Assisting an adult child with the purchase of a home

By Wendy L. Allard

Given the current real estate market, it is becoming more difficult for young people and first-time buyers to enter the housing market. As a result, many housing hopefuls are looking to parents and other relatives to help them acquire a residence. This article addresses some of the approaches that can be used to help an adult child purchase a residence, as well as some of the issues to keep in mind along the way. The strategies should be discussed and implemented in the context of the parents' larger estate planning goals, including the need or desire to reduce their potential estate tax liability. The individual circumstances of the parties, as well as the intended (and unintended) potential consequences to the relationship, will dictate which direction is best suited to each family.

Gift:

The most straightforward approach is for the parents to give a child all or a portion of the money needed to buy a home. If the gifted amount is greater than the $15,000 annual amount not subject to gift tax (or $30,000 if both parents are making the gift), then the parents will need to report the gift on a federal gift tax return (Form 709) and file it with that year's income tax return. Given the large federal gift tax exemption amount ($11.4 million per person in 2019), any gift will likely use up some of the parents' federal gift tax exemption amount rather than cause any out-of-pocket gift tax payment. Washington has no gift tax, and therefore no separate state reporting is required for gift tax purposes.

Another option to consider is to create an irrevocable trust to purchase the home for the child. This strategy not only affords the possibility of protecting the home from the child's creditors, but also allows the parents to determine the timing of any eventual outright distribution of the home to the child. For example, if parents are concerned that the home may become subject to division in a child's divorce, a trust is a good option to ensure its continued availability to the child. Further, if the child's level of financial responsibility is questionable, using a trust to own the home allows the trustee to ensure that all tax, mortgage, and other payments are timely made. Depending on how the trust is structured, the annual gift exclusion may not be available for a gift into a trust, as the $15,000 exclusion amount applies only to present, rather than to future, gifted interests.

Loan:

If the parents instead prefer to make a loan to the child, there are various ways to structure this. One option is to make the loan to the child directly. The loan should meet several requirements to demonstrate its legitimacy and to avoid recharacterization of the loan as a gift. These requirements include formalizing the loan with a promissory note at the appropriate interest rate that is consistent with the IRS Applicable Federal Rates (AFRs) and securing the obligation with the property using a deed of trust. It is also important that the child not only has the ability to make the interest payments, but that he or she actually does so. Finally, the loan should be addressed in the parents' estate planning documents if the intent is to offset the child's inheritance with any unpaid balance of the loan.

Co-Purchasers:

If parents do not wish to take the more formal and straightforward approach of a well-documented loan or a trust, another option is to enter the transaction as a co-purchaser with the child by making part or all of the down payment and treating their contribution as an investment in the property. Some questions to address in this strategy are: Will each party share pro rata in any appreciation, or will the value of the parents' ownership interest be limited to the dollar amount of their initial contribution? Who will be responsible for paying expenses such as the mortgage, property taxes, insurance, and maintenance?

This approach requires a thoughtful and well-documented transaction to ensure that it works correctly and meets the parties' expectations. Preparation of a written equity-sharing agreement is critical to appropriately capture the parties' intentions and responsibilities, including the payment of any mortgage and allocation of the mortgage interest deduction. This is especially important if the party making the mortgage payments and wishing to take the mortgage interest deduction is not, on the face of the documents, liable on the mortgage and/or listed as an owner on the title to the property. Seeking legal counsel is essential in this situation.

No matter which path is chosen, the parents and child should plan and discuss their options well before a purchase so that all parties fully understand the tax and legal implications. As with most things, taking the time to thoughtfully structure the purchase arrangement at the outset often prevents grief and surprises (and relationship tension) down the road.

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