Estate Planning Pitfall

You Sell Real Estate For $1

Someone may have told you a story along these lines: Years ago, my grandfather bought land along the shore in (fill in a desirable resort area) for $1,000. He built a vacation home on the property for $50,000 and his family enjoyed weekends and summers there.

When my grandfather retired, the home and adjoining property were worth $2 million. Then he sold it all to my parents for just $1. So, my parents paid virtually nothing for this $2 million property that was removed from my grandfather's taxable estate. A genius move, right?

Likely, no. Despite what the storyteller says, there are potentially dire tax consequences to this technique under current federal tax laws. First, the IRS could, and probably will, deem the transfer to be a gift because the parents received it for far less than its fair market value. So, it's subject to gift tax.

Second, and more significantly, the family forfeits the usual step-up in basis on inherited property. Instead, the property's basis is what the grandfather paid for it — $1,000 — plus $50,000 in improvements, for an adjusted basis of $51,000. This means the parents are sitting on a whopping taxable gain of $1,949,000 if they sell the property.

Better approach: Don't be swayed by mythic tales. The tax benefits of a $1 real estate sale are illusory. Presuming that the objective is to keep the property in your family, and that estate tax liability isn't a factor, from a tax planning perspective it's generally better for the next generation to inherit the property, thereby taking advantage of the step-up in basis.

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