The Washington Report

Wealth Transfer Edition

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Summer Homes and the Next Generation– Planning Options for a Family's Second or Vacation Homes

SYNOPSIS: A family vacation home often holds sentimental value; however, sustaining that home within the family over multiple generations presents unique challenges and requires a realistic assessment about the family's current and future commitment to maintaining the home and a plan for managing and funding that maintenance and potential development over the long term. In addition, owning a second home at death can augment the owner's taxable estate, especially given rapidly appreciating real estate values in recent years. Accordingly, families may want to consider (*particularly with the recent favorable estate and gift tax legislation*) using tax-effective methods for owning existing vacation homes, including gifting the home to a qualified personal residence trust (**QPRT**) or selling the residence to an irrevocable grantor trust. For families considering buying a new vacation home, another option includes a "split purchase" of the home through a special trust created by the intended lifetime and remainder beneficiaries. Whatever planning is selected, families can add more protection for the ownership of the vacation home, strengthen the likelihood of successful maintenance, provide an effective long-term funding structure, and most importantly, minimize family conflict by incorporating life insurance into the overall plan.

KEY TAKE AWAYS: When considering tax-effective options for holding second or vacation homes, and possibly transferring valuable real estate to the next generation, families should consider the benefits and planning hurdles that are associated with each of the available options as summarized in the attached chart, since a family's specific circumstances and dynamics will affect the long-term viability and practicality of each opportunity.

Families also should create a funding plan to ensure there are sufficient liquid assets for current and future generations to sustain the property's ownership and provide a governance structure to manage and minimize family disputes regarding the use, enjoyment, and maintenance of the property over time. While families are enjoying their summer and vacation homes, now is the time to consider these objectives and goals and plan accordingly.

Gift to a QPRT

OVERVIEW AND POTENTIAL BENEFITS [1]: A QPRT is an irrevocable trust funded with a personal residence, which allows the donor of the trust, as the grantor, to live in and use the home for a specified term of years. After the term expires, the QPRT provides that the property passes to the designated remainder beneficiaries, typically the grantor's children or a trust for their benefit (which also may provide for future descendants). Assuming the trust agreement meets the statutory and regulatory requirements for QPRTs[2], the donor is deemed to make a gift of *only* the present value of the remainder interest in the house (i.e., the right of the remainder beneficiaries to own the house after the term expires), rather than the home's full fair market value. The donor can allocate any available federal gift tax exemption to cover this taxable gift.

If the donor outlives the fixed term set by the QPRT agreement, the *full fair market value* of the residence and any appreciation thereon will pass to the remainder beneficiaries outside the donor's taxable estate. Thereafter, if the donor wishes to continue to use the residence, the donor **must** pay fair market rent to the remainder beneficiaries (or remainder trust). If the residence passes to a remainder trust that is a grantor trust with respect to the donor, then no income tax consequences should result from the donor's rental, and the donor can transfer additional assets (e.g., the rental payments) *without gift tax*. In addition, the remainder trust can include terms addressing the ongoing care, maintenance, and management of the residence.

Another more sophisticated planning option for QPRTs, which may further reduce the gift tax exposure, is to transfer undivided fractional interests in the residence to separate QPRTs, since fractional interests may benefit from a fair market valuation "discount". For example, each spouse can create and fund a separate QPRT with a 50% fractional interest in the family vacation home. The terms and beneficiaries of the separate QPRTs should vary somewhat, particularly if the same grantor is creating the separate QPRTs, to substantiate the potential planning and valuation discount. There also are additional technical issues and transactions costs that come with funding QPRTs with fractional interests that should be balanced against the potential reduction in the initial gift tax liability.

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[1]See generally Natalie B. Choate, *The QPRT Manual*: *The Estate Planner's Guide to Qualified Personal Residence Trusts* for a detailed and technical discussion of QPRTs and the other planning approaches discussed herein.

[2] *See generally* Internal Revenue Code (**IRC**) §2702; Treas. Reg. § 25.2702 et. seq.

CONSIDERATIONS: Regardless of whether ownership of the entire property or a fractional interest is transferred to a QPRT, a qualified appraisal of the transfer *will be needed* for gift tax reporting purposes. If the grantor plans to use the residence after the QPRT term expires, a qualified appraisal of the fair market rental value of the home *also will be needed*, and the grantor and the trust should enter into a written lease agreement, and the trust should track, record, and enforce timely rental payments.

If the donor dies before QPRT term expires, the *full value* of the transferred real estate will be included in the grantor's taxable estate.[3]Accordingly, when deciding how long the QPRT term should be, the donor and the donor's advisors should consider several factors, such as the donor's age and health at the time of the gift, the Section 7520 rate at the date of the gift (which affects the valuation of the donor's retained interest), and the donor's available federal gift and estate tax exemption. The longer the term of the QPRT, the lower the reportable taxable gift of the remainder interest will be, but a longer term also inherently carries more risk that the donor could die before the term's expiration.

In addition, one of the main planning issues with a QPRT is that it is *not* as efficient for multi-generational planning under the applicable generation-skipping transfer ("**GST**") tax rules. Generally, GST tax exemption cannot be effectively allocated to a QPRT until the expiration of the "estate tax inclusion period" ("**ETIP**") – i.e., the expiration of the initial QPRT term. Further, the allocation of GST exemption at the *end* of the QPRT's ETIP will be based on the property's fair market value as of the allocation date, which is problematic if the residence in the QPRT has significantly increased in value since the QPRT's inception (as the donor may not have sufficient GST exemption to allocate at that time).

The regulations and statutory requirements of a QPRT also are quite strict, so precise technical drafting is important when creating and funding the trust. The donor must use the home as a personal residence during the term of the QPRT or risk losing the tax benefits of having the trust own the residence.[4] During the QPRT term, the trust may only hold the residence (and certain surrounding property), with limited exceptions that permit the trust to hold cash for short term periods to fund operational expenses related to the residence.

[3] IRC § 2036(a)(1).
[4] IRC § 2036(a)(1).

The QPRT also <u>must</u> prohibit the donor, as grantor, and the donor's spouse from reacquiring the residence, both before and *after the QPRT term*. If the residence is sold or damaged during the term, it must be replaced with another personal residence within two years, and if it is not, then the residence (or its sale proceeds) must be either transferred to a grantor retained annuity trust or given back to the donor.[5]
Also keep in mind that a single donor can only have *up to two* separate QPRTs at a time (although multiple QPRTs that hold fractional interest in the same property are treated as a single QPRT for purposes of this rule).

LIFE INSURANCE PLANNING: The mortality risk of the QPRT's ETIP can and should be hedged by purchasing life insurance through an irrevocable life insurance trust ("**ILIT**"). The insurance proceeds received by the ILIT should remain outside of the donor's taxable estate and can provide added liquidity to pay any potential estate (and GST) taxes and to help maintain the future ownership and upkeep of the property. Acquiring a convertible term policy or a permanent product also would allow the ILIT to act as an additional long-term wealth transfer planning opportunity. If structured as a GST-exempt dynasty trust, the life insurance proceeds received and retained by the ILIT could grow within the trust without incurring additional estate or GST tax, thereby creating and maintaining a sufficient long-term "side fund" to support continued maintenance of the property by the remainder beneficiaries (or within the remainder trust). A frequently used alternative approach is to have the actual GST exempt dynasty trust/ILIT acquire the ownership of the property from the QPRT after the donor's death.

<u>Gift or Sale of Residence to an Irrevocable Grantor Trust</u>

OVERVIEW AND POTENTIAL BENEFITS: Another planning option for vacation homes is the gift or sale of the residence by an individual (the "**grantor**") to his or her irrevocable grantor trust. The recent "permanent" increase in the federal gift, estate and GST tax exemptions may provide many grantors with the current ability to simply gift the applicable real property to a trust using their available gift and GST tax exemptions. Alternatively, if a grantor does not have (or does not wish to use) sufficient gift or GST tax exemption to cover a full gift of the house, the grantor could sell the residence to the grantor trust at fair market value in exchange for deferred payments made under a secured promissory note. To avoid below-market loan treatment, at a minimum, the note should bear interest at the applicable federal rate ("**AFR**") set by the IRS for the month and year of the sale.

As with a QPRT, fractional interests in the real property also could be gifted or sold to multiple grantor trusts to take advantage of potential valuation discounts (but, as noted above, there are added transaction and structuring costs when creating and maintaining multiple trusts).

[5] Treas. Reg. § 25.2702-5(c)(8)(i).

Unlike a QPRT, a properly structured gift or sale of a residence to the grantor's irrevocable grantor trust essentially transfers ownership of the real property, and any subsequent appreciation thereon (*in excess of the AFR in the case of a sale*), outside of the grantor's taxable estate *without* requiring the grantor to outlive a specific term. To continue to use the property post-gift or sale, however, the grantor *must* lease the property from the trust for fair market rent. Both the payment of rent by the grantor to the grantor trust and, in the case of a sale, any payments under the note from the trust to the grantor, should be disregarded for federal income tax purposes. Also, the rental payments will not be treated as taxable gifts, allowing the transfer of additional wealth to the trust without the imposition of gift or GST taxes.

When compared to a QPRT, the gift or sale of a residence to a grantor trust generally is more efficient for GST tax planning. The grantor trust can be immediately created and funded as a GST-exempt dynast trust by allocating GST tax exemption to the grantor's gifts to the trust. Unlike a QPRT, there is no need to wait for the expiration of an ETIP to allocate GST tax exemption. Also, the grantor should *not* have to allocate any additional GST tax exemption to cover the fair market value purchase price of the residence (in the case of a sale) or any rental payments made to the trust. The trust also is not limited to holding just the real property, and the trust beneficiaries can use the residence during the grantor's lifetime (subject to any formal lease agreement with the grantor), without having to wait for expiration of a specified term.

CONSIDERATIONS*:* If considering a sale of a residence to an irrevocable grantor trust, some practitioners suggest that the trust should be appropriately funded with other assets and investments besides the residence to avoid the IRS re-characterizing the sale as a gift (in whole or in part), thereby risking future estate (and GST) tax exposure. Ideally, the trust also will have sufficient liquidity to make required interest payments to the grantor on a timely basis, in compliance with the note. As with a QPRT, the grantor also will need to retain a qualified appraiser to assess the fair market value of the home for any gift or sale to the trust and, if the grantor plans to use the residence post-sale or post-gift, a qualified appraisal of the current fair market rental value of the home will be needed. Complying with formalities is also important. For sales, note payments should be tracked and made timely, and like with a QPRT, if the grantor will rent the residence, the grantor and the trust should enter into a written lease agreement, and the parties should ensure timely rental payments are made. For sales, if the grantor passes while the note is outstanding, the value of the note will be includible in the grantor's taxable estate.[6]

[6] If the installment sale obligation is still outstanding at the grantor's death, there is also an unsettled question as to whether the grantor's estate must then realize all or part of the deferred gain (i.e., the difference between grantor's basis in the residence when sold and the purchase price), see Choate, *The QPRT Manual*: *The Estate Planner's Guide to Qualified Personal Residence Trusts,* §1.4.06.

LIFE INSURANCE PLANNING*:* The trust's ownership of the home again raises questions of how the trust will cover ongoing maintenance costs and property taxes associated with the home, particularly *after the grantor's death* when rental payments/income cease. During life, the grantor can consider creating and supplementing a side fund by making annual gifts to the trust to cover these current and projected future amounts, which gifts also could be used to support the trust's purchase of life insurance on the lives of the grantor and/or the grantor's spouse. As with a QPRT, the use of life insurance can ensure that the trust has sufficient liquidity to maintain ownership of the home after the grantor's death without exhausting other liquid assets in the grantor's taxable estate. It also provides a liquidity source to pay off any remaining note obligations. Going forward, the trust also could acquire life insurance on the trust beneficiaries (i.e., the grantor's children and more remote descendants) to provide future liquidity to the trust upon their passing, potentially bolstering the likelihood of successful multi-generational planning.

Split Purchase of a New Home

OVERVIEW AND POTENTIAL BENEFITS: A so-called "split purchase" may be an appropriate option for families contemplating the purchase of a *new* vacation property. In this scenario, a special trust qualifying as a "personal residence trust" under the Internal Revenue Code (**IRC**) §2702 purchases the home. The trust terms provide that the grantor, as the "life tenant," has the right to the exclusive occupancy of the residence for his or her life but also has all the obligations and financial responsibilities of a life tenant under applicable local law. The life tenant has no separate obligation to pay rent to use the residence. On the life tenant's death, the trust property *automatically passes* for the benefit of the remainder beneficiaries. Both the life tenant and the remainder beneficiaries fund the trust with an amount equal to *the actuarial value* of their respective economic interests (determined under the applicable IRS life expectancy tables).

With a properly structured "split purchase," the transaction does <u>not</u> trigger a taxable gift on creation (unlike a QPRT), since <u>each</u> of the life tenant and the remainder beneficiaries contribute full consideration for their corresponding economic interests. There also is <u>no</u> requirement for the life tenant to survive a specified term to avoid estate tax inclusion of the residence's full fair market value in the life tenant's estate.[7] Correspondingly, there is no ETIP period that prevents the allocation of GST tax exemption, so a grantor could, if desired, enter into a new split purchase with a GST exempt trust.

[7] IRC §2036(a)

In this situation, a "split purchase" of a vacation property involving a personal residence trust, *if implemented appropriately*, arguably would not only avoid a taxable gift and create a GST tax efficient ownership structure, but also would permit the life tenant to retain the right to use the property during the tenant's remaining lifetime (without any obligation to pay rent), and without the risk of the appreciated value of the property being included in their federal taxable estate at death.

CONSIDERATIONS: The trust used in a split purchase *must* be carefully crafted to comply with the requirements of a personal residence trust, which is an exception to the special valuation rules under IRC §2702 regarding transfers in trust. Otherwise, when two (or more) members of the same family acquire interests in property that has a term interest, the special valuation rules under IRC §2702 would treat the *entire* value of the property (the vacation home) as transferred to the trust by the life tenant, followed by a sale of the remainder interest to the remainder beneficiaries, which would essentially negate most of the desired tax benefits of a split purchase.

In addition, although the split purchase itself does *not* generate a taxable gift, the remainder beneficiaries *must* have the resources to fund their portion of the purchase price. If not, then gifts to the remainder beneficiaries may be needed to help them purchase the remainder interest, which gifts undercut some of the potential split purchase benefits and may raise "step transaction" concerns, particularly if the IRS were to re-characterize the transaction as a *full* gift of the property to the remainder beneficiaries with a life estate retained by the grantor (resulting in estate tax inclusion of the property). The "split purchase" also does not have the same statutory framework and clear guidance that a QPRT provides, potentially leaving the transaction open to more audit questions *after the life tenant's death*, especially if the trust is not carefully structured as a personal residence trust.[8] Finally, as noted, this approach generally only works for the acquisition of a *new* property, not an existing vacation residence.

LIFE INSURANCE PLANNING: The remainder beneficiaries still will need future liquidity and resources to maintain, care for, and pay the costs/taxes associated with the vacation property after the life tenant passes. As with a QPRT and sale to a grantor trust, life insurance planning in an ILIT is a relatively simple way to address these liquidity and long-term maintenance concerns, as well as provide financial protection against any potential estate (and GST) tax exposure.

[8] IRC §§2702(a) and 2702(c)(2)

Practical Planning for the Next Generation

While many families have created successful, multi-generational ownership structures to transfer and maintain family residences, others, even with great foresight and planning, still fail to create a workable long-term solution because there are not enough family members interested in supporting the creators' vision. Accordingly, before deciding on a plan of action for a family vacation property, the current property owners must balance their vision of preserving the family vacation home against the "reality" of their family members' actual interest in the retention of that property.

For example, parents should realistically evaluate how many of their children (or other family members) expect to use the home *after the parents' passing* and ascertain their actual *level of commitment* to maintaining the property long-term. If only one or two family members want to keep the vacation home "in the family", while most of the others want cash or other assets to fund their lifestyle and/or desired travel goals, then it may make more sense to develop a plan that transfers the vacation home to those family members that want it and equalizes the other family members accordingly.

If, however, a family decides to maintain ownership of a family vacation home through one or more generations after the current family owners pass, then the family should (i) estimate the current and projected annual maintenance costs, taxes, etc. required to sustain the property on a long-term basis, (ii) decide which family members or other persons should control and manage the property on behalf of the larger group of family beneficiaries (whether as trustees, investment advisors, or other fiduciaries) and how, and by whom, their successors should be appointed (with or without the participation of spouses), and (iii) develop a governance structure to address how decisions are made with respect to the property's use and stewardship (including how to resolve disputes or break "ties" among various governing family members).

Given the inherent illiquidity of real estate, the current family owners also should consider how to give additional assets to the family that can help sustain and support the on-going ownership, maintenance, and care of the home. The ability to generate future liquidity will be a priority in such situations, which makes life insurance especially appealing for any family vacation home planning.

KEY TAKE-AWAYS: When considering tax-effective options for holding second or vacation homes, and possibly transferring valuable real estate to the next generation, families should consider the benefits and planning hurdles that are associated with each of the available options as summarized in the attached chart, since a family's specific circumstances and dynamics will affect the long-term viability and practicality of each opportunity. Families also should create a funding plan to ensure there are sufficient liquid assets for current and future generations to maintain the ownership of the property and provide a governance structure to manage and minimize family disputes over the use, enjoyment, and maintenance of the property over time. While families are enjoying their summer and vacation homes, now is the time to consider these objectives and goals and plan accordingly.

COMPARISON SUMMARY OPTION FOR PLANNING WITH A VACATION/SECOND HOME

Planning Approach	QPRT	Gift or Sale to Irrevocable Grantor Trust	Split Purchase
Overview of Approach	Donor transfers the residence to a trust and retains the right to live in the house for a fixed number of years. After the specified term, the property passes to a remainder trust or other designated remainder beneficiaries.	Donor makes a gift of the residence to the grantor trust at fair market value or sells the residence to the grantor trust in exchange for a secured note bearing interest at the appropriate AFR.	A personal residence trust purchases a new property and grants the life tenant the exclusive right to use the property for life, with the property passing for the benefit of the remainder beneficiaries at the life tenant's death. The life tenant and the remainder beneficiaries each contribute to the trust the actuarial value of their respective interests.
Donor's Use of Residence	During the QPRT term, donor has the right to use the residence as a personal residence, rent-free. Thereafter, donor must pay fair market rent to the remainder trust/beneficiaries to use the residence. *The fair market rent should be re-assessed at appropriate intervals*.	From inception, the grantor is required to pay fair market rent to the trust for use of the property. *The fair market rent should be re-assessed at appropriate intervals*.	The life tenant is not required to pay rent for use of the property.
Funding with an Existing Residence	Can be funded with a residence that the donor currently owns.	Can be funded with a residence that grantor currently owns	Generally available only for the purchase of a new property.
Gift Taxation	As of the transfer date, donor makes a taxable gift equal to the present value of the remainder interest in the property (as determined based on the QPRT's term and the applicable 7520 rate). After the QPRT term, any rental payments made by the donor are not taxable gifts.	Gift of the residence will be a taxable gift equal to the fair market value of the transferred property. No gift is made if the property is sold to the trust in a *bona-fide* sale for fair market value. Any rent paid by grantor to use the property will not be considered a taxable gift to the trust.	No gif tax exposure if each party pays the actuarial value of their respective ownership interests to the trust, but any gift to the remainder beneficiaries to help fund their purchase would be subject to gift tax and should be reviewed in light of potential "step transaction" considerations.
GST Taxation	GST exemption cannot be effectively allocated to a QPRT *until expiration* of the initial QPRT term. Any GST allocation at that time would be based on the fair market value of the trust property (including any appreciation thereon).as of the allocation date.	Available GST exemption can be allocated to any gifts made to the trust at the time made. No allocation of GST exemption is needed to cover the fair market value sale of the property to the trust, if the sale of the property for a note is respected.	The split purchase transaction can be entered into between a parent and GST exempt trust, so the property can pass to an exempt remainder trust.
Estate Taxation	Donor must survive the specified QPRT term or the full value of the property is includible in the donor's taxable estate. If donor survives the QPRT term, then the residence and any appreciation thereon passes outside of the donor's taxable estate.	Assets gifted or sold to the trust, and any appreciation thereon, pass outside of the grantor's estate. However, any remaining balance on the note provided in the initial sale of the property will be includible in the grantor's gross estate.	No inclusion of the property's value or appreciation thereon in the life tenant's gross estate.
IRS Interest Rate Sensitivity	QPRTs may perform better in higher interest rate environments, since a higher rate *increases* the actuarial value of the donor's retained interest, thus *reducing* the present value of the remainder interest (and thus the value of the reportable taxable gift).	A sale of property to the trust benefits from a *lower* rate environment, since a lower rate (i) *increases* the likelihood there will be appreciation in the trust *in excess* of the interest rate of the note and (ii) *lowers* the payments that must be returned to the grantor under the note.	As with a QPRT, a *higher* interest rate will *lower* the present value of the remainder interest in the personal residence trust, which means the remainder beneficiaries will need to contribute *less* to purchase that remainder interest.

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