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Elder Law: Should You Give Your House to Your Kids to Avoid Inheritance Tax?

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Common "barbershop" law has it that you can avoid Pennsylvania inheritance tax on your assets by giving them away and surviving for at least a year. That is generally true, but it's not always such a good idea. Suppose you purchased you house years ago for $20,000.00 and it's now worth $120,000.00. The inheritance tax rate for lineal descendants (children) is 4.5%, and the tax is imposed on the house's date-of-death value. By giving away your house to your children, you would stand to save $5,400.00 in inheritance tax.

But if your children have their own homes and end up selling your house when you die, what will happen? Depending on their personal income tax brackets (and the ever-changing tax laws), they might end up paying 20% in Federal income tax and 3.07% in Pennsylvania income tax on the difference (capital gain) between what you paid for your house and its sales price, because the recipients of a gift acquire the donor's "carryover" tax basis in the gifted asset. So yes, you would save the $5,400.00 in inheritance tax on your house by giving it away, but your children might end up paying $23,070.00 in capital gains tax (instead of $4,500.00 in inheritance tax) on the $100,000.00 increase in the house's value. Saving $5,400.00 in inheritance tax is not a very good idea if doing so costs you $23,070.00 in income tax; you just end up paying $17,670.00 more tax. You can avoid that result if you transfer your home to your children but continue to live there until you die. In that case, your *implied reserved life estate* in the property causes its full date-of-death value to be subject to inheritance tax, but the property's income tax basis is "stepped-up" to date-of-death value, so there will be no capital gain (or loss) upon sale.

The same considerations apply to corporate stock, the other most-common asset having unrealized (i.e. built in) capital gains. But you can't live in stock. So, in order to be able to give stock away (perhaps to avoid probate) while preserving a step-up in tax basis at death, you have to do something different. Essentially, you have to retain a sufficient interest (e.g. the right to the dividends) in the gifted stock for it to be included in your taxable estate for death tax purposes. The only way to do this is to create a trust to hold the stock and pay you the income while you're alive, then pass it along to your children when you die. You could also put your house in such a trust to accomplish the same inheritance tax inclusion as continuing to live in it does, without the danger that the kids might decide to sell it out from under you.

The bottom line is that you would do well to consult with an estate planning professional on your way home from the barbershop.