

PLANNING FOR THE FAMILY VACATION HOME

Preserving Family Memories and Making Future Plans.



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Family vacation homes are treasures. They are the places where memories are made – the lazy days of summer at the beach house or the fresh mountain air on a winter holiday. But planning for vacation property, fondly associated with rest and relaxation, can be a challenge. Successful planning requires thoughtful consideration of the interests of all of the family members involved and a careful assessment of the logistics of the long-term shared family use of the property.

FRAMING THE CONVERSATION

Beginning the planning process with a conversation that includes the entire family is highly beneficial. There are many choices and associated decisions; starting from a place of consensus greatly increases the likelihood of developing a plan that meets the family's goals. Does the family desire to keep the property? Or is keeping the property the preference of the parents, but not the children? Do some of the next generation desire to keep the property but not others? In some circumstances the family may discover that the optimal plan is to dispose of the property rather than to pass it on.

If there is a collective desire to keep the vacation home in the family, there are many questions to consider:

- When should the property be transferred to the next generation? During the lifetime of the senior generation owners or at the passing of the last surviving senior generation owner?
- To or for whom should the property be transferred? To all of the next generation or only to some? If only to some, will there be compensating gifts or bequests to the others?
- How should the property be titled and transferred? Outright? In trust? In an entity?
- How will the property be managed? Who will handle repairs and upkeep?
- How will use be scheduled? If the 4th of July is the peak holiday, and there are three children and six grandchildren, but only four bedrooms, who has priority?
- How will the bills be paid? What if some family members use the property more than others or some have greater financial independence than others?

Addressing questions of this type in the planning process can be difficult, but doing so can make future shared use more enjoyable and less stressful for the entire family.

WHEN TO TRANSFER

Vacation properties are customarily transferred to the next generation by gift or bequest, rather than sale (although a sale may be desired in some circumstances). Gifts may be made during life or at death. One important tax difference to note is that with a lifetime gift, the donor's basis in the property generally carries over to the donee. With bequests at death the basis of the property is adjusted to its value at death (or an alternate estate tax valuation date in certain circumstances).



The basis adjustment may be an important factor to consider depending on whether the property has or is expected to appreciate and the anticipated likelihood of a sale by the next generation. Income, gift and estate tax rates, exemptions and exclusions tend to change from time-to-time. Assessing the tax consequences of a proposed plan with the family tax and legal advisors is recommended.

Beyond taxes, there is the question of control of the property. Depending on how a transfer is structured, the timing of the transfer will impact decision-making and control of the property.

HOW PROPERTY IS HELD

The way in which property is held—meaning, how it is owned/titled—will frame the conversation regarding planning options. At its most basic, the property may be owned outright. Therefore, the owners may generally use and dispose of the property as they please. If the property is held by the parents as joint tenants with the right of survivorship, while both parents are alive they both have an undivided right to use the property. At the death of the first parent, the property will pass to the surviving spouse. Including children as joint-tenants, while ostensibly simplifying the transfer of title at the death of the parents, can have unanticipated consequences (including the passing of the property to the last surviving child) and unexpected tax implications, and is not generally recommended.

If property is held outright as tenants-in-common, there is no passing of interests to surviving owners at death as with joint tenancy. The individual owners may sell or dispose of their interest to whomever they choose, during life or at death. Whether this type of freedom of disposition is desired is a matter to consider in planning.

Vacation property may also be held in an entity, such as a limited liability company or a limited partnership, or in trust, and entity interests may be held in trust. Entity and trust ownership allow for greater oversight of the management and disposition of property.

PLANNING OPTIONS

One option to consider is the use of a Qualified Personal Residence Trust (QPRT). The grantor transfers property to a trust for the benefit of the family, but retains an interest in the property for a term of years and, usually, a reversionary interest as well. The value of the interest transferred to the family, deemed a gift to the family, is the full fair market value of the property minus the value of the interest retained by the grantor. The value to the beneficiaries is determined in relation to the Internal Revenue Code Section 7520 rate, the interest rate used to value certain split interests, at the time of transfer (2.2% in June 2014). Therefore, any future appreciation to the property will not be considered for transfer tax purposes. The retained value will be for a predetermined term of years, so this planning option may not be advisable if the grantor may not have a long life expectancy. If the grantor does not survive the trust term, the entire value of the property will be included in the estate of the grantor for federal estate tax purposes.

At the end of the term, the QPRT may be structured to transfer the property outright to the children or to hold the property in trust for their benefit. However, once the property is transferred at the end of the term, the grantor cannot continue to freely use the property as before. Continuing to use the property as if the grantor still owned the property might result in the full value of the property being included in the grantor's estate for estate tax purposes. Therefore, the grantor



should consider a leasing arrangement, such as renting the property for fair market value, from the new owners (although there will be credit for any previously paid gift taxes).

Another option is to transfer the property into a limited liability company (LLC) or limited partnership. Interests in the LLC or limited partnership may then be transferred to the next generation or to a trust for their benefit, either immediately or over a period of time, possibly at a discounted value for gift tax purposes due to the closely-held, non-marketable nature of the interests. When gifting interests in the LLC or limited partnership, owners may consider taking advantage of the annual gift tax exclusion amount (\$14,000 in 2014) to minimize the transfer tax consequences. In order to receive the transfer tax benefits as well as the benefits of limited liability for members and limited partners and treatment as a pass-through entity for income tax purposes, the family should be mindful of the need to respect the formalities of the LLC or limited partnership.

COMPLETING PROPER PLANNING

However the property is titled and transferred, whether individually or in trust, outright or in an entity, any transfer should include planning for expenses, upkeep, and maintenance. Determining if the intended recipients are willing to maintain the property and establishing a plan for administration will ensure the validity of any planning structure, while helping to keep the valued property in the family. Because maintaining a property can be time-consuming and costly, having honest conversations with family members is a vital part of the process. A plan should be established to pay expenses and manage the property.

At the outset, a plan should also consider the possibility that a family member may wish to dispose of his/her interest in the property. Discussing the possibility of first offering to sell an interest to the other family members, or drafting into any agreement that the family should have the opportunity to buy the interest before anyone outside the family has the option, will help keep the property in the family.

Clearly defining roles and expectations is essential for the successful transfer of the family vacation home to the next generation. For property held in trust, this can be addressed in the trust agreement, with the trustee being responsible for management. For property held in an LLC or limited partnership, the operating agreement or partnership agreement can address the questions of management. For property held outright individually, a co-tenants' agreement may address the logistics of managing the property.

Purposeful planning with open communication among the family and their advisors will best position the family to preserve cherished memories and provide for the future enjoyment of the family vacation home.

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