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Assisting a Child with the Purchase of a Home

The dream of owning your own home in California, especially in the Bay Area, has become increasingly difficult. Many individuals, even those with well-paying jobs, are still unable to afford the purchase of a home. As a result, many clients ask us how they can assist a child with the purchase of a home, whether by assisting with the down payment or with the entire purchase price. Here are a few options:

One option is for you to loan money to a child. Structuring the terms of the loan can be quite flexible. For example, you can (1) choose a specific due date for the loan, or make the loan payable upon your demand, (2) make the loan interest-only with a balloon paymen of principal, or choose to amortize the loan so that some principal is made with each payment, and (3) make the loan secured or unsecured (we recommend a secured loan). One important requirement under any loan structure is that the interest rate must be no less than “applicable federal rate” (AFR). The AFR, which changes monthly and depends on the length of the loan, is the minimum interest rate you can use to avoid adverse tax consequences. Even though the loan is an enforceable contract between you and your child, it is possible to forgive your child’s payments under the loan (subject to possible gift tax consequences). Even if interest payments are forgiven, you will still need to report and pay the income taxes on the interest as if it was paid to you. Before you loan money to your child, you should carefully think about your “exit strategy” if your child fails to make payments on the loan – would you be comfortable extending the loan indefinitely or foreclosing on the home that secures the loan?

Another option is for you to gift money to a child. Depending on the gift amount, it may be covered by your annual gift tax exclusion or you may need to report the gift on a gift tax return (IRS Form 709) and use a portion of your basic exclusion amount (see related article in this newsletter for current exclusion amounts). If the gift is made directly and outright to your child, your child would purchase and own the home. If the gift is made to a trust for your child’s benefit, the trust would purchase and own the home and, generally, your child may reside in the home without payment of rent. The use of a trust adds complexity, but, if the trust is structured properly, it provides added protection if your child may face liability to a creditor or spouse, or if your child simply needs assistance with the management of the home.

Another option is for you to purchase some or all of the home yourself. If you do this, you will be on title to the home and have all responsibilities, obligations and liabilities of a homeowner. At some point, you likely will want to transfer ownership of the home to your child, and you could do this by gifting fractional interests in the home to your child over the course of several years or by gifting the entire home in a single transaction. Of course, gift tax issues must be considered, as well as issues of rent payment, payment of expenses, etc. A written lease or co-ownership agreement between you and your child is recommended to ensure that your expectations are aligned with your child’s expectations.

Regardless of which option works best for you, you should review your estate plan as part of the project. In most cases, your estate plan will need to be updated to take into account the assistance provided to your child. For example, you may need to provide an equalizing gift to another child, or a provision cancelling any remaining balance on a loan at your death.

We recommend that if you plan to assist a child with the purchase of a home, you schedule an appointment with us to discuss your options and the related estate planning and tax consequences.

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