MarketWatch

The Big Move

My husband and I are planning to give our daughter a home for Christmas. Are we making a mistake?

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‘2020 is a good year to gift just to time stamp use of a very generous unified gift and estate tax credit available now,’ one expert suggested.

Many parents these days are helping their kids out with the cost of housing. But some approaches have serious tax ramifications.

Dear MarketWatch,

My husband and I are mulling over a very big gift for our daughter and son-in-law, but I'm having second thoughts. We recently retired and purchased beachfront property, where we plan to spend most of our time moving forward.

Our daughter and son-in-law are early in their careers, but do want to have kids someday. We all live in the same town, which is in an expensive part of the country. Home prices are only going up where we live, and we're worried that our daughter won't be able to save enough to buy her own home one day.

My husband mentioned that if our house is just going sit empty most of the time, we might as well give it to our daughter now as a gift rather than her inheriting it down the road. I loved the idea and suggested we present the opportunity to our daughter at Christmas.

We're working through the various tax ramifications, and I'm starting to worry this could be a mistake. It will take time for us to move out our belongings and fully settle in our beach home anyway, so I'm wondering whether there's a better way to guarantee our daughter will have an affordable home for years to come. What advice do you have?

Sincerely,

Santa's Got a Brand New Pad

Dear Santa,

How lucky your daughter is to have such generous parent. You're not alone in worrying about your child's ability to afford the cost of housing. I've spoken with parents in a very similar situation in recent years. Indeed, as the cost of buying a home has risen, so too has the number of parents who are helping their kids out in one way or another.

You're right to be second-guessing such a big gift. There are a range of tax considerations at play here.

For starters, you need to consider how this will work from a gift tax perspective. The Internal Revenue Service allows individuals to gift up to $15,000 per year per person tax-free. Obviously, your home is worth more than that, but that doesn't mean anyone would pay taxes on the gift itself — at least at the federal level. Each taxpayer currently has a lifetime gift tax exemption to the tune of $11.58 million.

"Irrevocably gifting the house can take a large asset out of the taxable estate," said Ian Weinberg, a financial planner and CEO of Family Wealth & Pension Management in Woodbury, N.Y. "2020 is a good year to gift just to time stamp use of a very generous unified gift and estate tax credit available now, which could diminish under the new administration."

Under President-elect Biden, the tax code could become less generous to wealthier Americans, which could increase the taxes under those rules.

But the tax considerations don't end with the gift tax. There are also capital gains taxes to consider — and that's where a gift of this nature gets tricky. If you gift the home to your daughter, she will be the one who will pay capital gains taxes one day if she sells it.

"Assuming the home has appreciated over time the parents would avoid paying any capital gains taxes they might pay if they were to sell the home by gifting it instead," said Daniel Flanagan, a partner at Canby Financial Advisors in Framingham, Mass. "These capital gains taxes would still be paid eventually by the daughter and son-in-law when they sell."

That may seem like a good deal for you, but it could cost your daughter a lot. That's because of how the cost basis transfers. When calculating the capital gains earned through the sale of a home, you take the sale price and subtract the original price paid for the home (plus or minus the cost of improvements or depreciation.)

When you gift a home to someone, the cost basis remains the same as it was for the original owners. That's different from what happens when you inherit a home — upon inheriting a home, the basis is stepped up. That means rather than the original basis, the heir instead will calculate any capital gains using the market value of the home at the time of the inheritance.

Let me illustrate that with a simple example. Let's say you bought a home 20 years ago for $100,000 that's now worth $600,000, and you put in around $50,000 in repairs since then. If you sold it today, the capital gain from the sale would be $450,000. At the federal level, you can exempt up to $500,000 in capital gains from the sale of home, providing you meet certain requirements.

You need to know whether the child would use the home as a residence or rental/investment property.

— Brooke Salvini, a member of the American Institute of CPAs' personal financial planning executive committee

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Now, let's see what happens for your daughter if she receives the home as a gift and sells it down the road. Because of how the basis works, her cost basis for capital gains would be the same as yours is now, at $100,000. But perhaps the home will be worth more in 10 or so years, pretend it's $750,000. Assuming she made no other improvements on the home, her gain from selling would be $600,000. Because it's above the $500,000, she would owe taxes on a portion of the proceeds from the sale.

This is really only scratching the surface of the various tax considerations, since these rules vary at the state and local level. "You need to know whether the child would use the home as a residence or rental/investment property," said Brooke Salvini, a member of the American Institute of CPAs' personal financial planning executive committee. "This could impact how best to gift the property." In California, Salvini notes, a new law on the books that goes into effect in February will eliminate the ability to preserve the property tax base in a transfer of real estate to a child that doesn't intend to use it as a principal residence.

There are ways of reducing the tax liability the home represents, such as simply allowing your daughter to inherit it down the road or putting it into a trust. These options require careful planning, though, and should be worked through with a financial expert.

There are other financial considerations beyond the tax implications of such a gift. Yes, your daughter and son-in-law would avoid the cost of building a down payment and a mortgage if you gift the home to them — but can they afford the cost of property taxes, insurance, upkeep and utilities?

Some of the experts who gave me feedback on your situation argued there's a financial lesson that could be lost by not having to pay off a mortgage, too. "I prefer the recipient of the parent's generosity to have some skin in the game, as it makes them have a better appreciation for what they're getting as they have some financial liabilities to show for the 'investment,' whether it be for a house or an education," said George Gagliare, a financial adviser with Coromandel Wealth Management in Lexington, Mass.

Along those lines, I might suggest an alternative: Pitch in for the down payment, or maybe even assist with the monthly cost of the mortgage. If you choose to sell your old home now, the proceeds from the sale could go toward that. This way, your daughter and son-in-law have support but also avoid messy tax situations down the road, while learning vital financial lessons in the meantime.

Whatever you do, I encourage you to talk at length — not just with your husband, but with your daughter, too. I'm sure she will be beyond grateful at the generosity of whatever offer you make, even if she doesn't receive a set of keys with a bow on top under the Christmas tree this year. And with that, I wish all of you a happy holiday.