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Selling a house to a family member

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The majority of real estate deals are known as "arm's-length transactions," a term that reflects the distance between a buyer and seller who do not have any kind of existing relationship. However, there are scenarios where the two parties know each other — well.

Selling to (or buying from) someone you know, especially a family member, is often called a non-arm's-length transaction.

If you're thinking about selling your house to a child, sibling, cousin or any other relative, there are some important things to consider first.

Do you need an agent for a non-arm's-length sale?

If you have a relative who wants to buy your house, you may assume that means you can avoid real estate agents and the associated commission fees — just under 5.5% of the purchase price when split between the listing and the buyer's agents, according to Clever Real Estate. In fact, the most recent breakdown of home sales from the National Association of Realtors shows that 38% of for sale by owner deals involve parties who know each other, and after all, you're family. It's a win-win, right?

Not so fast. James Jensen, associate broker and owner at Re/Max Now in Valley City, N.D., points out that the closer your relationship is, the more useful a real estate agent with no connection to the property can be. "The most important piece of these transactions is having a neutral third party who can keep emotions in check and focus on the facts," he says.

Joseph Becker, managing principal broker at Re/Max Out West Realty in Prineville, Ore., agrees that an agent can play a key role in alleviating potential awkwardness in family deals. He points to former clients as an example: a divorcing couple who were selling the family home to their son, with plans for the father to continue living there after the sale.

"My Realtor role was in making sure the paperwork was done correctly," Becker says. "It was an interesting transaction. The couple had agreed on a price, the son had agreed to purchase, and my job was to make sure all legal requirements were met. With all the family dynamics, there were times I felt like a mediator of sorts, making sure everyone was treated fairly in the process."

Why is it important to get an independent appraisal during a family sale?

While a real estate agent is optional — which also applies even if you're selling a house to someone you don't know — hiring a professional appraiser is critical. An appraiser will assess the fair market value of the home, which is important for the new owner to understand when determining how much to pay for insurance.

It's also an important piece of information that factors into taxes: If you're selling your home to a child, for example, for significantly less than its appraised value, it will have gift tax implications. That means you may need to file a form and consider how the property factors into your overall lifetime gift limit (more on that below).

Should you order a home inspection before selling to a family member?

In addition to determining how much the property is worth, it's wise to identify any hidden issues that might impact that value — and that might create some friction between you and the new owner down the road.

A professional home inspector can also play a part in avoiding repair-related arguments at the Thanksgiving table. Make sure anything found in the inspection is addressed by a pro, and not just a DIY fix. That way, if there's an issue with it at some point in the future, "it's not on you," says Jensen. "Ten years down the road, you're still going to be siblings. You don't want to have botched repairs create a lingering issue."

Should you hire a real estate attorney?

Real estate attorneys can be essential when dealing with familial transactions. "The attorney can take the personal burden off the client, setting the rules and helping avoid potential trouble," Jensen says.

Is it faster to sell to a family member?

Selling to a relative might sound like a potentially speedy process: It's all in the family, so shouldn't you be able to skip some of the back-and-forth negotiation? However, these deals can wind up taking considerably longer than a typical sale.

"What I see quite often is a parent dies, and there are three or four children who have inherited the house," Jensen says. "Now, they all need to agree on how to sell it, and there are so many emotions involved. There is always one sibling who has a different mindset than the others. One may want to hold out for top dollar, and the others just want to be done."

In some cases, Jensen says that one sibling decides they want to buy the home, but drags their feet when it's time to actually get the deal done. "It's very important to have a timeline in place," he says. "That sibling might say they want to do it, and then the family winds up waiting and waiting. The sooner you sell it, the better, so you won't have to deal with ongoing payments."

To speed up the process, Jensen recommends listing the home to attract interest from prospective buyers, with an exclusion clause that allows the interested family member to buy the home at a certain price. This way, the property gets listed and the family member still has the ability to purchase.

There are always tax considerations when selling a home, but selling to someone you know can raise some unique questions. For example, if neither of you use a real estate agent, and you knock a few thousand dollars off the price to reflect the absence of commission fees, does the IRS consider that a "gift"? No, says Lisa Greene-Lewis, a certified public accountant and tax expert: "If the home is sold in line with the fair market value, there would not be a trigger for gift tax."

So, if the appraised value of the property is $400,000, and you sell it for, say, $385,000, you're in the clear tax-wise. However, if you want to sell it for a steep discount — $200,000, for example — you're going to need to consider what other parties, like a lender and the IRS, will think.

Here's a further breakdown of the tax implications you'll need to consider when selling to a family member:

- Gift of equity. If the purchaser of the property is applying for a mortgage to finance the deal, a lender will want documentation that you (the seller) do not expect to be compensated for the discount. It's similar to a gift letter if you were to give someone a large chunk of money for a down payment: The lender wants to be sure that the money won't need to be repaid.
- Gift tax. If the amount of equity exceeds the annual gift exclusion allowed by the IRS ($19,000 for individuals, $38,000 for couples filing jointly), you will need to file Form 709 with the government to document the gift. You may not need to pay any taxes, though. "The parent would have a choice to take the tax hit now on the amount that exceeds the annual gift exclusion, or apply the amount to the annual lifetime exemption," Greene-Lewis says. Given that the annual exemption amount is $13.99 million, or nearly $28 million for a married couple, most people will never hit this amount.
- Capital gains taxes. Don't forget to consider what you paid for the property when you purchased it, either. While real estate sales have fairly generous capital gains exemptions — up to $500,000 of profit for married couples — you may want to double-check with an accountant about any taxes you could incur for the sale.
- Transfer taxes. Depending on where you live, you may need to budget for transfer taxes, too. These are typically calculated as a percentage of the purchase price. If you're selling it to a family member for below market value, that means the two of you can enjoy a lower bill at closing.

Before you move forward with a deal that could impact family get-togethers for the rest of your life, make sure you weigh the pros and cons.

Pros

- Keeping it in the family. A home holds a lot of memories, possibly even for multiple generations. If you can sell it to a family member, the site of so many holidays, birthdays and big moments can continue to be part of your and your children's future. For some people, this may trump all other considerations.
- Reducing costs. If you have a very close relationship and feel comfortable forgoing real estate agents, you can eliminate paying real-estate agent commission fees on the sale.
- Eliminating promotional work. Since you aren't trying to attract potential buyers, you don't need to bother with the typical work of staging the home, crafting a listing, holding open houses and clearing out for showings.

Cons

- Potential for bad blood. Family ties can work both ways. To avoid driving a wedge between relatives, you'll have to be extra-careful to keep things friendly and be as fair and transparent as possible.
- Less profit. Whether it's your cousin, your brother-in-law or your uncle, buyers you're related to share one common trait: They're probably not going to want to pay top dollar. If you want to score the best possible price for the home, you're better off with an arm'slength transaction.

• Extra work for your taxes. If your sale involves a significant "friends and family discount," be ready to deal with the IRS. Even if it doesn't trigger a gift tax, this kind of transaction can create the need for additional assistance from a tax professional.

Key takeaways

• Selling a house to a family member or friend is common in FSBO (for sale by owner) transactions.

• Even when you're selling a home to someone you know, it's advantageous to hire outside professionals such as a real estate agent and an attorney to avoid any conflicts and ensure the deal checks all the necessary legal requirements.

• Selling a house to a family member can come with additional tax considerations, particularly if you're offloading the property for a price well below market value.