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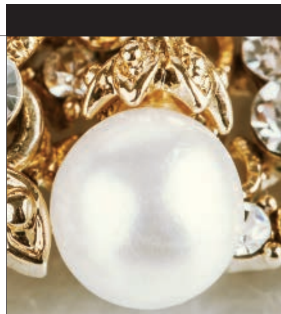

Client Gift of Vacation Home to SLATs: Valuable Technique but Traps to Consider

A dynastic trust can retain vacation property, as well as other assets needed to provide cash flow to cover maintenance and carrying costs, etc., in trust but there are many tax and non-tax issues to address.

PATRICK GORDON, ESQ., COURTNEY DOLAWAY, ESQ., DAVID NEUFELD, ESQ., BRIAN BOAK, BRONWYN L. MARTIN, AND MARTIN M. SHENKMAN, ESQ.

Some 7.4 million Americans own a second home.[1] Planning for these assets is important to the estate planning process. The current environment of lower interest rates and property values, high temporary exemptions (which may or may not have changed by the time this article is published), and a growing concern amongst 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 and other family goals. This can be particularly advantageous as many clients are 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 exemption and passing on a vacation home, with a myriad of personal issues, require planning. That planning often is best served with a long-term dynastic trust.

PATRICK GORDON, ESQ. is an attorney/CPA with the law firm of Gordon Davis Johnson & Shane PC in El Paso, Texas. Pat is Board Certified in Tax Law by the Texas Board of Legal Specialization. Pat specializes in representing clients in commercial tax matters. COURTNEY DOLAWAY, ESQ. is a shareholder and member of Flaster Greenberg's Trusts & Estates, Taxation, and Business & Corporate Departments. She concentrates her practice on complex estate planning, estate administration, business succession, and general corporate matters. She also serves as chair of the firm's Women's Initiative Committee. Ms. Dolaway can be reached at 215.279.9377 or courtney.dolaway@flastergreenberg.com. DAVID NEUFELD, ESQ. is a shareholder and member of Flaster Greenberg's Trusts & Estates, Taxation, and Business & Corporate Departments. Having practiced law for more than 35 years, he advises individuals and businesses around the globe on sophisticated federal income and estate tax planning, state tax residency planning and audits, asset protection, and insurance and investment planning. Mr. Neufeld can be reached at 856.382.2257 or david.neufeld@flastergreenberg.com. BRIAN BOAK, AEP®, CPRIA, CLU®, LUTCF®, has been advising clients for over thirty years. For the last twenty years, he has worked with family offices and advisors of highly successful families providing risk management for the personal property, liability and lifestyle exposures of their clients. Brian is on the Board of the Estate Planning Council of NYC and the Past-President of The Estate Planning Council of Rockland County. He can be reached at BBoak@BOAKS.com. BRONWYN L. MARTIN, PhD, MBA, ChFC®, CLU®, CLTC® CRPC®, CFS®, CMFC®, AEP®, LACP, AIF® has been in the financial planning industry for over 20 years and has an office in both PA and MD. She is a member of the NAEPC Board and a member of the executive board of the Chester County Estate Planning Council. MARTIN M. SHENKMAN, CPA, MBA, PFS, AEP (distinguished), JD, is an attorney in private practice in Fort Lee, New Jersey and New York City, New York. His practice concentrates on estate planning. Author of 44 books and more than 1,200 articles. Editorial Board Member of Trusts & Estates Magazine, CCH (Wolter's Kluwer) Co-Chair of Professional Advisory Board, and CPA Journal. Active in many charitable and community causes and organizations. Founded ChronicIllnessPlanning.org which educates professional advisers on planning for clients with chronic illness and disability and which has been the subject of more than a score of articles. American Brain Foundation Board, Strategic Planning Committee, and Investment Committee. Bachelor of Science degree from Wharton School, concentration in accounting and economics; MBA from the University of Michigan, concentration in tax and finance; Law degree from Fordham University School of Law. www.shenkmanlaw.com.

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Trust

One approach to eventually bequeath a vacation home to heirs may be 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 needed to provide cash flow to cover maintenance and carrying costs, etc., in trust for as long as state law will permit. This can facilitate passing the vacation home to future generations without estate tax concerns and future appreciation of the vacation home is removed from the donor client's estate. When the donor client's spouse is named as beneficiary of the trust, perhaps along with descendants (or with trusts for their descendants being the remainder beneficiaries), the trust is often referred to as a Spousal Lifetime Access Trust (SLAT). If the client is not married and wishes access a domestic asset protection trust (DAPT) might be used, or some other variation of trust.

Some of the provisions or characteristics of such a trust might include:

- Whether a draftsperson creates a SLAT or simply a trust for descendants, the trust instrument should have an express provision to permit the trustee to hold personal use property.
- The trust might include language permitting the beneficiaries to use that property rent-free. However, that may not always be optimal. If an existing vacation home is transferred into the trust some practitioners might recommend that the spouse/donor pay rent to the trust to reduce the risk of estate inclusion (although that may not be necessary in some instances). Also, if the trust is a grantor trust paying rent may have no income tax consequences, but may permit the clients to make gift-tax free transfers of funds each year that could be used to offset carrying costs for the property.
- Inquiry, if the trust is going to use an institutional trustee (see below), should be made at the drafting stage as to whether the trustee would have any issues holding personal use property such as the vacation home. If so, the trust might be structured as a directed trust with a person named to be in charge of trust investment decisions (e.g. as investment director), 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. It may not be certain whether a vacation home would be viewed as an investment decision within the purview of the investment director, or instead a distribution decision within the purview of the distribution director or the general trustee who may, depending on the terms of the governing instrument, be responsible for distribution decisions. 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 instead 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 creating a SLAT consider using as a jurisdiction for the situs of the trust one of the 19 jurisdictions that permit self-settled domestic asset protection trusts (if the trust is structured as a DAPT, that would be required). That way, if there is a challenge to the trust by the IRS or creditors that the settlor/donor retained the use of trust property, the donor client may have the fallback position that the trust qualifies as a self-settled trust and should still be respected. If the clients do not live in a state that permits such trusts, then an institutional trustee will have to be named to obtain situs in one of those permitted states.

In most instances it will be advantageous for the client to use

[1] http://eyeonhousing.org/2018/12/nations-stock-of-second-homes/.

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such a trust plan for more than just safeguarding a vacation home, e.g. to use exemption generally before the laws change.

Using an LLC to Hold Title to the Vacation Property

A limited liability company (LLC) is often beneficial, and in some instances essential, to the vacation home 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.
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, July 4th weekend may be highly desirable. For a mountain home, Christmas week may be the hot ticket. A rotational use system might be provided for. Other issues might include who is responsible for repairs and who can make decisions as to decorating or improvements.
3. If the property is located in a different jurisdiction then the trust jurisdiction where the trust has situs, the trust should not 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 where the real estate is located.

Consider whether the LLC should be a manger managed LLC. Since 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. That may make the LLC easier to administer.

Does the LLC Need a Business Purpose?

As a matter of state law it seems that, subject to any particular state law or ruling otherwise, a business purpose generally is not a prerequisite for forming and using an LLC. Many LLC's are formed with a business purpose. Owning a vacation home exclusively for personal use (as opposed to holding it primarily to rent out with limited personal use) is not on its face a business purpose. In most states this is not an impediment. Most states do not require the LLC to specify a business purpose to be formed. For instance, section 108(b) of the current version of the Uniform Limited Liability Company Act[2] provides that in forming an LLC it "may have any lawful purpose, regardless of whether for profit." The comment explains that "[a]lthough some LLC statutes continue to require a business purpose, this act follows the current trend and takes a more expansive approach." Thus, a purpose statement permitting the LLC "to engage in any lawful activity for which the LLC may be organized in this state" or a similar statement should suffice.

If an existing vacation home is transferred into the trust some practitioners might recommend that the spouse/donor pay rent to the trust to reduce the risk of estate inclusion.

While in the context of an operating business the income tax law requires a valid and bona fide business for several reasons, including tax free organizations and reorganizations,[3] issues relating to deductions and issues relating to income shifting,[4] and others.[5] But in a pure personal asset scenario these income tax rules typically do not come into play, and so the existence of business may likewise be irrelevant as a matter of income tax.

Even where the IRS might have a valid argument attacking the entity under the income tax rules based on business purpose the courts have rejected the IRS's position that the entity itself should be disregarded for transfer tax purposes.[6]

Having said that the LLC serves numerous economic purposes independent of tax savings. It:

1. Provides control and management.
2. Provides for succession of management.
3. Permits a trust to hold ownership of real estate.
4. Supplies an additional layer of asset protection.

The lack of any business purpose from the ownership and operation of the vacation home seems to be irrelevant.

Operating Agreement Considerations

When an LLC is used an operating agreement may be useful to prepare even though it is a single member disregarded (for income tax purposes) LLC. While many practitioners might not bother with an operating agreement, failure to use an operating agreement defaults to the rules imbedded in that state's LLC statute which may or may not reflect the needs of the family. There are a number of provisions that can be added that might be beneficial. As noted above, it may be advantageous to name a manager, and expressly provide provisions for acts a manager may be required to

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perform with third parties (e.g. express authority to acquire and finance a residence), name a successor manager, rules and regulations on the use of the property, and more. For example, personal and religious preferences of the family could be considered, such as requiring that the kitchen adhere to particular faith religious dietary restrictions: a Hindu family might want the kitchen to remain vegetarian, or a Muslim or Jewish family might require the kitchen to be used only in accordance with Halal or Kosher dietary rules. Or perhaps a restriction on pets may be mandated. Latter Day Saints might prohibit smoking, gambling, or alcoholic beverages on the premises.

Occupancy Agreement

An occupancy agreement could be embodied in an operating agreement or could be a separate document. Overlapping personal and financial interests raise challenging situations often; toss in family dynamics and the situation could be quite volatile. If good fences make good neighbors, good written agreements go a long way in keeping peace within a family sharing a vacation home. This is true whether the home is in a trust or otherwise. But the very act of transferring it to the trust gives the family advisor the perfect opportunity to address the need to anticipate problems before they become insurmountable. 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. Integrating these rules will go a long way to making sure house related spats stay out of Thanksgiving Dinner arguments.

What if the Client has No Exemption Left?

If a client has little or no exemption left, the client can sell the vacation home, or any other asset, to a trust to shift any appreciation on the home out of the client's estate. This can be a sale for a promissory note; if so the trust will need seed money, traditionally in the amount equal to 10% of the value of the home (although the necessity of that mythical figure is subject to question). If the client has sufficient exemption remaining (even the yearly increase to the federal exemption can be sufficient), the client can form a new trust and gift the trust the seed money. If the client has no exemption remaining, the client can look to a previously funded trust for a guarantee.

Once a trust with sufficient seed money is identified, the client can then sell the home to the trust in exchange for the promissory note. This is also beneficial for clients that desire an income stream. The promissory note must have an interest rate, that may be as low as the applicable federal rate (AFR). For December 2020 the long-term rate is only 1.31% (more than 9 years). With the AFR is at a historic low this a powerful strategy to transfer appreciating assets out of one's estate. The magic is in the arbitrage between the rate on the note (as low as the AFR) and any appreciation to the gifted property above the AFR rate. Although the note is repaid with interest this is considered a transfer tax win because substantial appreciation after the date of the sale is liberated from the client's taxable estate when the client dies.

Estate Tax Considerations

When a person transfers an asset out of his or her estate, the IRS may consider that asset still part of the person's estate upon the person's death if the person retains an interest or power over that asset. It is the presence of "strings" which draw the property back into the person's estate at his or her death for estate tax purposes that creates the problem that needs attention. What constitutes strings for estate taxation is addressed in Section 2036 (transfers with retained life estate), Section 2037 (transfers taking effect at death), and Section 2038 (revocable transfers). For purposes of this article, the focus will be on Section 2036.

Section 2036 provides that a decedent's gross estate includes any

> transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property of the income therefrom.

In *Estate of Reichert*,[7] the Tax Court considered whether assets the decedent transferred to a partnership

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2 Uniform Limited Liability Company Act (2006) (Last Amended 2013), adopted in 21 states thus far.

3 Section 355(a) and (b).

4 Reg. section 1.704-1(e).

5 Section 708(b)(1).

6 See, e.g., *Estate of Bosch*, 387 U.S. 456 (1967). This has been true even in the context of the discount wars. *Estate of Strangi*, 115 T.C. 478 (2000), *aff'd in part, rev'd in part and rem'd in part*, 293 F.3d 279 (5th Cir. 2002); *Church*, 2000-1 USTC ¶ 60 (W.D. Tex. 2000), *aff'd*, 268 F.3d 1063 (5th Cir. 2001) (unpublished table decision). But see *Holman*, 601 F.3d 763 (8th Cir. 2010). See Section 2703(b)(1).

7 114 T.C. 144 (2000).

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were included in his gross estate under Section 2036(a). Decedent transferred his residence to a revocable trust, which was the general partner of a partnership, but continued to live in the residence after transfer without paying rent. The Tax Court held that the decedent had retained actual control over the property despite the change in legal title.

Is the holding in *Estate of Reichert* a problem if the donor uses the gifted vacation home after it is gifted to a SLAT for the benefit of the donor's spouse if the SLAT provides that family members (which includes the spouse) of the beneficiary can use the vacation home? This has not been resolved by the Service or the courts; below are a few thoughts that might stave off potential Section 2036 challenges:

The Donor Client Can Pay Rent to Use the Vacation Home. Have the donor client execute a rental agreement with the trustee of the trust to allow the donor client to use the vacation home by paying fair market rent. As with rentals after the occupancy term of QPRTs, this is not considered a retained interest under Section 2036.

Bona Fide Sale. In *Estate of Nancy H. Powell*,[8] the Tax Court held for the first time that assets of a limited partnership could be treated as a retained interest under Section 2036(a)(2) where the decedent only held a limited partnership interest. Keeping in mind that Section 2036(a) turns on the retained possession or enjoyment of the property (or the income therefrom) or the right to determine alone or with others who can have possession or enjoyment of the property (or the income therefrom) and that possession can be inferred even without legal control, The solution might lay in avoiding *Estate of Powell* altogether by invoking the bona fide sale exception.

Section 2036 does not apply to any transfer that was "a bona fide sale for adequate consideration in money or money's worth." A sale of the vacation home to the trust for full and fair consideration should therefore negate the Section 2036 issue. But that sale of the property must serve a significant nontax purpose. If a valid nontax purpose exists, such as consistent management and investment strategy of a family's assets, *Estate of Powell* should not pose a problem.

There may be another line of reasoning to address Section 2036 issues. In *Estate of Allen D. Gutchess*, a family residence transferred by husband to wife about 11 years before his death was not included in the husband's estate under Section 2036, even though he continued to occupy the residence with his wife until his death. There was no written or oral express retention of right of occupancy by the husband and no agreement for right of occupancy will be implied from the fact that he lived there with his wife until he died.[9]

Income Tax Considerations

If the SLAT is a grantor trust there should be no income tax consequences and any income earned on the property, through rentals, will shift additional value to the SLAT without gift tax consequences.

There is a tension between the estate tax and the capital gains tax; planning that removes an appreciated asset from the estate leaves intact the potential capital gains that existed on the date of the gift. Yet planning that leaves the appreciated property in the estate gets to avoid the capital gains tax that would otherwise be triggered on the appreciation through the date of death at the possible cost of an estate tax depending on the size of the estate relative to available exemption.

If the vacation home is transferred to the trust through a gift, the trust will receive carry-over basis (assuming no change in law). If the trust sells the vacation home, the trust will have the same basis as the donor and pay capital gains on the difference. Likewise, if the vacation home is sold to the trust, the trust will still have carryover basis. Typically when a property is sold, the basis in the house is stepped up to the sale price. However, if the trust is a grantor trust, the trust's existence is disregarded for income tax purposes and the donor is viewed as still owning the vacation home for income tax purposes. If the vacation home has significant appreciation over time it might make sense, if the option is available, to trigger estate inclusion and obtain the basis step-up.

Insurance Considerations

A common topic within estate planning is the issue of a vacation home and sometimes a primary residence, which is owned by an LLC that is owned by a trust. For example, in an irrevocable trust that a family set up for child, and that child wants to buy a home. Some feel the preferable approach is not to give the money from the trust to the child for the down payment, but rather to have the trust purchase the house. If the trust is in one jurisdiction (Delaware, for example, which is a legal and tax favored jurisdiction), and the house is in a state like New York, the house would need to be held in an LLC to avoid an out of state trust owning a property in another state.

8 148 T.C. No. 18 (2017).

9 *Estate Of Allen D. Gutchess*. Docket No. 4926-63. 1966-08-9. Acknowledgement to Jonathan Blattmachr, Esq. for pointing out this case.

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This scenario is often not addressed adequately. Questions arise about handling insurance for a house owned by a trust or LLC, which is different from coverage of personal property. Who/what should be listed as insureds and additional insureds need to be examined, to assure protection in the event of a claim. Many agents are not used to dealing with this type of clientele and do not ask the correct questions. Clients also often are unclear and do not understand that simply being insured may not be sufficient.

If a lawyer or advisor is implementing a plan, this is something they need to suggest be addressed. Unless a bank is involved, due to a mortgage, adding the trust or LLC to the policy could be missed. If the home is bought for cash and nobody mentions to the insurance broker that a trust or LLC is buying the home, it will not be added. The client, lawyer, or advisor must proactively follow up. This aspect of estate planning, if handled poorly, could cost the client unrecoverable millions of dollars.

For lawyers drafting the document, part of their procedure could be to suggest to the client to ensure that change is made to the home and liability insurance. Some attorneys opt to request to see a copy of the document showing that this trust or LLC is listed on the home and liability policy to confirm. Many times, the disconnect occurs because a client does not want to incur the added fees for attorney follow-up. They may need to be convinced of the benefit.

At minimum, advisors might put the recommendation in writing. Advise and encourage the client about this type of follow up. This is a good item for all the different advisors on the team to have on their respective checklists. Clients need to understand the possibility of multi-million-dollar loss if it is not insured properly.

If good fences make good neighbors, good written agreements go a long way in keeping peace within a family sharing a vacation home.

In a structure where the house is owned by a trust or LLC in a different state, depending how it's structured, the client might have to name the LLC and the trust both to avoid issues. The client would inform the insurance broker that the home is owned by 123 Main Street LLC which in turn is owned by the Smith Family Trust. Spelling out the structure so the insurance company can use the appropriate wording. Advisers might consider documenting that this is done including requiring a response from the broker to be then followed up for the final documents from the insurance company showing all insured parties.

While a revocable trust, arguably, may not always need to be listed, an irrevocable trust or LLC always needs to be listed. Since putting the trust/LLC on the home and liability policy may cost nothing, practitioners may always recommend it.

Consider the following illustration. A house burns down and somebody is injured. If the house is owned by a trust/LLC, the insurance company may not pay to rebuild the house if the trust/LLC is not named on the policy. They may pay for the contents because those are owned by the individual named on the policy. If there is any art transferred into the trust/LLC, it may not be covered. Regarding the claim on liability, the insurance company will pay to defend the individual and pay their share of the judgement (up to the policy limit). The insurance company will not pay to defend the trust/LLC or pay any judgement assessed against it.

When a client has personal use vacation homes owned by a trust or LLC, advisers should remind the client to be certain that they have addressed the insurance coverage properly.

Conclusion

Vacation homes are a common asset and often can benefit from more robust and comprehensive planning. It may be useful in appropriate circumstances to fund a plan to use a client's gift and GST exemption. That plan can also carry out important goals of passing to future generations a family vacation property as a legacy. ■