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Planning for transfer of your vacation home?

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Vacation homes often represent a significant portion of an individual's estate. If the home is left in the estate, an unwanted estate tax will likely result. Transferring the vacation home to your children is the most common approach to removing the home from your estate. Two means of accomplishing this are (1) making outright gifts of the home to your children, and (2) using a qualified personal residence trust (a "QPRT").

An outright gift of the home to your children will cause the value of the property and any future appreciation to be removed from your estate. The value of the gift will reduce the amount of gift tax exclusion available to you. Currently, the gift tax exclusion amount is $1 million. To the extent that the gift value exceeds $1 million, the gift tax, which is currently 45%, will apply. If the gifting of the home is effected through the gifting of interests in the home, the value of the gift may be reduced by minority and marketability discounts for such interests. Such gifting of interests can reduce or eliminate any applicable gift tax.

One disadvantage of gifting the home during your life is that the tax basis that you transfer to your children will not be stepped-up to the fair market value of the property on the date of the gift. Your children's basis in the home will be the same basis that you have in the home plus the amount of any gift tax paid. On the other hand, under current tax law, testamentary gifts generate a stepped-up tax basis equal to the date of death fair market value of the home.

Use of a QPRT is another common method of transferring the home. You would create an irrevocable trust and transfer the home to the trust. The beneficiaries of the trust would be your children. You may live in the home rent-free for a reserved term of years, after which you must pay rent to the trust. If you survive the reserved term of years, the home will not be included in your estate. All appreciation in the home from the date of transfer to the trust is also excluded from the estate. Special tax regulations value your gift to the trust in a manner that reduces the gift tax cost to you.

There are some drawbacks to using a QPRT. First, if you fail to survive the term, then the home will be included in your estate. Second, if you survive the term, you must pay fair market value rent if you wish to continue living in the home. Of course, the payment of such rent will further reduce your estate; however, if you are concerned about cash flow issues, the payment of such rent could cause a major problem. It should also be noted that the rental payments will represent income to the children. Third, just as with an outright gift of the home, transferring the home through a QPRT does not allow for a step-up in the basis of the property - a step-up that would be available if the home were transferred at death.

There are several other means of transferring your vacation home to your children. You should consult with an estate planning lawyer to discuss the options.