

WILLMS, S.C.

MEMORANDUM

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**TO:** Clients and friends of Willms, S.C.  
**FROM:** Andrew J. Willms  
**DATE:** April 11, 2016  
**RE:** Estate Planning for Vacation Homes

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Vacation homes have a special place in the hearts of their owners and deserve a special place in their estate plans as well. However, the unique considerations surrounding the ownership of a home by more than one person make estate planning for a vacation home particularly difficult. Consider the following hypothetical situation.

Bob and Mary, who are in their late 60's, own a cottage in northern Wisconsin. While the initial purchase price of the cottage was relatively modest, the value has grown dramatically over the many years they have owned it. It now represents a significant portion of their total estate. Mary and Bob expect that they will use the cottage less often as they get older, and would like to plan for transitioning its ownership to their children.

Bob and Mary have three children. Their daughter Susan lives in San Francisco and hasn't visited the cottage in several years. Their son Bill lives in Wisconsin, is an avid outdoorsman, and visits the cottage frequently, and helps Bob and Mary maintain it. Steve is a successful Chicago businessman who periodically visits the cottage but is not as passionate about using it as Bill.

Bob and Mary would like to plan for the transfer of the cottage to their children in a way that they feel is fair to all three of them and will discourage disagreements. Let's review their options.

Option 1. Bob and Mary could gift the cottage to their children during their lifetimes.

In most cases, this is not the best alternative. That is because the recipients of gifted property have the same income tax basis in the gifted property as the person who made the gift. By comparison, the income tax basis of property received by inheritance is increased to its fair market value at the time it is inherited. As a result, a lifetime gift of the cottage could result in much higher income taxes if the children end up having to sell the property at some point in the future.

Option 2. Mary and Bob could bequeath the cottage to their children.

A second option would be to include a bequest of the cottage to their three children jointly in their trust or their wills. While such an approach avoids the income tax concerns associated with a lifetime gift, it fails to address a number of other issues that could arise after Bob and Mary die. These concerns could include:

- How will the use of the cottage be shared after Bob and Mary die?
- Who will be responsible for maintaining the cottage?
- How will taxes, insurance, repairs and other expenses be paid for?
- What if one of the children wants to sell their share of the cottage either because they do not plan to use it (Sue) or cannot afford to keep it (Bill)?
- Could a former spouse claim an interest in the cottage if a child is divorced?
- What happens to a child's share of the cottage when the child dies?

Option 3. Bob and Mary could bequeath the residence to one child (Bill) and leave assets of similar value to their other two children.

While a bequest of the cottage to one of the children avoids the problems that can result when real estate is owned jointly, this approach raises thorny questions of its own.

- Do Bob and Mary have sufficient assets to divide their estates equally if the cottage is given to just one child?
- Can the child who inherits the cottage afford to keep it while receiving a much smaller share of Bob and Mary's other assets?
- Will the children who do not receive the cottage feel left out?
- Will the child who receives the cottage allow his siblings and their families to use it?

Option 4. Bob and Mary could transfer the cottage to a family limited liability company during their lifetimes.

A limited liability company ("LLC") is a type of organization that is similar to a partnership. The LLC would issue "membership interests" to Bob and Mary that could be left to their children via their estate plan. There are several potential advantages to using this approach to transfer the cottage to Bob and Mary's children.

- An LLC can exist indefinitely.
- The “Operating Agreement” that establishes the LLC can set forth rules that govern the use and maintenance of the cottage. This can include scheduling, contributions to expenses, maintenance, guests, how and to whom members can transfer their LLC units, and what happens if a member would like to sell their LLC units.
- The LLC can protect the cottage from creditors, divorces and other claims.
- The LLC can prevent one child from forcing the sale of the property (a “partition”).
- The money needed to maintain the cottage could be given to the LLC by a bequest, or by naming the LLC as the beneficiary of a life insurance policy.
- The income tax basis of the cottage will be “stepped-up” when Bob and Mary die to its fair market value at that time.

Option 5. Bob and Mary could gift the property to a Qualified Personal Residence Trust.

If Bob and Mary have sufficient assets to potentially trigger estate taxes on the residence, then they may want to consider transferring the residence to a Qualified Personal Residence Trust (or “QPRT”).

- Either Bob or Mary could establish the QPRT as the “Grantor”. The Grantor (for purposes of this discussion we’ll assume it’s Mary) would be entitled to the rent-free use of the cottage for a term of years that is specified in the Trust Agreement (the “Term Period”). Upon the expiration of the Term Period, Bob could be given the right to continue to use the cottage (with Mary, of course) for the rest of his life.
- The transfer of the cottage to the QPRT is considered to be a taxable gift. However, Mary could use her lifetime gift tax exemption (\$5,450,000 in 2016) to avoid having to pay gift taxes. In addition, because Mary retains the rent-free use of the cottage, the value of cottage is discounted for gift tax purposes to account for the value of his retained interest. (It is not uncommon for this discount to be 50% or more). This means a smaller amount of Mary’s exemption is used by this gift compared to if she waited to transfer the cottage at death.
- As long as Mary is living when the Term Period expires, the cottage would be sheltered from estate taxes. (However, this also means the residence will not receive a stepped-up basis for income tax purposes.)

As the foregoing hypothetical demonstrates, there are a variety of estate planning techniques that can help ensure a vacation home will remain within the family for generations to come. Which of these techniques is best for your family will depend in large measure on your particular facts and circumstances. Therefore, please let us know if you own a residence that you would like to keep in your family. We would be pleased to help you identify the course of action best suited to your unique situation.

**End of Memo**

**Information contained in this memorandum is not a substitute for professional estate planning advice nor should any information provided in this memorandum be construed as legal advice. Therefore, none of the information being provided should be relied on without seeking the advice of legal counsel or other professionals regarding the tax and non-tax consequences associated with the same.**