The Tax Implications of Supporting Adult Children

Does financially supporting an adult child incur gift tax? It depends.

By Susan JohnstonSept. 30, 2013 | 12:15 p.m. EDT+ More

For college students who graduated during the recession, finding a job to pay rent and student loans hasn't been easy. Countless millennials – often called the boomerang generation – have moved back home with mom and dad as a result. Many others live on their own but receive financial support from parents as they cobble together multiple part-time jobs, attend graduate school or attempt to impress a prospective employer during an unpaid internship.

In 2011, nearly 60 percent of parents provided financial support to adult children who were no longer in school, according to a Harris Interactive poll sponsored by the National Endowment for Financial Education. While some parents may see helping adult children as an obligation, they may not have considered the tax implications of supporting kids to the tune of $14,000 or more per year (a ridiculous sum for some families but not improbable if a parent helps with rent and living expenses in cities like New York or San Francisco or pays for an extravagant wedding).

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"In their mind, they think of course they should be supporting their children," says Cindy Peterson, a senior advisor at wealth management firm Lau Associates in Greenville, Del. Some clients are surprised to learn that the government might see that as a gift.

However, small contributions probably won't get you in trouble. "The IRS doesn't worry about the kid moving back to their old room and eating meals at their home," says Mike Piershale, president of Piershale Financial Group in Crystal Lake, Ill. "But if you had a parent that was giving really serious money to their kids for whatever reason, they're going to be interested in that."

The Internal Revenue Service allows you to gift up to $14,000 per year to as many people as you'd like without triggering the gift tax. Married couples can agree to split a gift and collectively give up to $28,000 to one person, but a widow or single person is limited to $14,000 per year (and that amount does not roll over from year to year). If you give more than $14,000 to one person other than your spouse in a calendar year, you are supposed to file a gift tax return, also called IRS Form 709.

The IRS allows a $5.25 million lifetime gift exemption, which means individuals can give away that amount over the course of a lifetime or as part of an estate (although the government could lower that amount in the future). For most people, filing a gift tax is simply a formality and won't result in federal gift taxes because they haven't used up the lifetime gift exemption. But if you get audited and the IRS requests copies of bank statements, large unreported gifts to relatives could prove problematic.

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For instance, when a family business gets audited, the IRS may audit individuals involved with the business. "If the IRS sees the son received a $25,000 check from the father, they're going to ask about that," says Richard Davis, an accounting professor at Susquehanna University in Selinsgrove, Pa. A parent could legally pay a child reasonable wages for hours worked (parents can also pay children for tasks even if they don't have a family business), but large gifts could fall under scrutiny.

Beyond paying an adult child for lawn maintenance or other tasks, there are a few other ways to financially help a child without exceeding the $14,000 gift limit. For instance, parents can pay a child's medical expenses or health insurance premiums directly without needing to file a gift tax return.

Tuition is also exempt from the federal gift tax so parents could pay an adult child's undergrad or grad school tuition directly to the school rather than sending the child money and having him or her pay the tuition. (Some grandparents pay tuition as a way to gift money during their lifetime and avoid estate taxes when they die if they anticipate exceeding the $5.25 million exemption.)

In some cases, parents paying an adult child's tuition may also be able to claim the child as a dependent for tax purposes and take advantage of educational tax credits like the American Opportunity Tax Credit.

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However, not all students meet the IRS definition of a dependent. An adult child who files a joint tax return with a spouse, attends school part-time or earns more than the exemption amount ($3,900 for 2013) would generally not qualify as a dependent.

When giving money to a child, also keep in mind that gift and estate tax rules vary by state. "It's very important that you work with a professional within your state," Peterson says. "There are still a number of states where the estate tax exemption is still as low as $600,000, so it is important that you understand not only the federal implications but the state implications."

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