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Estate Planning for Vacation Homes

Vacation homes are a common asset and can be useful planning tools in appropriate circumstances.

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There are 7.4 million Americans who own a second home . Planning for these assets is important to the estate-planning process. The current environment of lower values, high temporary exemptions and a growing concern among the wealthy that estate taxes will be made harsher to pay for the coronavirus bailouts, suggest that planning for this popular asset has become even more important. Wealthy clients can use vacation homes as gift assets to use some of their current high temporary exemptions. This can be particularly advantageous now as many clients will be reluctant to gift away investment assets given market declines, as they may want to preserve those diminished assets to cover future living costs. Many wealthy families wishing to pass on vacation homes to future generations should take steps before the current high temporary exemptions decline.

Using exemptions and passing on a vacation home require planning. That planning often is best served with a long-term dynastic trust.

Trust

One approach to eventually bequeath a vacation home to heirs is for one spouse to gift the vacation home to an irrevocable dynastic trust. A dynastic trust can retain the desired property, as well as other assets, in trust for as long as state law will permit. The other spouse can be named a beneficiary of the trust, and the spouse's descendants can be named remainder beneficiaries.

The trust instrument should have an express provision to permit the trustee to hold personal-use property and to permit the beneficiaries to use that property rent-free. The trust, if it's going to use an institutional trustee (see below), should be structured as a directed trust with a person named to be in charge of trust investment decisions, including holding the personal use residence. Draftspersons should be careful to confirm which fiduciary will be responsible for the decision to hold the personal use property. The manner in which some trusts are drafted might make the general or administrative trustee responsible for decisions to hold personal use property. If an institutional trustee is to be named, it may be easier to have an individual trust investment director responsible for personal use property investment decisions. It may also be worthwhile to consider providing the investment director with the right to create rules or regulations for the use of the property (but see below).

When a trust is created for a spouse and descendants, consider using a trust-friendly jurisdiction for the situs of the trust that permits self-settled domestic asset protection trusts. That way, if there's a challenge to the trust by the Internal Revenue Service or creditors, the settlor/spouse can argue that the trust qualifies as a self-settled trust and should still be respected. If the clients don't live in a state that permits such trusts, then an institutional trustee will have to be named to obtain situs in one of the current 19 trust-friendly jurisdiction states.

In most instances, it will be advantageous for the client to use such a trust plan for more than just safeguarding a vacation home, for example, to use exemptions generally before the laws change.

LLC

A limited liability company (LLC) is often essential to the plan for several reasons:

1. An LLC can provide asset protection insulating the trust from liabilities associated with the ownership of the vacation home property. The default IRS classification is a sole proprietorship (disregarded as a separate entity) for LLCs with just one owner (or a married couple).
2. The LLC operating agreement can contain rules and regulations about the use of the property. For example, which beneficiary family can use the vacation home on key holidays? For a beach house, the July 4 weekend may be highly desirable. For a mountain home, Christmas week may be the hot ticket. The rules could provide for a rotational use system. Other issues include who's responsible for repairs and who can make decisions as to decorating or improvements.
3. If the property is located in a different jurisdiction than the trust-friendly jurisdiction where the trust has situs, the trust shouldn't own property outside of its home jurisdiction. Thus, the LLC effectively transmutes a real property interest into an intangible asset the trust can hold regardless of which state the real estate is in.

Consider whether the LLC should have a manager. Because the trust may be the sole member, it can be advantageous to have a manager named who has authority to execute documents, pay bills, etc. on behalf of the LLC. This setup will make the LLC easier to administer.

Operating Agreement Considerations

When an LLC is used, an operating agreement could prove useful even though it's a single member disregarded (for income tax purposes) LLC. While many practitioners might not bother with an operating agreement, there are a number of provisions that might be beneficial. As noted above, it may be advantageous to name a manager and expressly provide provisions for acts a manager, or the trustee, may be required to perform with third parties (for example, express authority to acquire and finance a residence), name a successor manager, rules and regulations on the use of the property, and more. Personal and religious preferences of the family could be considered. For example, a Christmas use rotation or religious preferences that the kitchen adhere to particular faith religious dietary restrictions might be addressed. The client may be Hindu and want the kitchen to remain vegetarian or perhaps Muslim or Jewish and wishes the kitchen to be used only in accordance with halal or kosher dietary rules, respectively.

Occupancy Agreement

In some instances, an occupancy agreement between the trust and the occupant may be used to memorialize the respective rights and obligations of the occupant and trust regarding the use, maintenance, improvement and repair of the vacation home. It could address which party will be responsible for the payment of which expenses relating to maintenance, utilities, ordinary repairs and so forth.

A Legacy

Vacation homes are a common asset and can be useful in appropriate circumstances to fund a plan to use a client's gift and generation-skipping transfer tax exemption. That plan can also carry out important goals of passing to future generations a family vacation property as a legacy.