Special Report

Vacation Area Homes: Tax and Management Issues

Case Study 1: Vacation home - no estate plan

Harry and Sally own a vacation home on a barrier island. They purchased the home many years ago for $50,000 and it is now worth $1 million. Harry and Sally have two children and five grandchildren. The children visit the vacation home on alternating weekends, bringing the grandchildren with them, and each of the children spends two weeks at the home during the summer. Both children would like to have the home after Harry and Sally die.

Harry and Sally would like to keep their vacation home in the family but aren't sure what to do with the property. Because they are undecided, they do nothing. After Harry and Sally die, the children decide they want to retain the home together. Turmoil ensues when they cannot agree on a schedule for using the home or when and if to make improvements to the property that one child can't afford. Eventually, bitterness develops between the children.

Meanwhile, the lawyer probating Harry and Sally's estate discovers that significant federal and state estate taxes will be due. Neither child has the money to pay the taxes. Finally, they agree that the home must be sold.

Case Study 2: Vacation home - estate plan

Bill and Linda own a vacation home on a barrier island. They purchased the home many years ago for $50,000 and it is now worth $2 million. Bill and Linda have two children and five grandchildren. The children visit the vacation home on alternating weekends, bringing the grandchildren with them, and each of the children spends two weeks at the home during the summer. Both children would like to have the home after Bill and Linda die.

Bill and Linda consult an attorney experienced in estate planning and elder law, who helps them determine how the matter should be handled. They decide to transfer the property to their two children now. The children and grandchildren sign a Joint Venture Agreement that spells out how a manager will be elected, what powers the manager will have, how a schedule for use of the property will be developed, what rules will apply to use of the property, how normal operating expenses (such as taxes and insurance) will be paid, and what will be done in the event of the need for capital improvements. The agreement is drafted to give protection to all of the families. Bill and Linda live four more years. At their death, the vacation home is not included in their estate for either federal or state estate-tax purposes.

What Estate-Planning Issues Must be Addressed When Passing On a Vacation Home?

If you own a home in a vacation area, it may be one of your family's most cherished possessions. Your children may have fond memories of times spent there over the years. And if your children are grown and married, with families of their own, the home may serve as the perfect location for enjoyable family reunions.

Yet, just as a vacation home can enhance family bonds, it can wreak havoc if parents fail to plan appropriately for the transfer of the property after their death. Passing on a vacation home to children and grandchildren can raise complex issues regarding taxes, maintenance costs and property management. An attorney experienced in estate planning and elder law can help you consider such issues as the following:

- Federal estate tax. The top federal estate-tax rate is 46%. The exemption from federal estate tax is $2 million per person. With planning, a married couple can transfer up to $4 million in assets without incurring any estate-tax consequences.
- Federal gift tax. Every individual is allowed to give $12,000 a year, per person, to any beneficiary or beneficiaries he or she selects. Individuals are entitled to give away $1 million during their lifetime without gift-tax consequences.
- State estate tax. Many states have an estate tax. For example, the New York estate tax applies once the value of an estate exceeds $1 million.
- Capital gains tax. Vacation homes purchased many years ago may have appreciated significantly in value. If and when the home is sold, there may be substantial capital gains tax due. Capital gains tax issues to consider include:
  - → Carryover basis. If a vacation home is transferred directly to children and/or grandchildren during the lifetime of the parents, the parents' cost basis carries over to the children and/or grandchildren and may result in a significant capital gains tax when the property is sold.
  - → Step up in basis. Currently, when a property passes to children and/or grandchildren at the death of the parents, the cost basis in the property is adjusted (or "steps up") to the fair market value as of the date of the parents' death. This may result in significant tax savings when the property is eventually sold.
  - → Principal residence exclusion. A single person has an exclusion of $250,000 from capital gains tax on the sale of a principal residence. For a married couple, this exclusion is $500,000.
- Estate-tax freeze. It is possible to transfer a property in such a way that future appreciation shifts mostly to children, freezing the value of the parents' interest for tax purposes.
- Discounted gifts. It is possible to transfer assets to future generations in such a way that the gift receives a discount for federal estate- and gift-tax purposes and for state estate-tax purposes, if applicable.
- Nursing home claims. If one spouse becomes ill and needs Medicaid to cover medical expenses, Medicaid will require that the vacation home be sold and the proceeds used to pay for care.
- Creditor protection. Certain forms of ownership offer protection from creditors.
- Control. Parents must decide if they want to retain control of the property during their lifetimes.

Which Strategy Will Help You Address These Issues?

There is no one answer to this question. An attorney experienced in estate planning and elder law can help you carefully review your overall situation and determine the best strategy for passing on your vacation home. Alternatives include the following:

- Making a lifetime outright gift of the home to your children and/or grandchildren.
- Transferring the home during your lifetime but retaining a life estate.
- Transferring the home during your lifetime, but retaining a right to use and occupy it.
- Establishing a Qualified Personal Residence Trust (QPRT).
- Establishing a Family Limited Liability Company (LLC).
- Establishing a Family Limited Partnership.
- Having the home transfer upon your death.

What are the Advantages and Disadvantages of Various Strategies?

Lifetime Outright Transfer

- Mechanics. Transfer the home by deed to children and/or grandchildren.
- Advantages.
  - → State estate tax: Transferring property to children can remove that asset from the estate for state estate-tax purposes.
  - → Estate-tax freeze: Future appreciation of the value of the property is not taxed to the parents.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility can be established. A lifetime outright transfer accelerates eligibility.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
- Disadvantages.
  - → Federal estate tax: Neutral.
  - → Federal gift tax: Limits the amount that can be transferred without incurring gift tax.
  - → Principal residence exclusion: Lost.
  - → Step up in basis: Lost.
  - → Valuation discount: Not available.
  - → Control: Lost.

Transfer Home and Retain Life Estate

- Mechanics. Transfer the home by deed to children and/or grandchildren but reserve the lifetime right to live on the property, receive a portion of proceeds if the property is sold and receive rents.
- Advantages.
  - → Step up in basis: Upon death.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility can be established. Transferring the home and retaining a life estate accelerates eligibility.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
  - → Control: Maintained.
- Disadvantages.
  - → Federal estate tax: The full value of the property is included in the parents' estate.
  - → Federal gift tax: Limits the amount that can be transferred without payment of a gift tax.
  - → State estate tax: The property is included in the parents' estate.
  - → Capital gains: The principal residence exclusion is lost with respect to interest transferred to the children.
  - → Estate-tax freeze: Not available.
  - → Valuation discount: Not available for tax purposes.

Transfer Home and Reserve Right to Use and Occupy

- Mechanics. Transfer the home by deed to children and/or grandchildren and reserve the right to use and occupy the home, but not to receive rent or any portion of the proceeds if the property is sold.
- Advantages.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility can be established. Transferring the home and reserving a right to use and occupy it accelerates eligibility.
  - → Step up in basis: Upon death.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
  - → Control: Maintained by written agreement.
- Disadvantages.
  - → Management: An agreement must be developed.
  - → Federal estate tax: The property is included in the parents' estate.
  - → Federal gift tax: The property is included.
  - → State estate tax: The property is included in the parents' estate.
  - → Principal residence exclusion: Lost.
  - → Estate-tax freeze: Not available.
  - → Valuation discount: Not available for tax purposes.

Qualified Personal Residence Trust

- Mechanics. Transfer the property to a trust, reserving the right to use the property for a period of time that the parents designate. The parents must outlive the term of the trust for this strategy to work. After the term of the trust, the parents must pay a fair market rental value to use the property.
- Advantages.
  - → Federal estate tax: Reduced or eliminated on appreciated value.
  - → Federal gift tax. Reduced.
  - → State estate tax: Reduced or eliminated.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility can

be established. Use of a Qualified Personal Residence Trust accelerates eligibility.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
  - → Valuation discount: Available
- ◆ Disadvantages.
  - → Federal gift tax: Applies.
  - → Capital gains tax: Parents' cost basis carries over to the children and/or grandchildren and the advantage of a step up in basis is lost.
  - → Principal residence exemption: Lost, if applicable.
  - → Estate-tax freeze: Yes, if grantor lives beyond term.
  - → Control: Lost
  - → Other: Parents must outlive the term of the trust; after the term ends, parents must pay rent.

Family Limited Liability Company

- ◆ Mechanics. The business purpose of a limited liability company (LLC) is ownership and management of the real estate. All members have a right to elect managers to govern the LLC. The property is deeded to the LLC and shares or percentages of the LLC are either given to or purchased by the children and/or grandchildren who are interested in owning or maintaining the vacation property.
- ◆ Advantages.
  - → Federal estate tax: May be reduced or eliminated. Minority and marketability discounts may be available.
  - → State estate tax: May be reduced or eliminated.
  - → Valuation discounts: For gift-tax and estate-tax purposes, the value of the property is less than its fair market value because it is held in a family LLC.
  - → Estate-tax freeze: Applies.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility can be established. Use of a Family Limited Liability Company may accelerate eligibility.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
  - → Control: Maintained.
- ◆ Disadvantages.
  - → Federal gift tax: Applies.
  - → Capital gains tax: Applies.
  - → Principal residence exclusion: Lost, if applicable.

Family Limited Partnership

- ◆ Mechanics. The property is deeded to the Family Limited Partnership, which operates in much the same way as the Family Limited Liability Company. There must be a business purpose for the partnership.
- ◆ Advantages.
  - → Federal estate tax: Reduced or eliminated.
  - → State estate tax: Reduced or eliminated.
  - → Valuation discount: Applies.
  - → Estate-tax freeze: Applies.
  - → Medicaid: Transfers cause a period of ineligibility but, after a certain period of time, eligibility may be established. Use of a Family Limited Partnership may accelerate eligibility.
  - → Creditor protection: Achieved for transferor unless transferor has existing creditor problems.
  - → Control: Maintained.
- ◆ Disadvantages.
  - → Federal gift tax: Applies.
  - → Capital gains tax: Applies.
  - → Principal residence exclusion: Lost, if applicable.

Transfer on Death

- ◆ Mechanics. The property is transferred to future generations by the terms of a will or revocable living trust.
- ◆ Advantages.
  - → Capital gains tax: A step up in basis is achieved.
  - → Principal residence exclusion: Maintained if the parents change their mind and decide to sell.
  - → Control: Maintained.
- ◆ Disadvantages.
  - → Federal estate tax: The entire value of the property, including appreciation, is included in the parents' estate.
  - → Federal gift tax: Not applicable.
  - → State estate tax: Applies.
  - → Estate-tax freeze: Not available.
  - → Valuation discount: Not available.
  - → Medicaid: The property is exposed to Medicaid claims.
  - → Creditor protection: Lost

What Management Issues Need to be Addressed?

Regardless of the estate-planning strategy selected, family members should enter into either a Joint Venture Agreement, an Operating Agreement or a Partnership Agreement that addresses issues such as the following:

- What schedule will apply for use of the property, e.g., who gets 4th of July weekend?
- Will the property be rented out and/or used by non-family members?
- What rules will apply to use of the property, e.g., will pets be allowed?
- How will routine expenses, such as taxes and insurance, be paid?
- Will special assessments be levied for capital improvements and extraordinary expenses, such as roof replacement?
- How will family members contribute toward expenses?
- What will happen if a family member fails to contribute toward expenses?
- Will a manager be selected and, if so, how?
- What procedures will be used to resolve disputes?

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