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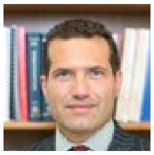
How Gifting Your Home Can Create Tax Consequences



Daniel Timins, CFP® | October 15, 2018

While many Baby Boomers have saved large amounts of money in their IRAs and brokerage accounts, their elderly parents tended to rely on fixed sources of income, such as pensions and Social Security. The elderly are also adverse to stock market volatility and invest instead in income-generating investments, such as annuities. So, it should be no surprise that the elderly's largest transferrable asset tends to be their home.

Often the elderly client suffers an age-related illness (dementia, Parkinson's, stroke) and wants to transfer this highly-appreciated real estate to their children or a trust so they can qualify for Medicaid. While this may make sense if prolonged-care at a nursing home is assured, it is often the wrong decision from a tax standpoint based on step-up in basis tax rules that take effect upon a person's passing.

Qualifying for Medicaid

Medicaid is a needs-based government program that pays for non-insured long-term care needs (helping you ambulate, feed yourself, etc.). It can encompass care at home or at a nursing facility. But to qualify you can only have a limited amount of assets and income (the amounts differ by state) and Medicaid has the right to place a lien on your home if you end up in a nursing home.

Planning must be done far in advance. There is a "look-back" provision that states transferring any assets must be done five years before applying for Medicaid (otherwise people would wait until the last minute to transfer their property). Many elderly parents facing a prolonged, debilitating illness feel like they have worked hard to maintain their home and would rather give it to their kids than have the government have a claim against it, so they gift their highly-appreciated house to them to avoid having a Medicaid lien on their home.

Real Estate Has Appreciated

The issue is today's elderly have lived through a period of incredible growth in the value of their real estate. I have seen a $1.4 million brownstone in Harlem that was originally purchased for $27,000, a $7 million plot of land and a shed-sized home in the Hamptons that was bought for $250,000, and a $750,000 house in the suburbs of New York that was initially acquired for $12,500.

Under the Internal Revenue Code's Section 1014, you receive a "step-up" in the cost basis of property transferred from a deceased person. So, if your elderly parents purchased the Harlem Brownstone for $27,000 and then pass away, you inherit the entire $1.4 Million value without a capital gains tax.

Capital Gains Taxes: Donee Takes Donor's Basis (Sometimes)

However, under Internal Revenue Code (IRC) Section 1015, when that same parent gifts you the family house during their life so he or she can qualify for Medicaid, the child retains the original cost basis. The lot in the Hamptons that was purchased for $250,000 may be worth $7 million now, but you will owe capital gains taxes on $6,750,000 at the time of the sale that would have been avoided if your parent had held onto it in his or her name and just paid for any long-term care needs. Clearly, in some instances, holding onto the property in your parent's name makes more financial sense.

As a side note, if someone gifts you a highly depreciated piece of property, such as a house that was purchased for $300,000 and is now worth only $100,000, your cost basis is the lower amount ($100,000), meaning even though you technically receive a person's capital gains, you cannot inherit another person's capital losses.

The elderly often receive exemptions and credits on their real estate taxes. Once they gift their real estate to a younger individual, these exemptions can be lost. In addition, the elderly usually no longer have the ability to contribute to tax-deductible IRAs, meaning their real estate tax credits may be their primary way to minimize the lash of income taxes.

What Can Go Wrong?

Still, for some elderly clients, Medicaid is too substantial of a benefit to ignore. Nursing homes can cost five figures every month when you are paying out-of-pocket. If the parent transfers their highly appreciated home with age-related real estate tax credits to their children, what could go wrong?

1. They may not be able to delay going the a nursing home before the look-back period expires, meaning a Medicaid lien will be placed on the home anyway.
2. They may pass away soon after the transfer, thereby receiving very little Medicaid benefits and passing on huge capital gains to their children who would have otherwise received the step-up in basis.
3. Their child who now owns the home may get sued or divorced, meaning their home is now a part of their lawsuit.
4. Their child may kick them out of the home.

When Should I Transfer My House to My Children?

When considering gifting your home to your children to avoid a Medicaid lien, try to balance the following factors:

- What are the chances you will need to be in a nursing home for a long period of time? If a prolonged stay is unlikely, don't bother transferring the home.
- Is your house highly appreciated? If so, proceed with caution. If not, transferring is an acceptable option.
- Will you make the full five-year Medicaid nursing home look-back? If you will clearly need a nursing home before five years pass, don't bother.
- Is there a better option for you to avoid a Medicaid lien? Some states allow for Medicaid-compliant trusts, or have exceptions for a healthy spouse, co-habitating sibling or full-time child caregiver.

Transferring a home to your child has more tax implications than it may appear upon first consideration. It is not a decision that should be made hastily without carefully considering all of the financial repercussions. If you decide to move forward with the transfer, be sure to do it at the most financially opportune time.

(For more from this author, see: *Why Your Estate Shouldn't Be Your IRA Beneficiary*.)

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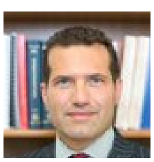

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