



Home Sweet Second Home: Plan Transitions Early to Achieve Desired Results

Your family's second home isn't just a house. It is rich in memories as well as dollar value. So passing on this property in a way that meets emotional as well as financial needs can be very satisfying. Owners who plan early have many options. Delays can lead to hurt feelings and high estate taxes.

Of course, it makes sense to have a basic estate plan—including items such as wills, revocable trusts, health care proxies, powers of attorney, and beneficiary designations—in place before you deal with your second home. Then, you're ready to tackle advanced topics such as real estate planning. Your process should include:

1. Figuring out what you and your family would like
2. Evaluating options for passing on your second home

Step 1: Start Talking

The first step owners should take is to talk with your co-owners about what you'd like to happen with the property. Once you've sorted out your desires, then talk with the next generation. These conversations are best once your children are older. For example, if they've started to raise families, they may have a better idea of what they want. Children who settle far away from the second home—or who buy their own second homes—are less likely to seek a stake in yours. But you can't know for sure until you ask.

The issue of control may be sensitive. For example, you may not feel ready to relinquish control over issues such as who gets the house when. It's important to recognize these concerns because there are legal techniques to accommodate them.

Finances may pose a problem. Members of the next generation may not be able to afford the property's expenses. That's why it's helpful if the owners can establish an endowment to fund them. Another option is to rent the house part of the year.

A family may wish to sell a property. But that isn't always practical. For one thing, depressed property values may cut the price a family can receive.

Estate and gift taxes, also known as transfer taxes, should be taken into account. The federal estate tax exemption is \$3.5 million per person as of 2009. Despite assorted proposals to repeal, extend, raise or otherwise change the exemption, it appears likely to remain at \$3.5 million for the next two to three years. The federal estate tax is a flat rate of 45%. Some states also impose estate taxes, but offer exemptions. The Massachusetts estate tax may run as high as 16% and the exemption is \$1 million.

Second home owners whose estates are likely to exceed the exemption should consider getting the property out of their estates to minimize the tax bite. If you believe that your second home's value will rise over the long run, you're transferring a source of capital appreciation to your family at a reduced price, particularly given the recent downturn in property prices. This means you can transfer a higher percentage of ownership, yet stay within your annual gift tax limits.

Step 2: Consider Your Opportunities

You have many choices for passing your property to the next generation. One of the simplest is to give it as a gift to family members. Other common choices include making gifts to irrevocable trusts, creating a qualified personal residence trust, setting up a limited liability company or family limited partnership, and taking advantage of charitable opportunities.

Your optimal choice will depend on:

- Your time horizon
- Your willingness to give up control
- Number of individuals in the next generation and heir interest in the property
- Cash flow available to you and the next generation
- Your charitable intentions

Option A: Gifts—Outright or to Irrevocable Trusts

As of 2009, any individual can make gifts of up to \$13,000 to any other individual without any gift tax consequences. These gifts can be made outright or to an irrevocable trust for identified beneficiaries. An added benefit: when you contribute a partial interest in real estate, it's less valuable than an unshared interest. As a result, you can take a significant discount for lack of marketability. For example, with 25% lack-of-marketability and control discounts, a \$2 million property might be worth only \$1.5 million. Your actual discount is determined by a qualified appraiser. Gifts to irrevocable trusts also protect the property against your creditors and provide for gradual transfer to children who may not yet be ready to assume all responsibilities and expenses.

Disadvantages include the length of time for the transfer to be completed, original owner's loss of control, lack of centralized management, and the need to contribute cash in addition to property—to the trust.

Option B: Qualified Personal Residence Trust

With Option B, your entire property transfers at once into a qualified personal residence trust (QPRT). In return, you retain the right to use the property for a period that you decide.

Benefits include even additional valuation discounts over and above those with Option A, immediate reduction of your estate, and safety from legal challenge because this technique is authorized by statute. The biggest drawback is that if you die before your rights end, you lose the estate-reducing benefits of the QPRT. It's as if the transaction never happened.

Option C: Limited Liability Company or Family Limited Partnership

When you create a corporation—either a limited liability company (LLC) or family limited partnership (FLP)—to which you contribute your real estate, then a manager or general partner handles the property's management. A big advantage is that you can become the general partner and retain some control over the property, even as you make gifts of LLC or FLP interests to the next generation. Additional benefits: protection against creditors, valuation discounts, centralized management, and an operating agreement covering details. Drawbacks include potential for IRS scrutiny, complicated management, and cash flow requirements. This technique is often favored by estate planners.

Option D: Charitable Opportunities

If you don't have family members interested in your second home—or you are charitably inclined—you have many choices for doing good and easing your family's tax burden. Some of your options include outright gift, sale at reduced price to a charitable organization, transfer of a remainder interest to charity while retaining life estate, conservation easement, and charitable remainder trust. Depending on your situation, other approaches may be more suitable.

Act Now

Start talking now about how to handle your second home, so you can maximize the emotional and financial benefits to your family. Your advisor can help you balance the pros and cons of your opportunities.

This report is based on a September 24, 2009, Breakfast at the Bank presentation by Rawson Hubbell, CFP®, Vice President, Boston Private Bank & Trust Company and Sarah Connolly, Esq., Nixon Peabody LLP.

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