

Summer House: Legacy Planning for Vacation Properties





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Overview



As summer fades, many families are exploring options for how to include beloved vacation properties as a portion of their overall estate transfer. This article discusses various concerns and strategies that clients should consider as they look for ways to reduce taxes and preserve assets. We hope this paper can ignite the conversation about preserving these legacy properties for the next generation.

Don't Wait to Make a Plan for Your Home's Future

Summertime tends to draw families together and often that gathering spot is the family vacation home. For many of our clients the vacation property has become a sanctuary where generations of memories and relationships have been forged. Maybe it's the sunset strolls on the beach with grandchildren, fishing a cool mountain stream with your kids or coming together for fried turkey and football that leads to years of fond memories. Having devoted so much time and resources to building the foundation for these "family pastimes," parents often aspire to pass the family property to the next generation.

With a desire to preserve the family estate, the importance of planning should be top of mind. Even, seemingly cordial families can experience discord and exasperation when parents are no longer around to mediate conflicts. Implementing a plan for the family estate can avoid future disputes and potentially forced sales of beloved properties. Beginning this planning process early - while you're healthy and everyone can communicate objectively - helps take the emotion out of the discussion. It's better for everyone to come to an agreement before they are forced to do so.



Open and Candid Communication

Having an honest conversation with the entire family your plans for the vacation home may be difficult, but it is a critical step in ensuring your legacy remains intact.

Approaching family members individually and framing the conversation ahead of time will foster meaningful conversations about desires, expectations and needs for the property. It's important to speak candidly when discussing all maintenance responsibilities, time, energy, and costs. The next generation needs to be aware of the efforts and resources involved in maintaining such a property in the condition they have grown to love. Open conversation allows for an assessment of family dynamics, financial circumstances, and practicalities of ownership by the home's beneficiaries.



It is possible that some family members may not harbor the same sentiment or ambition that is necessary to maintain the family estate as their parents or siblings would wish. In many cases aspirations for property ownership maybe shaped by financial, geographical, spousal or family dynamics. A child who lives on the other side of the country or is not as financially independent as their siblings may not have the means or desire to manage this type of asset.

For many clients, the “straightforward” answer to planning is to include the family property in the overall equitable distribution of the estate. Property could be split evenly between beneficiaries or passed in whole to heirs as part of their general inheritance. If a split level of interest in the property exists among beneficiaries, it is important that children who turn down ownership in lieu of other assets understand that they are no longer entitled to use the property as they may have been accustomed to doing.

Planning Items to Consider



There are many considerations that should be accounted for when passing property to the next generation.

Below are a few points of concern that should be addressed:

1. Do all family members, including spouses, get along well?

2. What expenses should beneficiaries plan to cover, who will cover these expenditures, and how?

-Homeowners insurance

-Liability insurance

-Maintenance

-Homeowner association and membership fees

-Cleaning

-Emergency repairs

-Utilities

-Yard work and maintenance

-Home furnishings, décor and appliances

-Improvements

3. Will a property management company be used?

4. How will disputes be handled and resolved?

5. How will time or use of the property be allocated? How will popular events and holidays be factored into calendar management?

6. Who can use the property? Can non-family members use the property? Can grandchildren use the property unsupervised? Will the property be used for charitable purposes?

7. Will the property be rented to help cover expenses? Will everyone agree to this?

8. What if one beneficiary wants or needs to sell their ownership interest in the property? What happens to property ownership in the event of a divorce or a death?

Transferring Family Property to the Next Generation

If there is consensus to transfer the vacation home to the next generation, it's important to structure the transfer to meet the needs of family members who are interested in inheriting the property.

While gifting home ownership outright to the next generation sounds like the easiest plan, it may not be appropriate for all families.



If there are varying levels of financial security, differing opinions on property usage, infighting or internal strife, you may need to create a family agreement or assign ownership to an entity. Careful consideration must be given to deciding how and when to transfer property to your heirs.

Gift

If you have an unused lifetime estate and gift tax exemption (currently \$24.1 million for couples married filing jointly), consider gifting a portion or full ownership to your beneficiaries free of transfer tax. While gifting property during your lifetime may remove the property from your estate, your heirs will not receive a step-up in basis. Some families prefer to make gifts during their lifetime to ensure the transfer of management responsibilities is properly established.

Sale

A sale of the property can protect all or some of the lifetime estate and gift tax exemption, while providing a source of retirement liquidity in certain circumstances. If beneficiaries can obtain financing for the sale of the property, parents could use the annual gift tax exemption amount (currently \$32,000 per beneficiary if married filing jointly) to help pay monthly mortgage payments and property taxes. If financing is unavailable, consider intra-family loans using the applicable federal rate (AFR). Set by the IRS, AFR rates are typically much lower than conventional financing.

Outright Transfer of Ownership



An outright gift or the complete sale of a family property is one of the simplest ways to transfer ownership to the next generation. . The sale or gift of the property can take place all at once, over a defined period or upon the death of the owners. Family members could own the property as tenants in common or as joint tenants with rights of survivorship. It's important to remember that if the property is held jointly, only half the ownership interest receives a step-up in basis at the death of the first owner. The outright transfer of ownership would do little to alleviate the risk of unforeseen financial problems, health events or family conflict as mentioned above.

Beneficiaries could create a use-and-maintenance agreement to address some of the above considerations, but ultimately, each child would have equal ownership and could gift or force the sale of the asset. Remember to think creatively when considering potential transfers. If a property was segmented into various assets and then select assets were transferred outright or within an entity, the overall property value could be greatly depreciated for gifting purposes and the original owners could selectively keep assets for continued use.

Let's consider the sale of a family ranch with valuable mineral rights associated with the land and significant infrastructure improvement of the primary structures. The patriarch and matriarch of the family could consider retaining a carved-out parcel of the property with the improved buildings and mineral rights intact while selling or gifting the remaining acreage to the next generation. If the overall value of the property is diminished by the segregation for valuation purposes, the original owners could continue to enjoy the primary aspects of the ranch and the next generation would control the land and benefit from its associated appreciation.

LLC or Family Limited Partnership



Establishing a family limited liability company is another way of transferring property to the next generation by way of membership interest. Interest in a family partnership or LLC can be gifted to beneficiaries over a period of years using the annual exclusion for taxable gifts. These annual transfers usually represent a small portion of the underlying value of the total estate. Due to the lack of marketability of these LLC shares, reasonable discounts in valuation of the partnership interest are justified, thereby reducing the value of the overall gift. In effect, this discounting adds leverage to the parents' lifetime gift and estate tax exemption limit.

More importantly, an LLC structure can provide a formal and more flexible framework for transferring property than outright fractional shares. LLC documents typically include an operating agreement, which serves as a blueprint for managing the property and policing inter family disputes. These covenants can designate property managers as well as set forth procedures that dictate how and when the partnership can sell the family home.

Although an LLC form of ownership requires some upfront costs associated 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 ensuring property stays within the family for years to come.

Trusts

A trust can be an advantageous way to ensure property is transferred to heirs while implementing a proper framework that establishes boundaries, expectations, and operating funds. Financial circumstances tend to pose the biggest challenge when keeping a vacation home in the family.

Unforeseen debt, disability, death, divorce, or nursing home admittance may cause financial strain that could put the property at risk of a forced sale. Setting aside funds specifically earmarked for property expenses will alleviate the burden on the next generation to choose between preserving the family vacation home or sustaining their own lifestyle. Funds can be left in trust to support such expenditures or fund life insurance policies to pay for ownership interest in the event of a death.

As the grantors, the parents would set up a trust and appoint a trustee to carry out their wishes. The children (and possibly grandchildren) play a passive role while the parents are alive, leaving the decisions about the property to the parents. The trust would have to be funded with enough assets to pay expenses and maintain the property accordingly. With the property held in trust, it may be sheltered from future divorces, an unforeseen bankruptcy, or a child who needs public benefits, becomes disabled or dies, while simultaneously keeping strategic tax benefits. After the grantors' deaths the property could continue to be managed within the trust.

Irrevocable Trust An irrevocable trust may be used to remove the property from the estate for tax reasons. The title to the vacation home is transferred to the trust for the benefit of the second generation. The grantors' spouse can be named as the trustee to maintain proper management while the parents are still alive. A properly written operating agreement and beneficiary designations can ensure that the property remains in the family and is managed according to the parents' wishes.

Revocable Trust For clients who wish to retain full ownership, a revocable trust can still offer structural management and beneficiary designations while keeping the residence under the purview of the parents' estate. This type of trust can lay the foundation for future ownership and operating wishes while the parents remain in full control of the property. Upon the death of each parent, the trust would become irrevocable

Qualified Personal Residence Trust ("QPRT") With this type of trust, the parents (grantors) will transfer ownership of the property to the Qualified Personal Residence Trust, thus removing the home from the estate and creating a taxable gift. Clients retain control of the property for the life or pre-determined term of the trust. Once the trust term expires, the property will transfer outright to the beneficiaries which could be the kids or another trust. Once the property is transferred to the trust, parents would need to pay rent to their beneficiaries in order to continue to use the property. For wealthier clients, this might be an attractive strategy to help reduce the overall taxable estate while helping to fund ongoing property related expenses.

If the grantor dies before the end of the trust term, the value of the QPRT as of the date of death will be included in the parents' overall estate for tax purposes. Fortunately, the estate will receive full credit for any tax consequences of the initial gift to the trust. The QPRT could be a good option if parents do not mind paying taxes now. With the looming decrease of the lifetime gift and estate tax exemption, this trust vehicle could be risky if the grantor does not outlive the trust terms. To hedge against premature death, the grantor can transfer fractional interest in a property to different QPRT trusts with varying term lengths such as five, 10 and 15 years.

The fair market value of the residence is discounted for gift tax purposes. This completed gift does not qualify for the annual gift tax exclusion because the transfer of the residence to the QPRT is not a gift of present interest. Furthermore, any capital improvements are treated as additional gifts to the trust.

Intentionally Defective Grantor Trust

For clients who have exhausted their lifetime gift and estate tax exemption limit, the intentionally defective grantor trust (IDGT) could be utilized to help transfer ownership shares of the vacation home from an LLC or family limited partnership. To start, parents would set up a grantor trust, electing to be considered owners for income tax purposes but relinquishing rights to the home in the trust in a way that allows the grantors to not be considered the owners of the asset for estate tax purposes. It is advisable that clients include a flip provision in the trust document that would allow the trust to flip back to non-grantor status for tax purposes in the future.

Once the trust is established, parents can sell discounted LLC interest to the IDGT in exchange for a promissory note owned by the trust. Loan provisions might include three-to-nine-year interest-only balloon notes that must consider the applicable federal hurdle rate. To support the loan, the IDGT could lean on the family's other existing trust and assets as collateral backing the promissory note. If the grantor dies during the term of the IDGT, only the note would be included in the parents' estate.

Summary

As the heat of summer dissipates and the kids return to the classrooms or parents resume a more full-time work schedule, it's the perfect time to reflect on memories captured at the family vacation home and make plans to foster those same memories for years to come. In 2025 the Tax Cuts and Jobs act of 2017 will expire and ultimately lead to the reduction of the lifetime gift and estate tax exemption. To take advantage of the current exemption rate, it is imperative that clients begin to think about which assets they would like to pass to the next generation and how to do it.

Your team at Edge is here to help get the planning process started and prepare you to meet with your estate planning attorney. We look forward to working with you and your family to ensure these cherished homes continue to draw family members together for those long walks and unforgettable sunsets.



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