Estate Planning

Your vacation home: Enjoy it while you are alive, and plan for it at your death.

By Patricia M. Annino, Esquire, and Dara B. Factor, Esquire

As the summer winds down, you may find yourself sitting on the deck of your vacation home and gazing at the sunset, thinking about the time you have spent in your vacation home with your family. A vacation home is the place where you, your children, grandchildren, and perhaps even great-grandchildren gather for vacations and holidays. As the family meeting spot, this vacation home has (or will have) special memories where your children and/or grandchildren went into the ocean for the first time, or built their first sandcastle, and where, at the end of the day, you all gathered around a bonfire roasting marshmallows for an evening snack.

At some point you may begin to think about the future and wonder, "What happens to my vacation home long after I am gone?" It may be your goal to continue to preserve the vacation home for generations to come, allowing your family to experience this special place; or your goal may be to just enjoy it while you are alive and leave it up to your heirs to figure it out once you are gone.

Just like your primary residence, your vacation home is an asset that must be accounted for in your overall estate plan, and specialized planning may be required to ensure that the vacation home remains a place for special memories and not family turmoil.

Whether your vacation home is in Nantucket, the Hamptons, Hilton Head, Myrtle Beach, Naples or Scottsdale, take some time to consider the potential estate planning issues that may arise, which are summarized below.

Current / Future Ownership

As a first step, you should obtain a copy of the deed to your vacation home. You will need to review whether your vacation home is properly titled and consistent with your estate planning objectives. Options for titling vacation property include your own name, jointly with a spouse or a child with rights of survivorship or as tenants in common, or possibly titling the vacation home into a trust or a limited liability company (LLC).

There is no correct way to title your vacation home. The decision will depend on your domicile and your net worth, estate tax considerations, overall goals and objectives, and familial relationships.

Probate and Location of Your Vacation Home

Keep in mind that if you own a vacation home in your own name (i.e., individually) probate will be required in the state in which the property is located. Thus, if your primary residence is in a different state from where your vacation home is, the personal representative (formerly known as executor) of your estate may be required to open ancillary probate proceedings in the state where the vacation home is located (in addition to probate in the state of your primary residence). Consider holding the vacation home in a trust or perhaps an LLC to avoid additional probate and associated costs. (Note, prior to doing so the tax consequences of a title transfer should be reviewed.)

Gifting a vacation home

You can gift all or partial interests in your vacation home to your children, or any other person for that matter. You can make outrights gifts or gifts in trusts. You can place your home in an LLC and then make gifts of the LLC interest. However, if making a gift of the vacation home to a trust, consider funding the trust with a specified amount of cash at the onset to be used for upkeep expenses.

The value of the gift is the fair market value (FMV) at the date of the gift, except if gifting partial interests, which may receive discounts from the FMV for being a minority interest and/or lack of marketability. Should you decide to gift the vacation home during your lifetime, the recipients of all or some of the interest in the vacation home would inherit your income tax basis.

(Note, if you pass away owning the home, or a part of it, the interest you own would receive a stepped-up tax basis to the date of death value because it is included in your taxable estate.)

In some states, gifting may be an especially appealing opportunity. By gifting the vacation home during your lifetime, you may remove it (the value of the home at the time of the gift and all subsequent appreciation of it) from your state's taxable estate at your death. Additionally, you remove any appreciation from the value from your federal taxable estate. One caveat to note, if you intend to continue to use the property after gifting it, you will be required to pay FMV rent.

VACATION HOMES FOR MULTIPLE GENERATIONS. In addition to ensuring smooth transfer of some or all of the vacation home, you may wish to establish an agreement of sorts for your heirs to be bound by, which would work to minimize the potential for disagreements pertaining to the use and management of the vacation home. This agreement can be signed by all heirs and be part of the gifting process, trust document, or operating agreement of a business entity.

Consider the following details to include:

- Who can use the vacation home (spouse, the ex-spouse of a child, etc.)?
- When can someone use the vacation home? (Who gets the week of the 4th of July?)
- Who is responsible for paying the maintenance expenses of the vacation home?
- Who manages improvements?
- Who can make the legal decisions?
- What type and how much insurance coverage should be maintained?
- If an interest is sold, is there a right of first refusal to other interest holders? What terms, if any, can the interest be sold on?
- Should the vacation home be rented when not in use?
- How are guests of a child treated?

- What is the mechanism for deciding if the vacation home should be sold?

GIFTS TO A QUALIFIED PERSONAL RESIDENCE TRUST (QPRT). A qualified personal residence trust (QPRT) is an irrevocable trust into which you can transfer your ownership of your vacation home. A QPRT has gift tax leverage. In a QPRT, you retain the right to use your home for a specified term of years and upon the expiration of the term, the vacation home would pass in the manner prescribed in the trust document (generally to your children in equal shares or to a continuing trust). If you die before the end of the QPRT term, the FMV of the vacation home is included in your taxable estate. If you live past the QPRT term and wish to continue to use the property, you must then rent the property at fair market value.

Owning a vacation home in another state

If you are domiciled in a state that does not have a state estate tax, and own your vacation home in a state that does impose a state estate, your vacation home and its contents will be subject to estate tax in that state. That may be true even if the value of the vacation home and its contents is less than the estate tax threshold for that state. If you do own your vacation home in a state other than the one in which you are domiciled, simply transferring the vacation home to a trust for your benefit will not suffice. What may work is changing the character of the property from real estate to an intangible interest. In other words, this means converting the ownership of the property into shares of stock in a corporation or interest in an LLC/partnership.

By changing the character of property owned to something other than real estate, you may avoid estate tax in the state in which the vacation home is located. Word of caution before you choose to register your newly formed business entity with the Secretary of State for the state in which the vacation home is located: The creation and upkeep of a business entity includes time and associated costs, e.g., for annual reports and tax returns. Thus, for this mechanism to be worthwhile, you must consider whether the savings in estate tax justifies the creation and ongoing maintenance of a business entity.

Another option may be to gift the entire property away during lifetime (but, keep in mind, if you use the property you must rent it at fair market value). This may also simplify things for your heirs, as the necessity for additional probate is alleviated; but be warned that such a gift during your lifetime can result in a gift tax return filing requirement (and, if applicable, the payment of gift tax). You should also keep in mind that if your heirs sell the property in the distant future, there may be tax on the capital gains associated from the sale (all depending on the appreciation in value since you acquired the property).

Additional Planning Opportunities

Being that vacation homes provide solace and relaxation for family members, it is no surprise that many people strive to maintain that sacred place for the next generation. It is critically important that if you own a vacation home, you include it in your overall estate planning and ensure it has been accounted for in your objectives and goals.

While there are various techniques that can help alleviate future family conflict, each technique comes with its own set of complexities and challenges, all of which should be fully discussed.

Consider your long-term goals for the property. It is important to consider these topics now to ensure that the next generation can use and enjoy the vacation home, without a financial or emotional burden, long after you are gone. Perhaps the waning days of a summer vacation provide a good time to review your estate plan and ensure that you have protected your vacation home and its memories.

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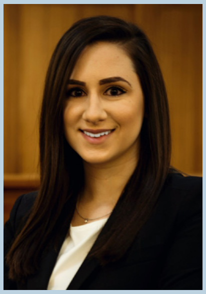

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