a written note. Also, it definitely helps your case if the child has the wherewithal to make the monthly payments.

Speaking of payments. You should charge at least the applicable federal rate (or AFR) on the loan. That rate, which changes monthly and is almost always well below the average commercial mortgage rate, is available in monthly Internal Revenue Bulletins. You can find them on the website at www.irs.gov. Make sure to go through the legal process of securing the note with the house. That way, your child can deduct the interest payments make to you as qualified mortgage interest. If you fail to take this step, your child won't be able to deduct the interest payments.

If you wish, you can then ease your child's financial burden by making gifts under the annual $15,000 gift-tax exclusion rule. Just make sure your child actually makes all the payments on the note. Then write checks for any gifts you decide to make. That keeps the sale, the note and the gifts separate. If you simply forgive some of the payments, the IRS may recast the entire arrangement as a bargain sale (with the less-desirable tax consequences explained earlier).

Income-tax-wise, you are treated as making a sale for $700,000. Assuming you qualify for the $250,000/$500,000 exclusion, you will hopefully be able to dodge any federal capital-gains tax. You will however owe income tax on your interest income from the note. But remember, your child will get an equal mortgage interest deduction, and the whole idea was to help the kid out. Your child's tax basis on the property is now the full $700,000 purchase price, which reduces the chance he or she will owe any capital-gains tax when the home is eventually sold again.

As far as the gift tax is concerned, you are in the clear. Estate-tax-wise, the sale removes from your taxable estate any future appreciation in the value of the home.

A few years after the sale, your child may be able to refinance and pay off the note. If so, your generosity comes to an end with no further tax implications. However, if there's still a balance due when you die, your child will be treated as receiving a bequest if the note is forgiven at that point. Of course, this uses up part of your estate-tax exemption, but that's OK because of the other tax benefits.

What if you want to live in your home?

Unfortunately, the IRS gets cranky when you transfer your home to a relative and then continue to live there. So tread carefully if this is your intention. One strategy is to make a seller-financed full market value sale to your child, as explained above, and then rent the property back at the market rate.

In a perfect world, this would remove the home's future appreciation from your taxable estate and you could shelter all or part of your gain with the $250,000 (for singles) or $500,000 (for married couples) home sale exclusion. The rental payments to your child could, in effect, finance at least part of the cost of buying the home. The payments would be nondeductible to you and taxable income to your child. But he or she could claim rental property depreciation write-offs, opening up the possibility of noncash deductible losses each year.

In fact, all these nice tax outcomes should be possible — if you sell the home for FMV and pay market-level rent afterward. If you sell for less or pay below-market rent, an obscure tax code provision could include the full date-of-death value of the home in your taxable estate. Why? Because you are considered to still own the home since you never completely gave up "possession and enjoyment" of the property. Also, paying below-market rent will preclude any deductible rental losses for your child.

The bottom line: If you want to transfer ownership to your child but stay put, make sure you make a FMV sale (as opposed to any gift or bargain sale arrangement). Then be sure to pay market-level rent to your child. You can still make $15,000 annual tax-free gifts to help your child out. However, keep these acts of generosity separate from your dealings regarding the sale or rental of the house. In other words, don't forgive payments on your seller-financed note and don't include gifts in your rent checks.

Qualified personal residence trusts

There is one way you can make an IRS-approved gift of your home while still living there. That is with a qualified personal residence trust (or QPRT). Using a QPRT potentially allows you to get the residence out of your taxable estate without moving out — even though you have not made a full FMV sale to your child. But there are heavy risks involved.

Here's how a QPRT works. Say a retired doctor in Florida wants to give his $1 million beachfront home to his two daughters. This strategy would require the doctor to put his home into an irrevocable trust for several years, while he continues to live in it. Through a complex IRS calculation based on interest rates, the length of the trust and his age, the IRS values his right to live in the house at, say, $600,000.

For the purposes of his taxable estate, that knocks the value of his house down to just $400,000 — regardless of how much the house appreciates in the meantime. (That $400,000, though, comes out of the doctor's unified federal gift and estate tax exemption.) When the trust is up after the stipulated number of years, if he chooses to continue living there, he can pay his daughters rent, further reducing the size of his taxable estate.

Of course, if you have a poor relationship with your kids, you might find yourself out on the street. And there is a tax catch to this kind of trust: You have to outlive it. If you die before the term of the trust expires, the full date-of-death value of the house is included in your taxable estate and your heirs receive no estate tax benefit.

This story was updated on Feb. 21, 2019.

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