Estate Planning With a Vacation Home

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Wealth Planning Insights

Real estate, and in particular, vacation homes, often have significant emotional attachment for family members. As a result, the family vacation home carries with it unique planning challenges. Families purchase vacation homes for many reasons, but almost all see them as a refuge from the day-to-day business of life where family members can gather, relax, and enjoy the beauty of the surroundings and one another's company. As owners of a successful family retreat, parents often wish to have the next generation, long after they are gone, create their own memories while spending time at the family vacation home. As such, they make plans to leave the property to the next generation, which most likely leads to multiple ownership of the property among children, grandchildren, and sometimes even spouses. As much as a family vacation home can be a vehicle for the next generation to stay connected, it also can become a flashpoint for family tension and strife. For these reasons, it is most important for owners of a family vacation home to be realistic in their assessment of family dynamics and the practicalities of having the next generation own and manage such an asset.

Keeping The Property In The Family

Does the next generation really want to keep the property in the family? This important question is often forgotten in the planning process for a family vacation home. Parents who cherish the property want to keep it in the family, so that the next generation can enjoy it as they have. As such, they are predisposed to leaving it to them in some way. If only such a decision were that simple! Family dynamics, such as sibling rivalries, difficult spouses, disinterest in retaining and

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using the property by some children who live far from it, and the financial burden of maintaining a vacation home all lead to potential conflicts down the road. Instead of a family vacation home keeping the next generation connected with one another, it can have the opposite effect of tearing them apart. Accordingly, parents should have an honest discussion with each of their children, perhaps separately to start with, in order to accurately determine the level of interest the next generation has for owning and using the property. Assuming at least a majority of the children wish to retain the property, then the next step is to determine the best way for them to leave the property to them.

Lifetime Gift Or Transfer At Death

The first decision to be made is whether the property will be gifted during the parents' lifetimes or at death. Transferring property to the next generation during lifetime can serve to reduce estate taxes, but this may not be the best approach if the parents have a low basis in the residence the taxable estate will be under the federal exemption. Depending on the value of the property and the number of family members who would receive an interest in the property, gifting can be done on either an incremental basis or all at once, in either case utilizing the annual exclusion for taxable gifts (currently $15,000 per donee per year). Before any gifting is undertaken, however, the parents need to decide on the form of ownership for the next generation to hold the property: outright, in trust, or through a limited liability company (LLC). An experienced estate planning attorney will explain the pros and cons of each form of ownership, allowing the parents to make an informed decision about which form of ownership works best for their family.

Outright Transfers

Outright transfers of fractional shares of a family vacation property is the simplest method for gifting a family vacation home. However, this option provides no structure for management of the property by the next generation. As such, the children are left to devise a working plan for its use and maintenance, and also must provide the funds to maintain the property. As joint titleholders, each family member has the right to leave his or her interest in the property to whomever he or she wishes. In addition, a disgruntled family member, by way of a court proceeding, could force a sale of the property, thereby causing problems for the other family members who wish to retain the property, but who may not be able to afford to purchase the interest of the family member wishing to sell.

Qualified Personal Residence Trust

If the property is quite valuable and the parents wish to gift the property all at once in a tax efficient manner, then a Qualified Personal Residence Trust (QPRT) is a common vehicle for transferring ownership to the next generation. The property is transferred to this specialized form of irrevocable trust, with the use and ownership retained by the parents for a term of years, after which the property is either left outright or continues in trust for the benefit of the next generation. A valuation discount for gift tax reporting purposes is achieved by way of the parents' retained interest of the QPRT. When the QPRT ends, the parents may continue to pay the costs for the property in the form of fair market value rent paid to the then current owners.

As effective as a QPRT may be for tax planning purposes, this form of ownership for a family vacation home does have its shortcomings. First, there is the risk of losing the transfer tax benefits if the grantor does not outlive the QPRT term, as the property would be brought back into the grantor's estate at death. Second, the parent's retained interest is valued using the Internal Revenue Code Section 7520 rate. Ideally you want the value of the retained interest to be higher and the value of the gifted portion to be lower, using less of the parents' lifetime gift exemption. However, Section 7520 rates are at historic lows and QPRTS are less attractive when rates are low.[1] Since a QPRT is an irrevocable trust with terms that, generally speaking, cannot be amended, and where all decisions about the property are made by a designated independent (i.e., non-family member) trustee, it is not a particularly flexible form of ownership for managing a family vacation home. Finally, a QPRT should be considered only in cases where the family is fairly certain that, for the foreseeable future, they wish to retain rather than sell the property.

Limited Liability Company

Establishing a Family LLC is another way of transferring a family vacation home to the next generation in the form of membership interests in the LLC. Typically, such interests are gifted over a period of years, using the annual exclusion for taxable gifts. Because the gifted interests represent only a portion of the underlying real estate, and because there are often restrictions on transferring the interests, reasonable discounts in the valuation of the interests are justified, thereby reducing the value of the gift. In addition, if the property is located in a state other than the state of the parents' domicile, and the parents do not gift all of their interests in the LLC during their lifetimes, they can nevertheless avoid ancillary probate administration at death, because the property is no longer considered "real estate" for probate administration purposes.

More importantly, an LLC often provides a clearer and more flexible framework for transferring a family vacation home to the next generation than outright fractional shares or a QPRT. This is because the LLC documents typically include an operating agreement, which serves as a blueprint for managing the property, and which can be modified over time to address changed circumstances. Typically, the agreement designates managers for the property (often members of the LLC) who are charged with i) collecting "dues" from members; ii) paying carrying expenses; iii) making decisions about repairs; iv) scheduling use of the property by members, and v) renting the property to third parties. In addition, the agreement sets forth the procedure for a member to transfer his or her membership interest, as well as for the LLC to sell the property if a majority of its members wish to do so. Although an LLC form of ownership requires some upfront costs in connection with drafting the operating agreement as well as annual filings of partnership income tax returns and possibly state registration fees, it is an effective vehicle for transferring a family vacation home to the next generation for their continued ownership and enjoyment.

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Whichever method is used to transfer an interest in a family vacation home to the next generation, a formal appraisal of the property should be completed prior to the transfers, and if transfers exceed the gift tax annual exclusion per donee, then a Federal Gift Tax Return will need to be filed.

Summary

Since family vacation homes often provide a refuge for family members to gather and enjoy one another's company, it is not surprising that parents often seek to find ways to keep such properties in the family. Before undertaking such planning, however, parents should be certain that there is sufficient interest from the next generation in retaining such ownership. If there is, parents should consult with a qualified estate planning attorney about the most appropriate method for transferring the property to the next generation and the tax consequence of the timing of the transfer and method. The discussion should include the topic of "endowing" the transfer with sufficient liquid assets to help maintain the property. This can help the next generation use and enjoy the property without its ownership becoming too much of a financial or emotional burden to them. ■

Updated September 2020

[1] As of mid-2020

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