Joint home purchase
A simple strategy offers big estate tax savings

If you're like most people, your home is your most valuable asset. And one of the most effective strategies for passing your home to your children or other loved ones while minimizing gift or estate taxes also is one of the simplest: the joint purchase.

Joint tenancy vs. joint purchase

Don't confuse a joint purchase with joint tenancy. There's a common misconception that owning property with a child or other family member as joint tenants is an effective estate planning strategy.

Indeed, joint tenancy offers simplicity: When you die, the title to the entire property automatically passes to the joint owner without the need for probate. But it also has serious drawbacks.

Adding your child's name to the title of your home generally is considered a taxable gift of half the property's value. Plus, when you die, some or all of the home's value will be included in your estate and may be subject to estate taxes. You also expose the home to the claims of your child's creditors, and you lose a great deal of the control you have over the property.

In a joint purchase, you (or you and your spouse) purchase a life interest in the home, and your children purchase the remainder interest. As the name implies, a life interest gives you the right to live in the home for your lifetime. You retain complete control over the property, including the right to mortgage or sell it (subject to the remainder interest). After your death (or the deaths of you and your spouse), the home — including any appreciation in value — passes to your children estate tax free.

Structuring a joint purchase

If you structure a joint purchase properly, you also can avoid gift taxes. Ordinarily, a joint purchase with a family member results in gift tax on the property's full purchase price. But the tax code contains an exception for a home, provided you use it as your primary residence.

To escape gift taxes, you and your children must pay adequate consideration for your respective interests in the home. The relative prices of the life and remainder interests are set by IRS tables based on your life expectancy (or the joint life expectancies of you and your spouse) and the applicable federal interest rate at the time of the transaction.

For example, Chris purchases a home for $500,000. When he dies 20 years later, the home, which has increased in value to $1.5 million, goes to his daughter, Tess. Assuming that Chris has exhausted his $2 million estate tax exemption and that his marginal estate tax rate is 45%, his estate is liable for $675,000 in taxes on the home.

Suppose, instead, that Chris and Tess purchase the home jointly, and Chris's life interest and Tess's remainder interest are valued at $375,000 and $125,000, respectively. Provided Tess can afford to purchase her interest with her own funds, a joint purchase generates $675,000 in estate tax savings.

Keep in mind that "family member" means your spouse, your descendants (children or grandchildren, for example) and your descendants' spouses. Further, your ancestors and their spouses are included, as are your siblings and their spouses. If you enter into a joint purchase with your cousin, niece, nephew or anyone else not considered a family member, you're not limited to your primary residence. You can purchase virtually any type of property and enjoy the tax benefits.

Don't overlook income taxes

When property is transferred at death, the recipient's tax basis is generally "stepped up" to the property's value on the date of death. The recipient can turn around and sell the property without triggering any capital gains tax liability. In a joint purchase, however, the property isn't transferred at death. The remainder interest holder's tax basis is the amount he or she paid for the interest.

In the previous example, Tess's tax basis is $125,000. If she sells the home after her father's death, she'll have a capital gain of $1,375,000. Assuming that the federal capital gains tax rate is 15%, as it is now, she'll owe $206,250 in federal taxes on the gain. Even if she also owes state income tax, when netted against the estate tax savings the family comes out ahead.

Bringing tax savings home

A joint purchase is a simple strategy that allows you to avoid gift and estate taxes on your home (or, if you partner with someone who's not a "family member," other property types). Your estate planning advisor can help you determine whether a joint purchase is right for you, but if your children or other beneficiaries can afford the initial investment, it's worth a look.

Another option: The QPRT

A qualified personal residence trust (QPRT) also can shield your home's value from gift and estate taxes. You transfer your home to an irrevocable trust for the benefit of your children or other family members, retaining the right to live in the home for a specified number of years. At the end of the term, the home goes to your beneficiaries, but you may be able to continue living there by paying fair market rent.

Unlike a joint purchase, the initial transfer to a QPRT is a taxable gift. But by retaining an interest in the home, you minimize the property's gift tax value. With careful planning, you may even be able to eliminate the tax by taking advantage of your lifetime gift tax exemption.

A QPRT has some advantages over a joint purchase. Your beneficiaries need not come up with the funds to buy their interests, and the trust offers some protection against claims by your creditors.

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