Helping Children Buy a House Using a Shared Equity Financing Agreement

By William E. Sigler

Adult children can buy their first house or acquire a more expensive home than they might otherwise afford by using a shared equity financing arrangement.

Background

Under Section 262 of the Internal Revenue Code, personal, living and family expenses are generally not deductible. This rule does not apply where the Code expressly provides otherwise, such as in the case of interest and taxes. In tandem with Section 262, Section 280A generally disallows deductions for the use of a ‘‘dwelling unit’’ used as a residence, subject to certain exceptions. Section 280A’s deduction disallowance rule is triggered when one makes personal use of a dwelling unit as a residence for which he/she also claims business expense deductions. There is an exception for shared equity financing agreements.

A “shared equity financing agreement” is an agreement under which two or more persons acquire qualified ownership interests in a dwelling unit, and at least one of those persons is entitled to occupy the dwelling unit as a principal residence in exchange for paying rent to one of the other persons. A “qualified ownership interest” is an undivided interest for more than 50 years in the entire dwelling unit and the appurtenant land being acquired in the transaction to which the shared equity financing agreement relates.

Alternative to Co-Signing a Loan

With a shared equity financing arrangement, a parent (or maybe a grandparent) shares in the purchase and cost of maintaining a house used by the child as a principal residence. The parent rents his or her portion of the home to the child and receives the annual tax benefits generally available from renting real estate. Since the child does not own 100% of the home, he/she is the parent’s tenant as to the portion of the home not owned and rents that interest from the parent at a fair market rate.

Example: Shared equity financing arrangement facilitates child's home ownership

Ozzie has agreed to help his son, Ricky, purchase his first home. The total purchase price is $100,000 consisting of a $20,000 down payment and a mortgage of $80,000. Ozzie pays half of the down payment and makes half of the mortgage payments pursuant to a shared equity financing agreement with Ricky. Ricky pays Ozzie a fair rental for using 50% of the property, determined as of when the agreement was entered into.

Ricky treats the property as his personal residence for tax purposes, deducting his 50% share of the mortgage interest and property taxes. Because his use is not attributed to Ozzie, Ozzie treats the property as rental. He must report the rent received from Ricky, but he can deduct his 50% share of the mortgage interest and taxes, any maintenance expenses he pays, and depreciation based on 50% of the property's depreciable basis. If the property generates a tax loss, it is subject to, and its deductibility is limited by, the passive loss rules.

Caveats

The parent's portion of any gain will not qualify for gain exclusion when the residence is subsequently sold. The result will be a taxable gain for the portion related to the deemed rental. If excluding all potential gain is a major consideration, then the parent may have to resort to cosigning the mortgage instead of acquiring the house by outright joint ownership. This should allow the parent to exclude the gain (up to $250,000 single and $500,000 married filing jointly), subject to specific requirements.

If it is anticipated that the child will ultimately purchase the parent's equity, and the rental will generate losses suspended under the passive loss rules, then the suspended passive losses normally allowed at the time of sale are not allowed when the interest is sold to a related party.

Implementing a Shared Equity Financing Agreement

Under the current proposed regulations, a shared equity financing agreement must be in writing. An oral agreement will not suffice. In addition, the child must pay the parent a “fair-market rent” for the portion of the home that the parent owns. Otherwise, the IRS can reduce or disallow some of the deductions taken.

Local realtors can usually provide an estimate of the home’s fair-market rent. You can also get an idea by checking “For Lease” advertisements in the classified section of the newspaper or online. It’s a good idea to copy these rental advertisements and keep them on file. If the IRS eventually questions whether fair-market rent was charged for the property, it will be helpful to have the ads as evidence that the proper amount really was charged.