

**Abstract:** Owners of vacation homes often plan to give their children the retreat when they die. But unless they plan carefully, doing so can cause needless problems. To avoid future conflicts, owners can place the property in an irrevocable trust, a limited liability company or a limited partnership. This article explains how each of these entities can benefit an estate plan that includes a vacation home.

## **A Vacation House Divided Make Your Retreat a Treat for Your Children**

If you own a vacation home, you'll probably want to pass it along to your children after your death. But unless you plan carefully, doing so can cause needless problems and conflicts.

Simply giving your children the property outright can lead to disagreements and questions about how they will share, maintain and pass it along to their children. For example, what if a child wants to sell his or her share to another, or can't afford his or her share of the property taxes? How will they resolve disputes in those situations?

### **Your Options**

Giving property to your children in joint tenancy or as tenants-in-common won't solve the problem, because these arrangements lack a structure defining ownership terms -- your children are left to work things out (or not) among themselves. The answer is to place the property in an irrevocable trust, a limited liability company (LLC) or a limited partnership (LP). Using one of these three entities, you can:

- Appoint a neutral third party to manage the property and resolve disputes among your children,
- Name one child (often the oldest) as the chief decision maker or arbiter of disputes in addition, or as an alternative, to a third-party manager,
- Dictate how your children should share, maintain and pass the property on to future generations,
- Provide funds for ongoing maintenance, improvements, real estate tax, insurance and other expenses,
- Stipulate how your children should share property-generated income and who should file income tax returns, and
- Protect the property from creditors and adversarial ex-spouses.

Let's examine each entity with respect to estate planning for vacation property.

### **Irrevocable Trusts**

An irrevocable trust holds the property for the benefit of your children or other beneficiaries. You may appoint a neutral third party, a financial institution or a beneficiary as trustee. Set up the trust during your lifetime as an irrevocable gift trust or as a testamentary trust that becomes effective at your death.

Make certain to fund the trust with enough liquidity to cover ongoing expenses and trustee fees if you use an institutional trustee. If the trust isn't fully funded, the trust beneficiaries should assume joint and several liability for ongoing expenses.

In states that allow perpetual trusts, you can choose to have the trust continue indefinitely so future generations may enjoy the property. Otherwise, you may leave instructions for the succession of each child's interest on his or her death, or specify a trigger event that will terminate the trust.

The trust document may include a buyout provision in case one beneficiary wants to sell his or her interest in the property. For example, the provision may call for one beneficiary to get approval from the others before offering his or her interest to an outsider. But you must balance the advantage of that type of provision against the loss of creditor protection resulting from the diminution of the trust's spendthrift clause.

You can give the trustee broad decision-making powers or limit those powers by establishing rules for managing the property. But one disadvantage of an irrevocable trust is that once you set the rules, the manager may be constrained in adapting to changing conditions or family relationships.

### **LLCs and LPs**

Operating agreements govern both LLCs and LPs. The beneficiaries of these entities are members or partners. Both entities provide many of the same benefits as a trust, but they offer more flexibility for the manager to exercise discretion in unexpected circumstances. For example, if you underfund the LLC or LP, the manager can solicit additional funds from the members or partners. If one member can't contribute funds, then the manager may be able to adjust the members' ownership interests or property use to compensate.

You may provide that members or partners can amend the operating agreement as needed, while you retain the power to constrain the types of changes they can make. As with a trust, you can appoint a manager or managing board, and you may structure the ownership into voting and nonvoting interests. In addition, you can restrict the transfer of members' and partners' shares.

### **Which Option Is Best?**

Deciding whether to hold your vacation home in a trust, LLC or LP depends on several factors, including your income level, the vacation property's value, the total value of your estate, relationships among your heirs and liability issues. We would be glad to help you assess the merits of each option and determine which is best for you.

### **Is Your Vacation Home a Tax Shelter?**

While on vacation, the last thing you probably want to think about is taxes. But your vacation home may act as a tax shelter. You can exclude up to \$250,000 in capital gain (\$500,000 for married couples) when you sell your principal residence. Then, if you move into your vacation home and live there two or more years before selling it, you can exclude another \$250,000 (\$500,000 for couples) in capital gains when you sell.

Owning a vacation home can lead to other advantages. If you rent out the home to paying guests part of the year, you may enjoy the following tax advantages.

Here are your options:

- You rent it to paying guests for fewer than 14 days per year. In this case, you owe no tax on that rental income, and you can still deduct mortgage interest, property taxes and uninsured casualty loss on Schedule A.

- You rent it or have it available for rent all year. Deduct mortgage interest, property taxes, insurance, utilities, repairs and other costs from rental income on Schedule E. If you report a loss on Schedule E, that loss can shelter ordinary income up to a limit.
- You occupy the vacation home fewer than 15 days per year or less than 10% of the rental days (if more than 15 rental days per year). You may use a loss on Schedule E to shelter up to \$25,000 in ordinary income.
- You occupy the vacation home more than 15 days per year or 10% of the rental days (which exceed 15 days per year). You generally cannot deduct a vacation-home loss on your tax return.