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Tax planning: How to turn a vacation property into a fiscal ally

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Owning a vacation home - this is an integral part of the American dream for so many people, but what happens when it comes time to pass control of that property to the next generation? While plenty of clients may be thinking about what they need to do now to afford a second home, too few may be thinking about what they can also do to minimize their taxable estate.

Fortunately, the answer is right in front of them. However, they just need to know which questions to ask. Vacation properties are fantastic components of a successful estate plan, and there are several avenues available to ensure that as many assets as possible are getting passed along to the next generation.

Vacation homes experience rise in popularity

As an advisor, you may soon see an uptick in the number of clients with questions about vacation homes. The popularity of the second residence is on the way up, and as the national housing market recovers that trend is likely to continue.

In early 2014, the National Association of Realtors released its annual survey of vacation home and investment property sales. From 2013 to 2014, the number of vacation-home sales across the country surged nearly 30 percent. In total, there were an estimated 717,000 units sold last year alone, compared to only 553,000 in 2012.

> "Growth in the equity markets has greatly benefited high net-worth households, thereby providing the wherewithal and confidence to purchase recreational property," noted NAR chief economist Lawrence Yun. "However, vacation-home sales are still about one-third below the peak activity seen in 2006."

Even so, the year-over-year increase in vacation home properties signals a growing interest in this type of real estate, which could mean that advisors will soon see more clients learning the nuances of tax management for multiple homes.

Can a vacation home be a tax ally?

Given the rise in popularity for vacation homes, clients will be on the lookout for ways to save money and protect their assets. While they have multiple avenues, one of the most popular choices is a good place to start: a Qualified Personal Residence Trust, or QPRT. Using this trust can turn a vacation home into a fantastic tax ally.

In an article for *Wealth Management*, Venita Zavidny, senior vice president and relationship manager with Kanaly Trust, explained that a QPRT allows grantors to minimize their taxable estate, thus transferring more assets to the next generation than would otherwise be possible.

The first step toward establishing this type of irrevocable trust is to get in contact with an attorney well-versed in these subjects. It is then that an initial document can be drafted, which, according to Zavidny, should clarify two crucial elements:

How long the trust will be in effect

What happens to the assets included in that trust when time expires

When this occurs, the vacation property then passes into the control of the beneficiaries. Like with other scenarios, the home can go to them outright or remain in a trust for an extended period of time. It is important for clients to understand that they can continue to use the property once the title has been transferred to the QPRT, but if the term ends, they'll have to negotiate rents with the new owners.

How a QPRT creates fiscal savings

A QPRT can have a number of benefits for clients. Specifically, using this trust alters how much is taxed when transferring ownership from one party to the next.

According to Zavidny, a QPRT is valuable because it affects the taxable gift made at this time. Without this trust in place, the amount taxed would be much higher. This is the case because a QPRT uses the projected residual value of the home to calculate the taxable amount, not the fair market value. In nearly all cases this is less money, and as an added bonus if the total gift is lower than a client's lifetime gift tax exemption amount - more than $5 million in 2014 - the exemption comes into play and nothing is taken out of pocket to handle the gift tax liability.

These aren't the only areas where a QPRT can be a smart way to improve tax savings. The values of vacation properties freeze once the gifts are made, meaning any and all appreciation takes place separate from clients' estates.

Be aware of the estate planning pitfalls of vacation homes

Many families have vacation homes, but many more may not have the right estate planning in place to ensure as few fiscal problems as possible. Second properties can complicate matters, and clients must know what they could be facing without taking the right steps beforehand.

In an article for Forbes, staff writer Deborah Jacobs explained that passing along a vacation home could create more problems than it solves. For example, if the beneficiaries are far apart age-wise, they might not have the same opinion of what to do with the property once they take control. There is also the question of upkeep, and if that isn't answered by a trust, the trustee may be on the hook for related expenses.

While these outline two of the broad estate-planning problems with vacation homes, QPRTs can create their own issues. Zavidny highlighted several key considerations:

Is the client prepared to pass on control of their home?
Are the beneficiaries ready to take ownership of the property?
Can all parties - such as children - make a co-ownership arrangement work?
Advisors should also be wary of the downfalls of using a QPRT for a primary residence, as some clients may not be comfortable with sacrificing some level of their existing ownership required for this type of irrevocable trust.

Think about the pros and cons

Estate planning is an inherently emotional process, and vacation homes can only complicate the matter. It is here where many families build memories they want to keep forever, and clients' personal relationships can impact their outlook on taxes.

Advisors must make sure they first think about the pros and cons. There are multiple ways a second home can be a tax ally, and a QPRT is one of the most useful strategies. But, if clients' families or other beneficiaries aren't prepared for this step, those positives could slip by.

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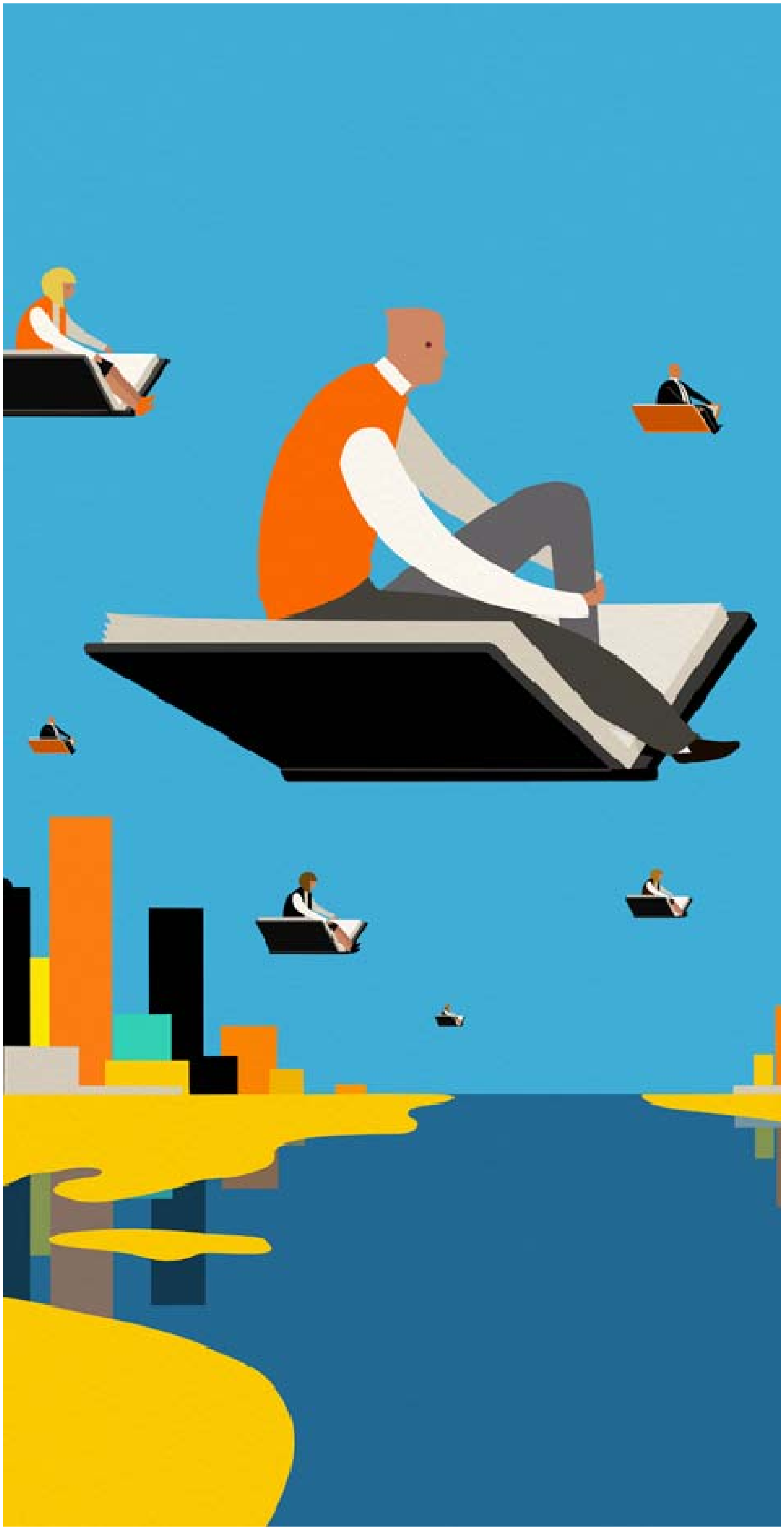

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