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Give Your House to Your Children? Maybe Not.

Parents often think it makes financial sense to transfer ownership. It rarely does.

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Parents, either to help their children out or to reduce the taxable value of their estate, sometimes weigh transferring ownership of their home to their children. But what may seem like a great idea often isn't.

For starters, parents often don't realize the security they're giving up, especially if they plan to continue living in the home. If your child were to get divorced, the ex-spouse could have a legitimate claim on the home. Creditors can come after the home if your child defaults on a loan. Your child could sell the property without your permission.

"There are few worse things in life then getting evicted by your kids," says John Collins, a principal at the wealth-management firm Aspiriant.

What follows are issues to consider, and, in those rare cases where a transfer can make sense, how to do it the right way.

Qualifying for Medicaid

Many parents think transferring a home to one's children will help them qualify for Medicaid's long-term-care benefits.

But in most cases, it won't. When an applicant gives away property within five years of applying for Medicaid coverage of long-term-care benefits, Medicaid presumes that the gift was made to qualify for Medicaid. This triggers a period of ineligibility on the theory that the property could have been used to pay for the individual's care, says Katherine Dean, managing director of wealth planning at Wells Fargo Private Bank in San Francisco.

In reality, the house may not have been counted in asset valuations anyway, says Ms. Dean. The five-year rule doesn't come into play, for example, if the applicant is transferring the property to his or her spouse or to a child who has been living in the house and providing necessary nursing care for at least two years.

Preserving Wealth

A home transfer is not advisable for wealth preservation or tax avoidance if the value of the parents' estate is within the limit allowed for exclusion by the Internal Revenue Service or state tax authorities. In a case where federal gift tax applies, the rate can be as high as 40%. There can also be state gift taxes.

The tax bite is likely to be far less if the home is part of a normal inheritance. The heirs will receive a step-up in the cost basis and be able to sell immediately with no impact on income or capital-gains tax, says Mr. Collins.

Parents looking to downsize can sell and share the proceeds with the children. For a married couple, the first $500,000 in profit is free of capital-gains taxes, or the first $250,000 for a single taxpayer, says Mr. Collins.

Giving a home also removes the option of a reverse mortgage, says Stuart Ritter, senior financial planner at T. Rowe Price in Baltimore. In a reverse mortgage, homeowners borrow against a home's equity and continue to live in the house with the understanding that the loan (and accumulated interest) will be paid off, in a lump sum, when the house is sold, or the borrowers move out or die.

Large Estates and Trusts

In cases where transferring ownership would reduce the parental estate to a level where no estate tax is owed, it can be a good idea. It may be the way to preserve the most assets for the children, even if they later decide to sell and owe taxes then.

If the parents want to transfer ownership but continue to live in the house, additional legal steps are recommended. One option is to set up a "life estate" in which the parent would pay "fair market" rent to the child, says Sal Salvo, principal of Summit Financial Resources in Parsippany, N.J. If rent isn't paid, the parent is considered to have a "retained interest" in the house, in which case the IRS could treat the transfer as if it never occurred and decide that the house is includable for estate-tax purposes. Legal assistance is advised when setting up this kind of arrangement, says Mr. Salvo.

Another option, a qualified-personal-residence trust, allows parents to transfer their residence to their children—through the trust—at a substantially reduced estate and gift-tax cost. It also allows the parents to stay in the home for a predetermined period they set themselves.

In this type of arrangement, if the parents live on the premises, it greatly reduces the gift tax, which is imposed at the time of the transfer. Depending on how long the parents plan to stay, the taxable value of the gift can be as little as 25% of the current fair market value of the home. All appreciation in the value of the home after the initial transfer also becomes tax-free for both the trust and the children.

Parents with large estates also can give or sell their home to a "defective grantor trust," says Mr. Collins. The value of the home for tax purposes is frozen, and any further appreciation during the parents' life happens outside of their estate. Any income earned by the trust is taxable to the grantor. But by giving or selling the property to the trust, the grantor reduces the value of his or her estate immediately, and all appreciation in the property will be tax-free for trust beneficiaries.