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Giving Your Assets to Your Children Now Can Cause Serious Problems

Sometimes people will transfer title of their assets to their adult children while they are living, thinking it will make things easier for their children when something happens to them. Doing this will prevent the court from controlling the assets if you become incapacitated and it will avoid probate when you die. And while there can be valid tax reasons to transfer some assets now, it can also create problems.

First, when you give away an asset, it's gone. You may think your children will give it back to you if you change your mind, but they don't have to, and things can change in families when money is involved. They could sell the asset against your wishes, they could lose it to creditors, or they could be influenced by a spouse. If you outlive your children or they divorce, a daughter- or son-in-law could end up owning the asset. Would she or he give it back to you?

Second, there could be tax problems. Currently, when you give someone other than your spouse more than $14,000 in one year, a *gift tax* may be involved. And when your children sell the asset, there will probably be a *capital gains tax*. That's because, under current law, the asset would not receive a *stepped-up basis* like it would if it were inherited upon your death. The basis of an asset is the value used to determine gain or loss for income tax purposes. Most of the time, the basis is what you paid for the asset. If you give an appreciated asset to your children while you are living, it keeps your old basis (what you paid for it). But if they receive it as an inheritance after you die, it may receive a new stepped-up basis as of the date of your death.

Let's look at an example. Let's say Bob purchased his home for $100,000, and today it's worth $350,000. He gives it to his son Tom, who then sells it for $350,000. Because Bob transferred title to Tom while he was living, the house keeps Bob's original cost basis of $100,000. That means Tom has a $250,000 gain on the sale and under current tax law, he has to pay at least $50,000 in capital gains tax. Currently, the capital gains tax rate for this type of asset is 20%. Depending on Tom's other income and filing status, he may also have to pay an additional 3.8% Net Investment Income Tax - possibly another $9,500 of tax.

Now, let's look at the other scenario. Tom receives the house as an inheritance after Bob dies instead of as a gift while Bob was living. Because it is received as an inheritance instead of as a gift, the property receives a new stepped-up basis to the market value as of the date of Bob's death, which is $350,000. Now when Tom sells the house for $350,000, there is no gain on the sale...and no capital gains tax (or Net Investment Income Tax) to pay.

Substantial gifts may also disqualify you from receiving Medicaid and SSI (Supplemental Security Income) benefits for a significant period of time.

Gifting can be a great way to reduce estate taxes if your estate is larger and you can afford to give away an asset. But never give away an asset you may need later. And make sure you consult with an experienced professional before making a substantial gift.

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