



The Family Vacation Home

Keeping It in the Family Is Hard to Do—
It's More About Cooperation Than Planning!

By William S. Forsberg

Minnesota is known as the land of 10,000+ lakes, and winters can be long and very cold. But when spring finally arrives, the decade old summer ritual of getting in the car and driving two or more hours “up north” to the family cabin or vacation home is commonplace. The family vacation home is often one of the most cherished family assets. Whether it is a small one-room rustic

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log cabin by a pristine lake in northern Minnesota or a modern and luxurious winter home in sunny Florida or Arizona, the family vacation home not only has economic value, but more importantly it has sentimental value. Planning for the use and transfer of the family vacation home to successive generations must take into consideration these often deep-seated emotional feelings and considerations.

Each family member has his or her own view and association with the family vacation home. Family members may have grown up there or put significant sweat equity into the family vacation home. Often, the family

vacation home is viewed as a special or sacred asset. In many cases, it has been in the family for generations. Therefore, it is understandable that family members have a heightened focus and interest in making sure the family vacation home passes down to the next generation intact and in a fair and equitable manner.

Transfer of the family vacation home from one generation to the next requires careful planning, but more importantly it requires family member cooperation. Transfer of the family vacation home can take many forms. Each form of ownership and transfer has its benefits and detriments.

Ownership or transfer can be direct in fee, by tenancy in common, by joint tenancy with right of survivorship, or by tenancy by the entireties in some states. Community property considerations should also be considered. Ownership can also be indirect, such as a life estate, in trust, or in a family limited partnership or limited liability company. Each of these ownership forms and transfer vehicles will be explored, together with their tax and nontax implications. Finally, getting along is not always easy, especially among family members. So, different management issues surrounding the family vacation home will be discussed.

Fee Simple Transfers of the Vacation Home

One form of transfer of the family vacation home is a fee simple transfer by deed. Fee simple transfers by deed from parents to one or more children, whether as tenants in common, joint tenants with right of survivorship, tenancies by the entireties, or by a transfer of a remainder interest with a reserved life estate, is simple and familiar to most clients. Fee simple transfers have a number of practical benefits. A gift or sale of the family vacation home by fee simple transfer is easily understood by most clients, and most conveyances can be made by deed. A gift or sale of the family vacation home by fee simple transfer is generally less expensive. Discounts for a gift or sale of a fractional interest in the family vacation home may be available to lower the gift tax cost or gain on sale. In some cases, discounts may not be limited to the cost of partition. *Estate of Baird v. Commissioner*, T.C. Memo 2001-258, allowed a fractional interest discount of 60% after considering appraisals, which took into account that fractional shares of Louisiana timberland sold at similar discounts. The gift tax regulations for adequate disclosure require either an appraisal or other documentation to support the discount claimed to start the running of the three-year gift tax statute of limitations on assessment. Treas. Reg. § 301.6501(c)-1(f)(2), (3). Any discount claimed requires the taxpayer to check the “yes” box on the Federal

Gift Tax Return (IRS Form 709). Finally, if a parent retains a fractional ownership interest in the family vacation home, he or she can continue to use and occupy it after the transfer under most states’ laws.

Fee simple transfers have some limitations and downsides. A fractional ownership interest in a family vacation home may be subject to the claims of the parent’s or children’s creditors. This may be particularly troublesome when the donee/children are younger and less financially stable than the parent donor. A donee/child with an outright ownership interest in the family vacation home (tenant in

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common, for example) may expose the family vacation home to claims by a spouse in a divorce. Even if the interest in the family vacation home were obtained by gift and would normally be considered nonmarital property in most states and not subject to division in divorce, marital property may have been used to help maintain the family vacation home, such as by payment of real estate taxes, maintenance costs, or contributions for improvements. This commingling of marital and non-marital property may inadvertently “convert” the family vacation home to marital property and embroil the family in a fight by an in-law over ownership and use of the family vacation home—an event never contemplated by the parent/donor when the gift was made.

Also, not all family members are happy campers forever. Disputes can arise, and one or more family members

might get disgruntled with the arrangement and want “out.” But what if the “ins” don’t want to (or more likely, can’t afford to) pay off the “outs.” Their only recourse may be to go to court and compel liquidation of the family vacation home by a partition. In most states a partition action can be brought for any or no reason. Also, the financial wherewithal of each family member/owner may be different. Family members may not all have the same level of interest or responsibility in the family vacation home. Informal oral financial contribution agreements may break down, resulting in one family member “fronting” most of the costs of maintenance for the family vacation home. This can result in heated discussions and dissatisfaction with the arrangement. It may even result in a partition action, and an accounting to compel contribution for the improvement and maintenance of the family vacation home.

Another limitation is that a sale of the family vacation home, when parents and children own fractional interests or when parents retain a life estate and the children own a remainder interest, still necessitates the consent of all co-tenants and fractional owners before a sale of the family vacation home to a third-party buyer can be completed. On sale of the family vacation home before death of the life tenant, the remainderman is generally entitled to the actuarial value of the interest sold.

Income and estate tax issues must be considered. Any lifetime fractional interest transfer of the family vacation home to a child by a parent will result in a carryover income tax basis to the donee. If the cabin were owned entirely by the parent at death it would receive a full step-up in income tax basis at death. Likewise, if the parent transferred a remainder interest and retained a life estate, the family vacation home would receive a full step-up in income tax basis at the parents death under Code § 1014. Of course, with a retained life estate, the full value of the family vacation home would be included in the parent’s gross estate under Code § 2036.

Another concern is that transfers of fractional interests in property or transfers of remainder interests in real estate may cause disqualification for medical assistance based on the value of the property transferred for a period of time after the transfer.

Finally, if the relationship between the life tenant and the remaindermen deteriorates, the remaindermen's remedy may be limited to a suit for waste against the life tenant. Partition is usually not an option.

Holding the Vacation Home in a Trust

Another way to own the family vacation home is a lifetime trust. The two most common lifetime trusts are a revocable living trust and a qualified personal residence trust (QPRT). There are benefits to placing the family vacation home in the parent's revocable living trust. By placing the family vacation home in the parents' revocable living trust it continues to be under the control and direction of the parent/grantor during his or her lifetime. Also, the parent can be the sole trustee of the revocable living trust. The transfer of the family vacation home to a revocable living trust is easily accomplished by deed. The revocable living trust is a grantor trust for income tax purposes, so any transactions related to the family vacation home (payment of expenses and taxes, for example) is reported and deductible by the parent/grantor the same as if he owned the family vacation home outright in his individual name.

If the parent/grantor were to become disabled, the successor trustee of the revocable living trust could continue to manage the family vacation home without interruption or court involvement. In the event of death or disability, the parent/grantor determines who his or her successor trustee will be and therefore who will manage the family vacation home. Finally, the family vacation home in most states would not be subject to probate administration if held in a revocable living trust at death.

Placing the family vacation home in a revocable living trust has some

downsides. The full fair market value of the family vacation home will be included in the parent/grantor's taxable estate if held in a revocable living trust. There is no "transition of ownership" or "succession plan" if the family vacation home remains in the parent/grantor's revocable living trust with no specific direction as to its disposition at death. Also, contributions of funds by children for expenses may create gift tax issues. The revocable living trust is generally not a good vehicle for multiple parties making capital contributions for improvements or for



sharing expenses for maintenance. If the parent/grantor becomes disabled and a successor trustee is appointed, the successor trustee may not have the discretion to keep the family vacation home "alive and well." If the grantor needs funds for other reasons (for example, health, support, and so on), the successor trustee may be forced to sell the family vacation home. Finally, creditor protection is limited with a revocable living trust as it is a self-settled trust. In most states creditors can attack assets of a debtor held in a self-settled trust.

Another trust for the transfer of a primary or secondary home, such as a family vacation home, is a qualified personal residence trust or QPRT. The QPRT allows the grantor to make a gift of the family vacation home to children while retaining use and enjoyment for a term of years. The gift of an interest in the family vacation home using a QPRT is less than if the gift were

made outright in fee simple. The QPRT allows for gifts of fractional interests, thereby reducing the gift tax cost. The QPRT is sanctioned by Code § 2702 and is a relatively "safe" way of making gifts of interests in the family vacation home to children. The QPRT is a grantor trust for income tax purposes, so all deductible costs (real estate taxes, for example) continue to be deductible by the grantor for income tax purposes during, and possibly after, the QPRT term. Finally, the parent can be the trustee of the QPRT during the QPRT term.

There are also detriments to transferring the family vacation home to a QPRT. If the parent/grantor dies during the QPRT term, the family vacation home will be included in the parent/grantor's taxable estate. This may result in the waste of gift tax credit. No generation-skipping tax (GST) planning can be done with a QPRT because of certain GST estate tax inclusion period (ETIP) rules until after the QPRT term. At the end of the QPRT term, if the grantor/parent survives and continues to occupy the family vacation home, the grantor/parent must rent the family vacation home from the QPRT continuation trust or the QPRT individual beneficiaries (children, for example) at fair rental value. If the family vacation home is sold during the QPRT term, the net proceeds of the sale must be reinvested in a qualifying replacement home, or the arrangement must be converted to a grantor retained annuity trust.

It is not recommended that the grantor be the trustee of the QPRT continuation trust after the QPRT term. The grantor, however, may retain the power to remove or replace a trustee so long as the grantor can appoint only an individual or corporation that is not a related or subordinate party as defined in Code § 672(c). Rev. Rul. 95-58.

Creditor protection is generally better with an irrevocable trust than with a revocable living trust. But the QPRT is a self-settled trust under most states' laws (that is, the grantor has retained an interest in the trust after formation), which may subject the QPRT assets to creditor claims. Also, in states that

recognize tenancies by the entireties, transferring title to a QPRT trustee may eliminate the creditor protection that such an ownership arrangement affords the individual owners. In general, when IRS interest rates are high, the gift tax costs of a QPRT are lower. When interest rates are low, the QPRT is not as attractive.

Holding the Family Vacation Home in an Entity

The family vacation home also could be placed in an entity, such as a general partnership, an S or C corporation, a family limited partnership (FLP), or a limited liability company (LLC). Hereinafter, all references to an entity holding the family vacation home will be to a family limited partnership or "FLP," but the term is used for convenience only and the concepts are equally applicable to other types of entities (limited liability company, for example).

There are a number of nontax and tax reasons for forming an entity to hold the family vacation home. One consideration in placing a family vacation home in an entity is whether or not the formation of an entity with a single "personal" asset fulfills a business purpose under some states' laws. Another consideration is whether or not the personal use nature of the family vacation home causes estate tax inclusion under Code § 2036. One nontax reason for forming an FLP to hold the family vacation home is retention of management control by the parents. A parent general partner of an FLP continues to control and manage all FLP affairs (including control over timing and amount of distributions). If children become limited partners of an FLP, they generally do not participate in the management of the FLP. Gifts of undivided fractional interests in real estate can be cumbersome. A deed is required and there are costs of recording. Gifts of limited partnership interests in an FLP are much easier. Generally, all that is required is a simple assignment instrument. Many FLP agreements contain right of first refusal provisions that give the nontransferring partners the ability to purchase FLP interests when a voluntary transfer to a nonfamily

member is contemplated. This mechanism provides some assurance that the family vacation home will stay in the family.

The principal remedy for a partner's "outside" creditors is to receive a charging order against the partner's interest in the FLP. The creditor may not satisfy his or her claim against the FLP's underlying assets. A charging order does not give the creditor any management or voting rights. The creditor has only the rights of an assignee and is entitled only to the

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partner's allocable share of FLP income and loss. To the extent FLP income is allocated proportionately among the partners, but income distributions are not made, the creditor will have a tax burden that must be satisfied from the creditor's own resources. This may lead to a quick settlement by the creditor for substantially less than the amount owed.

It is not uncommon to commingle assets in a marriage, and thus to convert nonmarital property into marital property. It is easier to maintain FLP interests as separate nonmarital property. Also, a transfer of an FLP interest incident to divorce is an involuntary transfer that generally "triggers" a right of first refusal provision, thus preserving the asset in the family. An FLP agreement may be amended. In comparison, an irrevocable trust generally may not be amended or terminated without court approval and the participation of a guardian ad litem if there are minor

beneficiaries. The termination of an FLP generally requires less formalities than the termination of a corporation and is not fraught with the same potential adverse tax consequences. In most cases, the business judgment rule applies to FLPs versus the stricter prudent investor rule applicable to trusts. Also, general partners in an FLP are not subject to the same diversification rules applicable to trustees.

Assets held individually (and without a beneficiary designation) are generally subject to probate. Probate can be avoided by transferring assets to a revocable living trust during the client's lifetime, but often this does not occur. Instead, assets could be transferred to an FLP with only a single transfer of the FLP interests needed to the revocable living trust to avoid probate. If the FLP interests are part of the probate estate, privacy concerns are still protected because underlying FLP assets generally need not be disclosed in a probate proceeding. Ancillary probate may be avoided for real property owned in a nondomiciliary state by transferring ownership to an FLP.

Many FLP agreements provide for arbitration or mediation to settle disputes. Arbitration and mediation are often less costly than full blown litigation. Also, confidentiality is more easily preserved. The FLP structure allows senior family members to educate junior family members about asset and property management. The FLP structure may facilitate communication among family members. Family members may for the first time have something in common—an ownership interest in a FLP that owns the family vacation home.

There are also tax reasons for forming an FLP to hold the family vacation home. Gifts of FLP interests generally are present interest gifts thereby qualifying for gift tax annual exclusion. But see *Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003), aff'g, 118 T.C. 279 (2002), in which gift tax annual exclusion was denied; the general partner had complete discretion over distributions of partnership income and could withhold distribution "for any reason." The IRS concluded that such power was

“extraordinary and outside the scope of a business purpose restriction. . . .” In addition, significant restrictions were imposed on the ability of limited partners to withdraw or transfer interests with no corresponding restrictions on the general partner; a gift of limited partnership interests was not a gift of a present interest and, therefore, did not qualify for the annual exclusion. The retained power of the donor/general partner to reinvest FLP income and the indirect power to affect marketability of limited partnership interests does not cause estate tax inclusion under Code § 2036(a)(2) or § 2038. See *United States v. Byrum*, 408 U.S. 125 (1972); however, compare *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005). If the family vacation home is placed in an FLP it may be viewed by the IRS as a personal use asset, which may result in estate tax inclusion in the senior family member’s estate. Also, if FLP income is used to pay the personal expenses of the decedent, or if FLP and personal funds are commingled, estate tax inclusion may result. *Estate of Reichardt v. Commissioner*, 114 T.C. 114 (2000); *Estate of Schauerhamer v. C.I.R.*, 73 T.C.M. (CCH) 2855 (1997). FLP interests are generally valued for gift and estate tax purposes with discounts for lack of control and marketability. The size of the discounts varies from situation to situation, state to state, and sometimes court to court. It should be noted, however, that H.R. 436 introduced on January 9, 2009, by Rep. Earl Pomeroy of North Dakota provides that no valuation discounts will be allowed for transfers to family members of interests in an entity that holds nonbusiness assets (such as a vacation FLP). The family vacation home does not generally produce income. Therefore, it might be a good idea to fund the FLP with other income-producing assets to avoid any issues with the gift tax annual exclusion. Another option might be to incorporate a *Crummey*-type withdrawal power in the FLP agreement.

Finally, forming an FLP may have state estate tax benefits. FLP interests are intangible personal property and generally subject to estate or other

death tax only in the state of the decedent’s domicile. In contrast, some states continue to apportion their estate tax to real estate and tangible personal property located in the state, even if the decedent was domiciled in another state.

Family Vacation Home Operation and Maintenance Issues

One of the most important nontax issues surrounding the transfer of the family vacation home to the next generation is its operation and maintenance—who pays, who works, who does what! The mantra here is “cooperation, cooperation, cooperation.” The operation and maintenance of the family vacation home can be broken down into the following main categories:

- Category 1—Duties, responsibilities, and payment for routine regular maintenance;

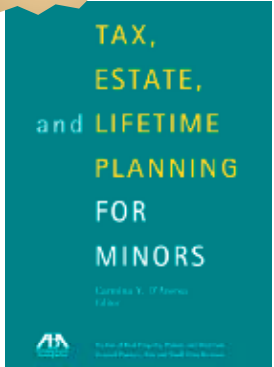
- Category 2—Duties, responsibilities, and payment for extraordinary maintenance;
- Category 3—Responsibility for payment of regular operating expenses;
- Category 4—Schedule of personal and rental use of family vacation home; and
- Category 5—Sale of the family vacation home and division of tangible personal property.

Again, reference is made to an “FLP” as the entity holding the family vacation home.

The duties and responsibilities in Category 1 include such things as regular house cleaning, window washing, lawn maintenance, and spring and fall cleanups—a complete list of maintenance items is probably longer than this article. These responsibilities could be handled informally by verbal agreement, by a written agreed-

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on schedule, or more formally in an FLP agreement. They could also be outsourced. If so, a managing partner could be selected who would be given authority to contract for needed and agreed on services. Generally, a dollar “cap” is placed on the managing FLP partner’s contracting authority to allow him or her to freely bind the FLP without the need to obtain the consent of the other FLP partners. Finally, an equitable and transparent payment and reimbursement mecha-



nism among FLP partners must be established in the FLP agreement if the FLP does not have sufficient funds or income to pay these items on an ongoing basis.

The duties and responsibilities for extraordinary maintenance in Category 2 might include such things as exterior and interior painting, roof replacement, furnace replacement, air conditioning replacement, kitchen appliance replacement, dock replacement, window and door replacement, and garage repair or replacement. Category 2 responsibilities should not be done informally. A procedure for decision making should be incorporated into a written FLP agreement. Before any decision is made to contract for extraordinary maintenance expenses, a meeting of FLP partners should take place (in person or by phone) at which everyone can “weigh in” on any final decision. These duties and responsibilities are generally outsourced to contractors. Again,

a managing FLP partner could be selected to contract for these services, but only after all FLP partners have vetted and approved the contractor. Again, an equitable and transparent payment and reimbursement mechanism among FLP partners must be established if the FLP does not have sufficient funds to pay these items on an ongoing basis.

Category 3, regular operating expenses, might include such things as real estate taxes, insurance, utilities, and mortgage payments—items that are relatively fixed, known, and recurring. Responsibility for payment of these expenses can be made informally by verbal agreement, but a more formal written agreement is the better option. A managing FLP partner could be selected to pay these expenses as incurred and to provide a periodic accounting to the other FLP partners. Again, an equitable and transparent payment and/or reimbursement mechanism among FLP partners must be established if the FLP does not have sufficient funds to pay these items on an ongoing basis.

Category 4 is personal use and rental of the family vacation home. The FLP partners should agree on a schedule of personal and rental use. Some dates may be viewed as more desirable than others (summer versus winter, for example, holidays, weekends, and so on). The schedule could provide for an annual rotation among FLP partners for use during the more desirable time slots. If the family vacation home is to be rented to third parties, an agreement among FLP partners on who will handle this role should be entered into. Some questions that must be asked and answered are: (1) will an outside rental agency be retained? (2) will FLP partners be allowed to find renters independently? (3) what will rental rates be, and how are they established? (4) how long can a renter stay? (5) will a “finder” FLP partner get a rental commission? and (6) are there block-out times when no renters will be allowed to stay at the family vacation home? Again, the FLP partners can select an FLP managing partner

to address these questions and handle all third-party rentals.

The final category, Category 5, is the sale of the family vacation home and how the personal property located at the family vacation home will be divided among family members. The sale decision should be in writing. One option is to incorporate the sale terms in the FLP agreement and provide that a sale of the family vacation home to a third party can only occur if all FLP partners agree. Also, the FLP agreement can (should) provide for a right of first refusal of any FLP partner, or any combination of FLP partners, to acquire the family vacation home before it is sold to a third party. Liberal FLP partner financing terms (including price) can be incorporated into the FLP agreement to assure that the family vacation home stays in the family. If one owner or partner wants “out,” incorporating a “put” right in the FLP agreement might work. Caution must be exercised, however, because a put right can be unduly burdensome to the FLP and other FLP partners. Finally, the division of personal property on the sale of the family vacation home should be addressed in writing. Many times the most important assets located at a family vacation home are items of personal property that have been in the family for generations. FLP partners should periodically review a written list of personal property items, similar to a written list prepared for a will, to determine who will get what when the family vacation home is sold. The list should be reviewed and approved by all FLP partners and made a part of the FLP records.

Conclusion

The family vacation home is often a cherished asset, and, if it is well managed and maintained, it can provide generation on generation with invaluable enjoyment and lasting memories. Keeping it in the family, however, requires forethought, planning, and some well-heeled management and cooperation skills—especially the latter. ■