The Joys of Home Ownership: Balancing Financial Support and Tax Consequences with Real Estate Wealth Transfer Strategies

For high-net-worth individuals, the art of wealth transfer extends beyond merely providing financial assistance to future generations; it is about strategically positioning the next generation for personal success. Unfortunately, it also requires navigating a complex landscape of income, gift, and estate taxes.

Many individuals want to provide financial assistance to family members to help them experience the joys and pride of home ownership. From aiding grandchildren to purchase their first homes, to empowering children or other loved ones to build their personal balance sheets through investing in residential real estate, there are many options to explore regarding how financial support is best provided. Each approach has tax implications, and determining the best approach will require consideration of a number of factors, including:

- Whether the residence is already owned by the family or is being newly acquired;
- The anticipated growth of the home's value;
- The expected period of time that the family will own the home; and
- The availability of attractive bank financing terms.

This article explores some of the options that may be considered and identifies some of the tax implications that should be evaluated.

Navigating Estate and Gift Tax Exemptions

The estate and gift tax lifetime exemption is currently $13.61 million for individuals and $27.22 million for married couples, under the Tax Cuts and Jobs Act (TCJA), but it is set to be reduced to an estimated $7 million per person beginning January 1, 2026. If the value of your residential real estate is a significant component of your personal balance sheet, transferring those assets outside of your estate may be a prudent way to take advantage of the higher lifetime exemption before the TCJA estate tax provisions sunset. **Learn More Here >**

The Generation-Skipping Transfer Tax

In addition to the estate and gift tax, the generation-skipping transfer (GST) tax often comes into play when wealth owners wish to transfer real estate, like vacation properties or second homes, to younger family members. GST tax is imposed on wealth transfers to grandchildren and more remote descendants that exceed the exemption limits so individuals cannot avoid transfer taxes by "skipping" a generation. The GST tax is levied in addition to gift or estate taxes and is not a substitute for them. The exemption for the GST tax is also $13.61 million per person and the exemption may be applied to gifts during lifetime or transfers through the grantor's estate. The GST tax exemption is also scheduled to sunset at the end of 2025 and will be lowered to $7 million per person in 2026.

Gifting as a Means to Support Home Ownership

Many individuals consider offering a "deal" to their loved ones by pricing the residence at a level their family member can afford, below the current market rate. However, this situation can create a tax filing obligation because the IRS considers any transfer of assets for less than full and adequate consideration than would be paid "between a willing buyer and a willing seller" (Treas. Reg. §20.2031-1) to be a gift. A gift tax return must be filed to disclose the gift to the IRS, and it must include a qualified appraisal as of the transfer date, if the delta between the transfer price and the market value of the gift is higher than the annual exclusion ($18,000 for 2024). When the total value of all gifts made throughout an individual's life exceeds the lifetime exemption amount (again, currently set at $13.61 million per person), then a 40% gift tax will be assessed on the excess of the total over the lifetime exemption amount.

Rather than gifting an entire property, wealth owners can make a cash gift to a beneficiary to cover the down payment, the monthly mortgage, property tax, insurance payments, maintenance and repair costs, and more. As mentioned above, the Internal Revenue Code provides an annual gift exclusion that allows individuals to give up to $18,000 in 2024 to as many people as they'd like without incurring gift taxes. If the gift is solely in cash, does not exceed the annual exclusion amount, and there are no other gifts to report for the year, a gift tax return is not required.

Gifting Real Estate Through Trusts

Using trusts to gift real estate is a technique often used in estate planning, as many trusts include provisions that allow the trustee to make discretionary distributions to or on the beneficiary's behalf for health, education, maintenance, and support. The ongoing costs of home ownership, such as real estate taxes, insurance, mortgage payments, and home repairs can fall within the maintenance and support standard, to assist beneficiary's with home ownership expenses.

Some types of trusts can be structured to continue for several generations, allowing a wealth owner to provide for home ownership even for decedents who are not yet living at the time the trust is created, if desired. This is done by allocating the GST exemption to the trust. Some trusts qualify for the $18,000 annual gift exclusion too, if there is a single beneficiary and all the assets and income go to the beneficiary or their estate.

Using estate planning techniques like a qualified personal residence trust (QPRT) may allow individuals to transfer a residence to their children, and still allow that individual to live in the home. In addition to reduced transfer taxes, any future appreciation in the residence after the QPRT is established is transferred to children without being subject to additional transfer tax. **Learn More About QPRTs Here >**

Living Arrangements and Reduced Rent Options

If you already own the home you want to gift or transfer, you could consider allowing a family member to live there rent-free or at a reduced rent. An annual gift tax return may be required if the market value of the reduced rent is higher than the annual exclusion, but a key advantage of this approach is that if you intend to transfer the property to the beneficiary upon your passing, maintaining the asset within your estate ensures it will benefit from a step-up in basis. This is an attractive option for a home that has a very low basis and has appreciated significantly over many years of ownership.

Loan Options for Home Purchase Assistance

Another option you can consider is loaning your family member the money to purchase the home from you at fair market value. However, there are protocols that must be followed to avoid running afoul of IRS regulations. Such loans must be formally documented, and payments made according to the terms of the agreement. Interest rates on related-party loans must be set, at a minimum, at the interest rate provided by the IRS in monthly published Revenue Rulings (known as the Section 7520 rates) and other arm's length terms must be observed.

Of course, the grantor could forgive part of the loan at any point during the loan term. If the loan forgiveness amount is $18,000 or less per year, then it should qualify for annual exclusion gifting and not reduce the grantor's lifetime estate and gift exemption.

However, it's important to avoid a predetermined arrangement for forgiving the loan annually under the annual exclusion, as the IRS might view this as a single gift made in the first year, resulting in an inadvertent reduction of the donor's lifetime exemption.

Financing Strategies for Home Purchases

Many families have relationships with their banking partners that allow them to obtain favorable interest rates or terms. In addition, they may own other assets, such as brokerage accounts, that may be used as additional collateral to support a loan, although it would not be advantageous to sell those assets. Using such assets as collateral usually entails the addition of restrictions that prevent disposition of the assets while being held for collateral without prior authorization from the financial institution. A parent or grandparent can serve as a personal guarantor on the loan between the beneficiary and the bank, but there may be a gift value to a personal guarantee and consideration should be given as to whether this triggers a gift tax filing requirement.

Consulting with Advisors for Tailored Strategies

As you can see, there are many ways in which wealthy individuals may offer to help loved ones to achieve home ownership or favorable living arrangements. Talking with your advisors will help determine which options accomplish your goals while utilizing tax-efficient strategies. The Private Client Services team at BDO stands ready to address your inquiries and assist in crafting a personalized strategy that enables you to transfer your wealth not merely as a gift, but with meaningful intent and purpose, aligning with your family's home ownership goals and financial well-being.

HAVE QUESTIONS OR WANT TO LEARN MORE? CONTACT US!

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