

A MAGNET OR A BATTLEGROUND PLANNING FOR THE FAMILY VACATION HOME

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Mr. Botwinick received his undergraduate degree in accounting from the University of Florida in 1989, and was awarded his J.D. from Rutgers School of Law - Camden, with honors, in 1992. He was admitted to practice in New Jersey and in the U.S. Tax Court in 1993. Mr. Botwinick earned his LL.M. in Taxation in 1996 from New York University.

Mr. Botwinick frequently lectures on estate planning and other related matters. In the past, he has been an adjunct instructor on Estate Planning in Fairleigh Dickinson University's Certified Financial Planner program. He has recently been published in the New Jersey Law Journal, and has often been quoted in the Star Ledger on tax matters.

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I. Social Aspects of the Family Home.

- A. Acts as a magnet in bringing all generations of the family together in a relaxed, fun atmosphere.
- B. Creates a sense of pride and a sense of identity.
- C. Close quarters can breed warmth.
- D. Can also result in squabbles, resentment and hostility.

II. Financial Issues.

- A. Can often become the largest financial holding – *With significant appreciation in the values of shore property and properties in warm climates (e.g., Florida), these assets which were once a small fraction of the value of the estate, have now become significant.*
- B. Can become expensive to maintain – *Real estate taxes, insurance, maintenance, condo association fees, and utilities which may be affordable by the older generation, may become a significant burden on the next generation.*
- C. Creates liquidity problems – *When the property makes up a significant fraction of the estate, and estate taxes are imposed, the only way to pay the taxes may be to sell the house.*
- D. How the use of the property is allocated – *Should it be for the exclusive use of the family? Can it be rented? Should greater use require a greater financial commitment?*

III. Building a Family Consensus.

- A. All generations must participate in order to design an effective plan.
- B. Consider options for passing home to next generation.
 - 1. Should the property be sold?
 - 2. Should the home go to one child with the others receiving comparable assets?
 - 3. Should a child have the right to buy out the others?

4. Should the home be donated to charity?
- C. Daughters-in-law and sons-in-law should be involved in the discussions.
 - D. Should be a frank, open discussion regarding the desires and means of the family members.
 - E. Consider using a third party intermediary; perhaps meeting privately with each family member.
 - F. Parents should develop a list of expenses associated with the home so all family members are aware of the extent of the costs associated with the home.
 - G. Parents and children must understand each other's expectations; parents should explain their goals and intentions to the children (e.g., family togetherness, building memories).
 - H. Discuss particulars about the property, and learn about the rights of the owners.
 1. Can the property be subdivided among the members of the family?
 2. Can portions be sold off to pay expenses or to satisfy members of the family who are not interested in keeping the property?
 3. Can adjacent property be purchased?
 - I. Do the various family members expect to use the property? Do some family members live so far away that they will likely be unable to use the home as much as other family members?

IV. Effectuating the Transfer.

- A. Outright gift of the property.
 1. Results in an actual shift of ownership rights – *Parents no longer own the property and may result in a situation where the younger generation's interests conflict with parents' intentions.*
 2. Takes future appreciation out of parents' estate for tax purposes.
 3. Gift tax consequences.

- (i) Can qualify as annual exclusion gifts to extent the gifts are outright.
 - (ii) Can gift fractional interests and thus take a discount.
 - (iii) Can qualify for split gift treatment.
 - (iv) To the extent that the gifts exceed the annual exclusion, the gifts will be taxable gifts.
 - (v) Could exceed the value of the lifetime gift tax exemption (\$1,000,000).
4. Loss of stepped-up basis – *Where there is significant appreciation, this could result in a large capital gain at the sale of the home. The gain could be reduced, or maybe even eliminated, if the property is included in the parent’s estate at death.*
 5. Loss of control – *Parents may be at the mercy of their children, their children’s spouses and the grandchildren. This could affect the parents’ use of the property, their desire to sale the property and enjoy the proceeds, and decisions regarding the maintenance of the property.*
 6. Creates rights in all donees, including a right of partition – *This means that even an outright gift of a fractional share could vest a right of partition in the minority interest holder.*
 7. Becomes subject to creditors of donee.
 8. Can become entangled in a divorce proceeding.
 9. Gift of remainder interest with retained life estate.
 - (i) §2036 inclusion for estate tax purposes.

B. Qualified Personal Residence Trusts (“QPRT”).

1. Effective technique for passing the home to subsequent generations in a tax-efficient manner.
2. The QPRT is an effective estate tax savings technique that is grounded in statutory authority. **See I.R.C. §2702 (a) (3) (A) (ii) and Treas. Reg. §25.2702-5 (c) .**
3. Permits the donor to make a gift of a personal residence, which includes the “principal residence” and one “other residence” **(including a vacation**

home) to a trust for children at a reduced gift tax cost. A residence constitutes an “other residence” if the donor uses the house for the greater of 14 days per year or 10% of the number of days it is rented. **Treas. Reg. §25.2702-5 (c) (2) (i) (B) and I.R.C. §280A (d) (1) .**

4. Grantor reserves a right to the use of the home for a period of years specified upon the establishment of the trust.
5. During the reserved period of time, the Grantor has the exclusive use of the property and owes no rent to the trust.
6. At the expiration of the reserved term, the home belongs to the beneficiaries, which may be a further trust for the beneficiaries.
7. The longer the term, the smaller the value of the gift. However, the longer the term, the more likely it is that the grantor will die before the end of the term, thus causing the entire value of the residence to be included in the grantor’s gross estate.
8. *Example* – Father (F), age 60, transfers his vacation residence, worth \$1,500,000, to a QPRT. Under the terms of the QPRT, F retained the right to use and occupy the residence for 15 years, after which the trustee was to distribute the residence to a trust, which will continue for the life of the succeeding generation. Assuming F's retained interest was worth \$1,031,865, F made a gift to the trust of less than one-third of the present value of the residence - only \$468,135. The gift tax cost of the gift is offset by applying part of F's unified credit against the tax. For gift tax purposes, each person has a unified credit which is equal to the tax cost of making a taxable transfer of \$1,000,000. If F outlives the QPRT's 15-year term, the residence will not be included in his estate for tax purposes, even though its value may have increased to \$3 million. On the other hand, if F dies during the 15-year term, the value of the residence will be included in his estate for estate tax purposes.

If F does not create a QPRT and retains his residence until his death 15 years later, when the residence is worth \$3 million and he owns other assets worth \$3 million, about \$1,000,000 in Federal estate taxes will be due from his estate. (This assumes that the estate tax will remain in effect after 2009 and the unified credit will shelter up to \$3.5 million.) On the other hand, if F transfers his residence to the 15-year QPRT described above, lives for more than 15 years, and dies leaving \$3 million in other

assets, no estate tax will be due on his death. Of course, if the residence were included in F's estate for estate tax purposes, its income tax basis would be increased in the hands of the beneficiaries to its federal estate tax value in F's estate - \$3 million. If the residence is transferred to a QPRT and not included in F's gross estate, the basis of the residence would not be increased by reason of F's death.

9. Drawbacks to QPRT

- a. *Rent – At the end of the term of years, the grantor will have to pay for the use of the residence. Of course, when a vacation home is being used, the entire family is likely taking advantage of the use of the property. As such, the rent would be much less than if this were a primary residence used exclusively by the grantor.*
- b. *Survival – Requires the grantor to survive to the end of the term in order to accomplish tax benefits. Otherwise, the entire value of the residence is included in the grantor's gross estate at the fair market value at death.*
- c. *Stepped-Up Basis – Because the residence is gifted during the lifetime of the grantor, the beneficiaries will take a carryover basis from the grantor. If the residence was simply inherited at death, the beneficiaries would take a stepped-up basis. Since the capital gains rates are significantly lower than the estate tax rates, this may be of little import, especially if the residence is unlikely to be sold shortly after death. However, if the estate is unlikely to be a taxable estate, then the use of the QPRT would not be advised, as the loss of the step-up would be a significant drawback with little benefit available as a result of the QPRT.*

C. Revocable Trust

1. Can be an effective method for dealing with situations that will arise after Mom and Dad are gone.
2. Can be designed and implemented in a way that addresses the family objectives.
3. Allows the grantors to design a plan and then see how the plan works before their deaths.

4. Since the trust is revocable, the grantors can change the plan over time as circumstances may change.
5. Not designed as a tax savings technique as the assets of the trust will be included in the grantor's estate.
6. The grantors should consider the issues that might need to be addressed after they are gone. For example:
 - a. Who is entitled to hold a beneficial interest in the trust?
 - b. Are decisions made by all beneficial owners, a committee of the owners, a trustee or someone else?
 - c. How is the use of the property divided among the family members?
 - d. How is the funding of future expenses to be handled?
 - e. Should there be some sort of endowment?
 - f. Should rentals be allowed, and if so, can a beneficiary choose not to use his or her allocation and instead rent the property for a return?
 - g. How are buyouts to be handled?
 - h. What happens upon the death of a beneficiary? Can a widow or widower continue to use the property?
 - i. How to effectuate a decision regarding the sale of the property.
 - j. How can the terms governing the use of the residence be modified and who will participate in decisions regarding the modification of the terms?
 - k. What happens when the endowment runs out or if there is no endowment?
 - l. How are disputes resolved?

D. Family Limited Liability Companies or Limited Partnerships

1. Can be an attractive alternative to the use of a revocable trust.
2. The parents will establish the entity and, with or without the participation of the next generation, produce an agreement that will govern the use and maintenance of the residence.
3. While Mom and Dad are alive, they might consider making fractional gifts of the membership interests to the children that may qualify as annual exclusion gifts, or they could retain all of the interests. **Caveat** – It is likely that the IRS would challenge the use of any discount for a fractional interest when the only asset in the entity is the vacation home.

4. While Mom and Dad are alive, they will typically continue to manage the property pursuant to the terms of the agreement. Alternatively, they could allow all members to vote their respective interests.
5. Stepped-up basis will be lost on gifted interests.

E. Irrevocable Life Insurance Trusts

1. Combining an ILIT with the planning for a vacation home can be beneficial.
2. Creates a mechanism to fund the buyout of any family member who does not wish to have an interest in the property.
3. Can be used to establish an endowment for the purpose of paying future expenses and maintenance costs.
4. Consider funding the ILIT with payments from children who use the property to satisfy those family members who don't use the property and will not enjoy the benefit of the property.
5. Can also provide liquidity when the home will constitute a disproportionate share of the estate, or if the grantor fails to survive to the end of the QPRT term.

VACATION HOME SURVEY

Please answer all of these questions truthfully, as the answers will be considered in implementing a plan which may affect each of you.

1. On a scale of 1 to 10 (with 10 being very important and 1 being not at all important) how would you rate the importance of maintaining the vacation home as a family resource after Mom and Dad are gone? _____

2. Please describe your desires regarding the disposition of the vacation home after Mom and Dad are gone:

3. Attached to this survey is a schedule which Mom and Dad have prepared, which reflects the costs and expenses associated with the maintenance of the vacation home. Do you believe that after Mom and Dad are gone, would you be able to afford to pay these expenses either alone or in a shared manner with your siblings? Explain your thoughts and include any questions or comments.

4. Do you believe that if the vacation home was owned together with your siblings, either outright, in trust or in some other vehicle, that you would all be able to get along, compromise, and work out any issues that would arise regarding the use and maintenance of the home? Explain in detail.

5. In the event that, at Mom and Dad's death, one or more of you does not want to keep the vacation home in the family and one or more of you does, how do you think the difference could be resolved?

6. In the event that you want to keep the vacation home in the family, and then at some time after Mom and Dad's death you have a change of heart, or you find that the shared use of the property has become untenable, how would you suggest that a sale of the property be handled?

7. In the event that the vacation home is maintained after Mom and Dad's death, how would you suggest that the use of the property be divided? For example, should there be a draft system to allocate weeks, should there be a bidding-type system for the weeks, should all weeks be valued the same?

8. In the event that one of the family members cannot use the week allocated to him or her, should he or she be entitled to let a non-family member use the home? Could the family member rent the home and keep the proceeds?

9. Is there a non-family member that you trust to arbitrate any family disputes regarding the issues of the vacation home after Mom and Dad are gone?

10. How should the use of the home handled if one of the children is deceased? Should the rights belong to the widow or widower of the deceased child? Should the rights belong to the grandchildren (to be allocated among them) ? Should the deceased child's family be bought out? Should the house be sold at that time?

11. Are there any other issues which you would like Mom and Dad to consider while addressing the issue of the vacation home?
