Keeping It in the Family

PLANNING FOR VACATION HOMES

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When discussing the need for proper estate planning with clients, it is often useful to begin with a story about what can happen in its absence. In the context of planning for the family vacation home, we might use as an example the 2019 decision of the New Hampshire Supreme Court in *Hayes v. Connolly*.[1]

In *Hayes*, members of two families owned the vacation property as tenants in common, whom we might easily imagine to have been siblings and their respective spouses, though they may have been two unrelated families that bought half interests together back in the early 1950s. The families had an agreement in place to share expenses and to create a mechanism for one family to buy the other out in the event of a death. But the agreement did not contemplate what might happen through subsequent generations. The half interests ended up in separate trusts that eventually became irrevocable, and over the years, the agreement sort of fell away. The day finally came when one family wanted out. The other family did not want to buy them out, and the end result was a partition action.

Rather than put the property on the block for a public auction, the superior court ordered one family to buy out the other family at a price to be determined by a panel of appraisers. Interestingly, it was the family who would be cashed out that objected because they thought they might get a better price at auction. The New Hampshire partition statute[2] is flexible enough, at least according to the supreme court, to allow this kind of remedy, even though it might not maximize the price.

OBJECTIVES OF PROPER PLANNING

Estate planning for the family vacation home involves structuring the transfer from one generation to the next, possibly for multiple generations, of a property that is used by a family as a vacation home. Our premise is that we want to avoid situations such as the one that arose in *Hayes*. In order to illustrate some of the issues we want to plan for, assume we are talking about a second or third home that is titled to a married couple who has several children. Possibly one spouse or the other also has one or more children from a prior marriage. Obviously there are many other possible scenarios, but some of these will be illustrated by inference as we go along. We will also assume we are starting with a blank slate—that is, that no planning has yet been done.

The underlying premise is that the vacation home is different from other assets passing from the parents to subsequent generations: there is a nostalgic value we are trying to preserve, the property should be kept intact through at least two or three generations, and an increasingly extended family should somehow be able to share the use of the property equitably.

Even before we begin planning, questions will inevitably arise as to how this can be accomplished. Unlike a brokerage account, for example, a vacation home cannot be divided in a manner that allows the distributees to go their separate ways. How will we determine who can use the property, when they can use it, who will be responsible for upkeep and repair, and how they can fairly share property taxes and other expenses? Further, keeping in mind that various children and grandchildren, as well as their spouses, will have greater or lesser degrees of attachment to the property and will be more or less able to carry their fair share, how can we enable parties who no longer want an interest in the vacation home to opt out—or how might we force them out?

PLANNING FOR THE INCUMBENT GENERATION

At the outset, we must consider how the property is presently titled. It is possible that the property, or a fractional interest in the property, has already descended to one of the spouses from that spouse's parents, in which case it may be titled to that spouse alone—even in a community property state, it may be one spouse's separate property. Or the property may be owned by the spouses jointly, with a right of survivorship or as tenants in common, though the latter is unlikely unless they took title before they were married. The property may also be held in what is called a tenancy by the entirety, which resembles a joint tenancy but is different in some key respects.

1 217 A.3d 87 (N.H. 2019).
2 N.H. Rev. Stat. Ann. § 547-C:25 (2019).

The differences among these various forms of property ownership largely pertain to whether the property is an asset from which the claims of a creditor of only one spouse might be satisfied. If the property is held by one of the spouses alone, clearly it will be subject to the claims of that spouse's own creditors, but it will generally not be subject to the claims of the other spouse's creditors. If it is held as community property in a state that recognizes that form, the entire property will be protected from claims against either spouse alone. In a common law state, similar protection is afforded by a tenancy by the entirety, which unlike a joint tenancy, cannot be severed by the unilateral action of either spouse. Each spouse is treated as owning the entire property, subject to a shared life estate in the other. The survivor does not succeed to the other's interest.

A joint tenancy with right of survivorship can be severed by the unilateral action of either co-tenant, converting the form of ownership to a tenancy in common. Each co-tenant then holds an undivided half interest in the property, which can be separately conveyed during life or separately disposed of at death by will or by intestacy. Because a joint tenancy is severable, the half interest of each co-tenant is vulnerable to the claims of the co-tenant's own creditors, who may themselves cause a severance, leaving the other as a tenant in common with strangers. After the death of one spouse, the entire title devolves to the survivor, with no protection at all against the claims of the surviving spouse's creditors—unless we do some advance planning.

That is our starting point, even before we begin planning for subsequent generations. If the property is not already held by both spouses as a community in a community property state, or in a tenancy by the entirety in a common law state, then we need to accomplish at least that much—keeping in mind that if claims have already accrued against one spouse, a transfer of property that would otherwise be answerable to those claims might be subject to being set aside by an equity court as having been made in fraud of those creditors. The details are beyond our immediate scope, except to say that state law will generally protect a transfer made some specified number of years before the creditor seeks to have it set aside.

TRANSFERS INCIDENT TO DIVORCE

Before we look at transfers structured to keep the vacation home in the family for multiple generations, we must touch briefly on transfers from one spouse to the other in the event of divorce. There is a potential for such a transfer to be treated as a sale on which the transferor might recognize a taxable gain, or as a gift for which a marital deduction would not be allowed. The Internal Revenue Code (I.R.C.) provides safe harbors against each of these possibilities.

Under I.R.C. Section 1041, a transfer between spouses during the marriage is not a recognition event, period. And a transfer to a former spouse is not a recognition event if it is "incident to" the divorce—that is, if it occurs within one year after the decree, or if it is otherwise "related to" the divorce. That latter phrase is defined in the Treasury Regulations[3] to mean that the transfer is made "pursuant to" the decree and is completed within six years.

A transfer to someone who is no longer a spouse will of course not be eligible for a gift tax marital deduction. However, under I.R.C. Section 2516, a transfer to a former spouse may be treated as a sale, and therefore not as a taxable gift, if it is made pursuant to a written settlement agreement, regardless of whether the agreement is incorporated in the divorce decree, provided the transfer occurs within a three-year period beginning one year before and ending two years after the date of the agreement. With careful planning, it is possible to fit within both safe harbors, that is, the transfer is not a recognition event nor a gift for which a marital deduction would not be allowed.

I.R.C. SECTION 121 GAIN EXCLUSION

The exclusion under Section 121 of the first $250,000 of gain on the sale of a personal residence—or $500,000 on a joint return, or on the return of a surviving spouse who sells within two years of the death of the predeceased spouse—applies only to the sale of a principal residence. It may be possible, however, to convert what had been a second or third home into a principal residence for this purpose. This would require the seller to have lived in the house for periods aggregating two years within the five years preceding the sale.[4] Even if a seller meets that condition, gain will be allocated pro rata to periods of nonqualified use, reaching back over the entire period of ownership since January 1, 2009.[5] And you can exclude gain from only one sale in any two-year period.

I.R.C. SECTION 1031 LIKE-KIND EXCHANGE

It may be possible to defer recognition of gain on the disposition of a vacation home in a Section 1031 like-kind exchange, but only if both the relinquished property and the replacement property can be said to be held "for productive use," that is, for rent

3 Treas. Reg. § 1.1041-T, Q&A 7.
4 I.R.C. § 121(a).
5 *Id.* § 121(b)(5).

or "for investment." Both the IRS, in Revenue Ruling 59-229,[6] and the Tax Court, in *Moore v. Commissioner*,[7] have said that a personal residence, as such, does not meet these requirements. But in Revenue Procedure. 2008-16,[8] the IRS has also specified a safe harbor within which a vacation home might qualify. If the property has been held at least two years, and if it has been rented out at least fourteen days in each of the two twelve-month periods immediately preceding the exchange, and if the transferor or specified family members have used the property as a personal residence no more than the greater of fourteen days or 10 percent of the number of days the property was rented out in each of those two twelve-month periods, then the property will be treated as held for rent. Because the replacement property must itself also be held for productive use, be careful about immediately converting it to personal use: if you are trying to qualify for the Section 121 gain exclusion, you will need to hold the replacement property for at least five years and occupy it as a principal residence for at least two of those years.

REPORTING RENTAL INCOME

If the property is rented out to nonfamily members fewer than fifteen days in a tax year, the rental income is literally not reportable.[9] But if rental income is reportable, the amount of personal use by the owner and family members will affect the extent to which that income can be offset by deductions for real estate taxes, mortgage interest, depreciation, etc.[10]

Rental income itself is reported on Schedule E. If personal use is no more than the greater of fourteen days or 10 percent of the number of days the property was rented out, this is treated as rental property, and the owner may be able to report deductible losses. However, for most taxpayers, this will be treated as a passive activity and losses will be limited to $25,000 per year. If personal use exceeds those thresholds, deductions apportioned to Schedule E will be limited to simply offsetting rental income.[11] Mortgage interest and property taxes will be prorated to the number of days of rental and personal use. The personal use portion of these two items is reported on Schedule A, where we run into a second layer of difficulty: mortgage interest on a personal residence is deductible only to the extent it is attributable to acquisition debt of not more than $750,000, and at least through 2025, there is a $10,000 cap on the deductibility of state and local taxes.[12]

In short, there may be some benefit to renting out a vacation home when it is not in use by family members, provided they can keep their personal use to under 10 percent of rental use. The downside is that they will be taking depreciation deductions on Schedule E that will reduce their basis in the property, both increasing the amount of taxable gain on a later sale and causing a portion of that gain to be taxed as depreciation recapture at ordinary income rates. Also, the rental use would make it more difficult to later qualify the property for the Section 121 gain exclusion. However, if the property is held in a form that would cause it to be includible in the taxable estate of either spouse, there will be an adjustment to the basis to the fair market value at the date of the spouse's death, per I.R.C. Section 1014. In a community property state, the step-up in basis would apply to the entire property at each death. In a common law state, assuming the property is held either in a joint tenancy or by the entirety, the basis adjustment at the first death would apply only to the half attributed to the decedent spouse. Which brings us, finally, to planning for an intergenerational transfer.

ABSENT A PLAN

If no planning has been done—if the first decedent spouse literally has no will—then the law of intestacy in most states would leave the decedent spouse's entire probate estate to the surviving spouse unless there are children by a prior marriage, in which case the survivor will be limited to half. The details depend on state law, and the law of the state where the property is physically located will control.

At the second death, when there is no surviving spouse, the intestate estate will typically be distributed in equal shares among each line of descent, with descendants of a deceased child taking *per stirpital* portions of their deceased parent's share. Each of these distributees—the surviving children and descendants of deceased children—would hold fractional interests in the property as tenants in common.

This generalization applies only to property titled to the decedent alone, however. Community property, or property held in a joint tenancy or by the entirety, will pass entirely to the survivor. Assets held subject to a transfer on death or beneficiary designation—typically life insurance policies and retirement accounts, but also possibly bank accounts and brokerage

6 1959-2 C.B. 180.
7 93 T.C.M. (CCH) 1275, 2007 T.C.M. (RIA) ¶ 2007-134.
8 2008-1 C.B. 547.
9 I.R.C. § 280A(g)(2).
10 A recent case illustrating these principles is Lucero v. Comm'r, 120 T.C.M. (CCH) 231, 2020 T.C.M. (RIA) ¶ 2020-136.
11 I.R.C. § 280A(c)(5).
12 But as a practical matter, the $10,000 cap does not apply to property taxes that are treated as an expense of operating a rental property.

accounts—will pass to the designated beneficiary. Some states, by statute, will recognize a beneficiary designation as to real property. Others, by common law, will recognize the transfer of a remainder after a retained life estate, even if the transferor also retains a power of sale that would destroy the remainder. Yet others will not.

Even assuming the surviving spouse ends up holding the vacation home outright, the surviving spouse might remarry, leave the property to children from a prior marriage, or disinherit some of the children of the first decedent spouse. Also, now that the property is not held in a community or by the entirety, it will be vulnerable to the claims of the surviving spouse's separate creditors. Alternately, if a portion of the property has descended to children or grandchildren as tenants in common, each fractional interest will be vulnerable to the claims of that co-tenant's creditors, and any co-tenant can petition the court for a partition of the property, forcing a sale at what would likely be a distressed price.

Even if the parents did some minimal planning—placing their assets into revocable trusts to avoid probate, for example—if special provision is not made for the vacation home, it may end up being held in fractional shares among several trusts for the children and grandchildren. However, those trusts might or might not provide adequate protection against creditor claims, there may still be the potential for partition, and the problem of how to share the use of the property and the expense of preserving and maintaining it has not yet been addressed. Our discussion of various planning alternatives is informed by the hazards of failing to plan.

THREE PLANNING ALTERNATIVES

We will consider three approaches to planning for the family vacation home: (a) a tenancy in common subject to an ownership agreement, (b) an irrevocable trust, and (c) a limited liability company.

Tenancy in Common with an Ownership Agreement

Even if both parents have already died without adequate planning such that there is a tenancy in common among several children or grandchildren, or several trusts for their benefit, it may still be possible to salvage the situation by negotiating a written agreement among the co-tenants, which would be binding on their successors in interest. At a minimum, such an agreement should specify workable mechanisms for

- determining who may occupy the property and when, including possible use by guests of a co-tenant or by short-term renters;
- agreeing on necessary repairs, maintenance, and improvements, as well as sharing the expenses;
- assuring that property taxes and other recurring expenses are paid;
- resolving any disagreements about these matters, possibly through mediation or arbitration;
- limiting the transferability of each co-tenant's interest and determining the price at which one or more of the others might buy out the interest of a co-tenant who might want to sell; and
- averting the necessity of a partition in the event of the death, divorce, or bankruptcy of a co-tenant, or in the event a co-tenant's creditor asserts a lien on the co-tenant's interest.

Obviously, it will be more difficult to negotiate such an agreement after the fact. If the property is passing from one generation to the next under a parent's will, and if the personal representative has a power of sale, the personal representative might be able to use the threat of selling the property to strangers as leverage. However, the better plan is to put these mechanisms in place before the surviving parent dies.

Irrevocable Trust

One method of accomplishing this would be for the parents, or the surviving parent, to place the property in an irrevocable trust, either inter vivos or testamentary. A well-drafted trust document would expressly obviate each of the enumerated weaknesses inherent in a tenancy in common, and it would also

- place decision-making authority in the hands of fewer than all of the interested parties, or possibly even a disinterested third party, and specify a mechanism for determining successors to that authority over time;
- include spendthrift provisions that would prevent a creditor or a divorced spouse of any beneficiary from attaching an interest in the trust; and
- provide for a succession of interests through multiple generations, subject to the state's rule against perpetuities.

It is also possible to fund such a trust with an endowment in an amount that may be expected to carry the reasonable costs of maintaining the property indefinitely. Current earnings on the endowment and realized capital gains on the sale of securities would be taxed to the trust. The rate brackets for a nongrantor trust are quite compressed, so if income is being realized in any significant amounts, tax will be incurred at the top marginal rate.

An inter vivos trust can also serve as a vehicle for lifetime gift planning. If the settlor (i.e., the parent) is also a trust beneficiary, I.R.C. Section 2702 will treat the transfer as a completed gift of the entire value of the property—that is, the parent's retained interest will be valued at zero—unless the trust is structured as a qualified personal residence trust,[13] which would require that the parent's retained interest be limited to a specified term of years, after which—assuming the possible inclusion of the value of the property in the parent's taxable estate is a concern—the parent should pay fair market rent for continued use of the property. A qualified personal residence trust (QPRT) may be used not only for a transferor's principal residence, but also for one other residence,[14] namely, the vacation home.

Limited Liability Company

A third alternative would be to place title to the vacation home in a limited liability company (LLC) with voting and nonvoting interests. In many family situations, the two approaches we have already discussed, the tenancy in common subject to an operating agreement and the irrevocable trust, might almost be seen as second best alternatives. Beyond the advantages inherent in the irrevocable trust, the LLC offers considerably greater flexibility, as well as greater protection against potential claims against individual members. As the name implies, potential liability for damages arising from the use of the property can be limited to the assets of the LLC itself. A judgment creditor of an individual member will be limited to a charging order, which would entitle the creditor to receive distributions that would otherwise be made to the member. Of course, typically there would be no distributions, but the creditor could not obtain even nonvoting membership, as such.

Only a very small percentage of membership units need be voting units, and only those members holding voting units would participate in managing the property. However, each unit—voting or nonvoting—would represent an equal percentage of the equity in the property. The entire structure would be governed by an operating agreement, which could be amended from time to time as circumstances might require. Even nonvoting units would participate in making fundamental, structural changes. The agreement would provide formal mechanisms for resolving disputes.

The operating agreement would also include mechanisms by which the managing members might make necessary capital calls, and it would specify circumstances in which an extraordinary capital call would require the approval of a supermajority of nonvoting units. It might permit a member who was not able to answer a capital call with cash to instead provide specified labor. The operating agreement should also provide that unit holders who are unable to respond to capital calls, or who no longer want to participate in ownership of the vacation home, could cash out in whole or in part, with the LLC itself or other members having a first option to purchase at a price determined either by a preset formula or by an independent appraisal. The agreement could flatly forbid transfers outside the family, at least without the consent of

13 I.R.C. § 25.2702-5(c).
14 *Id.* § 25.5702-5(c)(2)(i)(B).

all the other members, in which case unit holders might be given a put option to sell their units either to the LLC itself or to other members who might step forward, again at a price determined by formula or appraisal.

Unless it elects to be taxed as a corporation, an LLC is treated for federal income tax purposes as a partnership, with any taxable income and deduction items passed through pro rata to the individual members. Unless the property is being rented out, this will not typically be an issue.

Unlike an irrevocable trust, the LLC vehicle can in theory be used to make present interest gifts that are eligible for the annual gift tax exclusion,[15] and transfers can readily be made from one family member to another or from one generation to another without the need to record deeds (which can trigger property tax reassessments in some states) or open ancillary probate proceedings in the state where the property is situated.

However, there is a tension between structuring the LLC to centralize control and limit the transferability of membership units on the one hand, and qualifying gifts, especially of nonvoting units, for the gift tax annual exclusion on the other hand. The difficulty is especially acute in the case of the vacation home, which typically does not generate income.

In the 2002 reviewed opinion *Hackl v. Commissioner*, the Tax Court determined that transfers of membership units in an LLC operating a tree farm could not qualify for the annual exclusion where the transferor, as the sole manager, had retained controls that effectively prevented the transferees from realizing any value on their units.[16] A key consideration was the fact that the tree farm was not expected to yield any income for some number of years. The result was affirmed by the Seventh Circuit Court of Appeals.[17]

This decision was followed several years later by *Price v. Commissioner*, a memorandum opinion in which the Tax Court determined that gifts of interests in a limited partnership, again subject to stringent restrictions on transferability, did not qualify for the annual exclusion despite the fact that rental properties owned by the partnership did generate significant income, where distribution of that income to the partners was at the discretion of the corporate general partner, controlled by the transferors, and actual distributions had been sporadic.[18] By contrast, in *Wimmer v. Commissioner*, the court determined that gifts of interests in a partnership holding only marketable securities did qualify where the partnership agreement required current distribution of net cash flows.[19]

With specific reference to a family vacation property, a federal district court in Indiana, ruling on cross-motions for partial summary judgment in *Fisher v. United States*, rejected the taxpayers' argument that their gifts of limited partnership interests to their children did convey a "substantial present economic benefit" in that the children had thereby acquired the right to use the property.[20] The court stated that not only was it not clear that the partnership agreement actually provided for this right to use, but in any event this would be a right to "a non-pecuniary benefit," and thus per *Hackl* and its progeny, not a present interest.

However, these decisions need not mean that a limited partnership cannot be the appropriate vehicle for preserving a family vacation home through multiple generations. On one hand, a transferor who is unlikely to consume his or her lifetime exclusion amount, presently $11.58 million, need not be concerned with whether some of the gifts are treated as future interests. On the other hand, where maximizing the use of the annual exclusion is a concern, it should be possible to make these transfers subject to a temporary put option, allowing the recipient to redeem the recipient's interest for cash within a limited window, somewhat analogous to the *Crummey* power with which we are familiar in the context of irrevocable life insurance trusts.

CONCLUSION

For families with vacation homes, fond memories of times spent together may produce a desire to enable children and grandchildren to create the same memories. There are a variety of estate planning issues involved in enabling families to leave this kind of legacy to the younger generation. The strategies covered here, which should be tailored to fit the needs and desires of each family, can help clients realize the goal of leaving not just an asset but a family legacy.

15 *Id.* § 2503(b).
16 118 T.C. 279 (2002).
17 335 F.3d 664 (7th Cir. 2003).
18 2010 T.C.M. (RIA) ¶ 2010-2.
19 103 T.C.M. (CCH) 1839, 2012 T.C.M. (RIA) ¶ 2012-157.
20 No. 08-CV-0908, 2010 WL 3522952 (S.D. Ind. Sept. 1, 2010).