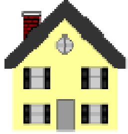

Gifts of Real Estate to Children, Not a Good Idea

Question: My husband and I own our house free and clear. We purchased it in the l960's for $30,000, and have added approximately $50,000 of improvements over the years. We are at the stage in our life when we can no longer take care of the house, and are planning to give the property to our only son, and then move into a retirement home.

We believe the property is worth $500,000. How do we go about transferring title to the house?

Answer: Transferring title is easy; **the real question is should you do it?**

In order to transfer title, you -- or your attorney -- should prepare a deed, which would reflect that you and your husband conveyed the property to your son, for love and affection -- in other words, no consideration. You will have to include the legal description of the property in the deed, and in order to avoid any transfer and recordation tax, you will need an affidavit stating that this is a transfer to your son.

Generally speaking, and you need to review the specific rules in your jurisdiction, there will be no transfer and recordation tax owed when you transfer property to a son or a daughter. These documents must be notarized and recorded in the jurisdiction where your property is located. If you do not have an attorney, the local Recorder of Deeds office should be able to assist you in making the transfer valid.

However, before you take such action, you should give serious thought to the tax consequences of your proposed action. Although your property is worth approximately $500,000 today, for tax purposes your basis in the property is $80,000 (the initial price of $30,000 plus the $50,000 in improvements).

The Internal Revenue Service computes capital gain on the following formula: Sales Price less certain selling expenses minus the original cost of the property plus improvements. The latter (i.e. the cost of the property plus improvements) is known as the "basis" of the property for tax purposes. It should be noted that if your property had been rented out, and you took depreciation over the years, your basis would be reduced by the amount of the depreciation.

In our example, your basis is $80,000. If you sell the property now for $500,000, (and ignoring for the moment any real estate commissions or other selling expenses which would reduce the selling price), you will have made a profit of $420,000. Under current tax law, since you are married and most likely file a joint return, and have lived in the house for at least two years in the last five years before a sale, you can exclude up to $500,000 in profit and not pay any tax. Since your profit would be less than $500,000, you can walk away from a sale and keep all of the sales proceeds.

Although the property is worth $500,000, tax law requires that the tax basis of the donor (the person giving the gift) becomes the tax basis of the donee (the person receiving the gift). Thus, while in your mind you are giving your son a house which is worth $500,000, in reality you are giving him a house with a tax basis of $80,000.

Now you have moved out of the house into the retirement home. The first question to consider is whether you will have enough money to continue your life style. While it is nice to be able to take care of your children, you must consider your own needs first.

The second question is whether you are really doing your son a favor. When he receives the house, his basis will be only $80,000. If he should decide to sell the property -- and if he has not lived in the house for two out of the last five years before the sale -- he will have to pay a hefty capital gains tax. Under current tax laws, even if he only can sell the property for $500,000, he will owe the government $84,000 (20 percent of the gain of $420,000).

Of course, there are two ways in which your son could avoid (or postpone) the tax.

First, he could move into the house and live there for two years. If he is not married, however, he will only be able to shelter $250,000 of gain. And this, of course, assumes that Congress will not change the favorable homeowner tax laws in the years to come.

Second, if your son treated the property as an investment, he can do a "like-kind" exchange under section 1031 of the Internal Revenue Code. This is a subject for another column.

However, for many reasons, I cannot recommend that you give the house to your son unless you thoroughly discuss all of the various issues with your attorney and your tax advisor. You should also understand that there is a tax concept called the "stepped up" basis. This means that upon your death, your son will inherit the property at the value of the property on the date of your death.

Let's explore this a little more. Obviously, while no one wants to discuss death, it is unfortunately a fact of life. If, for example, on the date of your death (and assuming that your husband died before you) the house is worth $500,000, your son's basis in the property for tax purposes will be $500,000. If he should immediately sell the property for that price, he will not have to pay any capital gains tax at all. (Note: under the new tax law, this stepped up basis at death will be eliminated after year 2009, and clearly there will be different matters to consider after that year.)

Thus, another factor which you and your financial advisor must consider is the difference between any estate tax which your estate may have to pay as compared to the capital gain savings based on this stepped up basis.

And finally, and most importantly, you should also understand that your gift to your son will trigger a gift-tax consequence. You and your husband are entitled to gift your son, each and every year, $10,000 per person (or $20,000 in your case). If you give the house to your son, you will have to file a gift-tax return.

However, everyone has a lifetime gift and estate tax-exemption, and this year that

amount is $675,000. The gift of $500,000 to your son will reduce your and your husband's exemption by this amount (less the $20,000 allowable gift), and may impact on your ability to make additional gifts in the years to come.

As you can see, although this sounds simple, in reality it is a very complex issue -- which requires a lot of thought and examination before you sign over the deed to your son. What you consider to be a generous parental gesture may, in fact, become a financial nightmare for you, your husband and your son.

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