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Passing it on: Generational Property Transfer
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Squam Lakes Conservation Society

KEEPING THE FAMILY LAKEHOUSE IN THE FAMILY

by

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I. INTRODUCTION

Families need to plan for how to best preserve and protect assets for the surviving spouse and children, reduce potential estate tax liability, and maintain sufficient resources to pay for a comfortable retirement. One of their most valuable assets, from both an emotional and financial standpoint, may be the families' summer cottage or other "legacy property". This outline will discuss some of the ways families might consider passing on the family camp or cottage to the next generation, including restrictions on ownership, protections against creditors and unhappy marriages, and providing a management structure for the operation, use and enjoyment of the property by future generations.

A. RETAIN/SELL/GIFT REAL ESTATE: The Problem

1. Real estate assets, especially lake property, will continue to appreciate in value.

2. Estate assets include residential and non-residential real estate, life insurance, retirement accounts, investment assets, and personal property. Much of it may be illiquid.

3. Estate tax is 40% of any amount above $12,060,000, the current estate tax exemption amount ($24,120,000 for a couple)[1], and is payable nine (9) months from date of death.

4. While New Hampshire does not collect an estate tax, real estate located in Massachusetts, Maine and Vermont, regardless of one's residence, may be subject to a state estate tax.

B. SALE OF PROPERTY

1. Benefits. Creates cash flow and removes the property and its appreciation, from the estate.

2. Capital Gains Tax. However, since the cost basis for many family legacy properties is based on its value when purchased years ago, the sale of the property would result in significant capital gains tax.

3. Promoting Family Values. Many families are concerned about conserving and protecting the NH environment and do not wish to see the property developed or sold. In addition, they would like to keep it in the family for future generations to enjoy.

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[1] Federal estate tax laws currently allow a surviving spouse to apply the first-to-die spouse's unused federal estate exclusion (referred to as the deceased spousal unused exclusion amount or DSUE), referred to as "portability", to the surviving spouse's own transfers during life and at death, allowing a married couple to have $24,120,000 excluded from federal estate and gift taxes (at the 2022 levels, adjusted for inflation in subsequent years). **Please note**, the Federal exemption, whatever it may be at your death, will control. The current Congress may change the laws and lower the exemption. It is currently set to sunset back to $5 million indexed for inflation at the end of 2025.

C. OTHER ALTERNATIVES: INTER-VIVOS GIFTS OF PROPERTY

1. Annual Exclusion Gifts. Families can consider deeding undivided interests in their lake property to their children, using annual exclusion gifts of $16,000 per donee per year.

2. Lifetime Exclusion. In the alternative, they could make one gift of the whole property using their lifetime exemption of $12,060,000 each.

3. Subdivision. Some properties can be subdivided with gifts of separate subdivided parcels to the children. However, this would involve contracting with surveyors, engineers, septic system designers, etc. in order to obtain local and state subdivision approval.

4. Advantages Of Lifetime Gifting:

a. Simple transaction. Requires a deed to facilitate the transfer.

b. Removes the property and its appreciation subsequent to the gift from the taxable estate.

5. Disadvantages of Lifetime Gifting:

a. Lose Control/Expose to Creditors. Parents lose control of the property and expose it to the creditors and divorcing spouses of the children.

b. Unrestricted Transfers. Unless there are restrictions placed on the transfer of the property, once the gift is complete, the children would have the right to do what they wish with their interest, including conveying their undivided interest in the property to third parties outside the family.

c. IRC §2036. The continued use of the property by the parents after the gift is made would be viewed as a retained right and result in the property being included in the gross estate of the parent, regardless of who owns it.

NB. This result can be avoided by leasing the property back from the children at fair market rent.

d. Appraisal. The value of the gift for federal gift tax purposes is based on a *qualified* appraisal of the fair market value of the property at the time of the transfer. A current appraisal needs to be filed with the tax return for every year in which a gift is made.

NB. We recommend filing a gift tax return for any type of real estate gift transfer, even if the client believes the value to be less than the annual exclusion amount, in order to start the statute of limitations running under the IRC.

e. Tax Basis. The donees will take the donor's tax basis in the property (*i.e.*, its value when purchased or inherited), and not get a "stepped up" date of death basis.

II. ESTATE PLANNING OPTIONS USING REAL ESTATE

There are several options available to the families with respect to their valuable real estate holdings, which could lower, or possibly eliminate, the likelihood that the estate would be assessed federal estate taxes.

A. QUALIFIED PERSONAL RESIDENCE TRUST ("QPRT")

A QPRT is an irrevocable trust to which a primary or second home is transferred for a specified term of years. At the expiration of the term of years, the property passes to the beneficiaries and is no longer part of the gross estate. It is one of the very few remaining methods by which a taxpayer can give away an asset, but continue to use it during the taxpayer's lifetime.

1. Characteristics of a QPRT:

a. Survive The Term. The Grantor must survive the term of the Trust in order for the asset to be out of the estate.

b. Retained Use. The Grantor retains the exclusive use of the residence for a term of years, after which the property is distributed outright or in trust (such as a family compound trust, discussed below) for the benefit of the beneficiaries.

c. Lease Back. The Grantor can retain the right to exclusive use of the residence for a longer period than the term of the trust by providing for a lease back to the Grantor and spouse.

NB. However, the lease terms must be commercially reasonable and rental payments must be at fair market rates, established by real estate professional.

d. Gift Tax. The grantor pays a gift tax on the actuarial value of the *remainder* interest at the time the trust is created, typically a fraction of the current value of the residence.

Example: Joan, sole owner of the lake property, creates a QPRT in May 2021 with a 7 year term (which she and her advisors feel she will survive), and funds it with the lake house worth $2.5 Million. Based on Joan's current age (76) and the IRC interest rate for May 2021 (1.2%), the value of the reportable gift to her children is $1,525,275. The remaining amount is the value of her retained life estate in the property.

e. Real Estate Taxes and Improvements. QPRT is treated as a grantor trust for income tax purposes, meaning that the grantor can continue to deduct real estate

taxes paid on the trust property. Capital improvements to the property are treated as additional gifts.

f. Trustee. The donor or spouse can serve as trustee of the QPRT until it terminates, which keeps the administrative costs to a minimum.

2. Qualified Residential Property. The IRC defines what is the appropriate amount of real property "incidental to the residential use" to qualify for a QPRT. In some cases, it may require subdivision of the property, unless large lots are normal residential lots for the area.

3. Length Of Term. The donor must choose a term for the trust which is short enough that she will survive it, but long enough to provide a sizable tax benefit. *The longer the term, the lower the value of the gift to the children, and thus the greater the tax benefit.*

4. Two QPRTs. In the case of joint owners, a separate QPRT can be established for each co-owner so that even if one donor does not outlive the QPRT term, the other might, which would result in at least some of the value of the property transferred out of the taxable estate.

5. Advantages:

a. Transfers valuable appreciating asset out of estate to family members for discounted value (i.e. the future value of the property, after the retained term of years), and therefor reduced gift tax.

b. Allows the grantor to retain a legal right to use the property for the duration of the trust term, and possibly beyond.

6. Disadvantages:

a. If the grantor dies before the term of the trust ends, the property is brought back into her gross estate as if she never transferred it to the trust.

b. Carry-over tax basis to the children, rather than a stepped-up date of death tax basis.

c. A contemporaneous real estate appraisal must be obtained at the time of the gift, and the donor must file a Federal Gift Tax Return (Form 709) by April 15 of the year following the gift.

d. Not recommended for property subject to a mortgage.

B. FAMILY COMPOUND TRUST

A family compound trust is a realty trust that is created to own and manage family "legacy" property. Typically, parents want to provide that the family camp or cottage, which has been the gathering place for the families for many years, remains in the family for future

generations to enjoy and foster family traditions and common experiences. The trust provides a mechanism for organized decision making among a group of owners, including defining voting rights, payment of expenses and collection of assessments, restrictions on future transfers and sales, establishing rules and regulations for the use of the property, alternative dispute resolution, selection of successor trustee(s), termination events etc.

1. Characteristics.

a. CBIs. The beneficial ownership of the trust (called "Certificates of Beneficial Interest" or "CBIs") is held by individuals, similar to the way shares of stock are held in a corporation. In a family of four children, there would be four (4) classes of shares (typically Class A, B, C and D) with a certain number of shares in each class.

b. Voting Rights. Voting rights can be held by individual CBI holder or by family groups.

c. Restrictions On Transfer. Typically, CBIs may be given to the issue (children) of the CBI holder without restriction. However, CBIs cannot be sold outside of the family without first offering them to the family group. And the purchase price, even for family members, can be discounted (*i.e.*, 75% of fair market value) in order to discourage family members from "cashing in" on their legacy.

d. Withdrawal. Most families want to provide a mechanism for CBI holders to voluntarily surrender their shares and withdraw from the family trust, whether out of necessity or desire. In some cases, the trust will compensate the withdrawing member, but more often than not, there is no compensation.

For many families, this will be an important feature as there may be some children who have either few resources or little interest in contributing to the maintenance and upkeep of the property.

e. Trustee Selection. The trust will name current trustees, define their powers, and determine how future successor trustees are selected.

f. Rules And Regulations. The trust will describe how decisions are made, by what percentage of votes, and how the rules and regulations for the use of the property are determined.

g. Assessments And Capital Improvements. The trust will provide how assessments for the maintenance and repair of the property and capital improvements are made and collected, and how liens are enforced.

In some cases, where there is a wide discrepancy in resources between children and payment of an assessment might constitute an economic hardship, the trust can provide a mechanism to suspend the obligation to pay the assessment for a period of time or indefinitely.

h. Deadlock Resolution/Binding Arbitration. The trust will provide a mechanism for resolving a deadlock by the voting CBIs, including informal dispute resolution, then mediation, then binding arbitration.

i. Termination. The trust will have a termination clause (usually by unanimous vote) and provide for what happens to the trust asset upon termination.

2. Advantages:

a. Ease Of Gifting. The parents can make gifts of CBIs ("off record") rather than undivided interests in the property. No deeds or recording fees are required for the transfer (other than the deed to transfer the property to the trust). Rather, gifts are made by simple assignment of the beneficial interest in the trust.

b. Continued Use of Property. The parents can continue to use the property in accordance with their ownership interest. Once they have given away all of the CBIs, they would need to pay rent if they continue to use the property, in order to avoid IRC §2036 estate tax inclusion.

c. Differentiating Use. The "shares" or "units" in the trust can have different rights of use and liability for expenses and capital improvements, depending on where the beneficiary lives and how often he/she uses the property.

This provision would be very helpful where you have some children who rarely use the property and others who are at the camp every weekend.

d. Keep The Property in The Family. Most importantly, the trust restricts the ability of the family members to transfer their shares outside of the family (think divorce), thus ensuring the retention of the property for the future use by the family.

e. Asset Protection. The trust provides certain protections from creditors and divorcing spouses by mandating automatic rights of purchase of the CBIs in the event of involuntary transfer.

f. Endowment. The parents can endow the family trust as part of their estate plan, in order to offset the maintenance expenses of the property.

3. Disadvantages:

a. Expensive and Complex. The family compound trust is a complex document with many moving parts. It sometimes involves a lot of family input, so it can be expensive to create.

b. Real Estate Transfer Tax. A careful review and analysis of the application of the NH real estate transfer tax needs to be made for each transaction, to be sure that no transfer tax is assessed.

C. FAMILY LIMITED LIABILITY COMPANY

A Family Limited Liability Company ("FLLC") is an entity, like a corporation, used to protect assets and keep them in the family. It can be used to hold and manage many types of assets, including real estate and marketable securities. Many of the characteristics of a Family Compound Trust are similar to those in a FLLC, including restrictions on transfer of membership interest to family members, buy-out and withdrawal provisions, voting rights, process for setting budgets and collecting assessments, choice of manager, deadlock provisions, etc. Also, ease of gifting, continued use of property by the owner, and differentiating uses and charges to family members are common attributes.

However, one major advantage of a FLLC is that it provides significant creditor protection for the owners, which may be important if the property is rented to third parties. Members and managers have no liability for debts of the FLLC beyond the member's interest in the FLLC, and creditors can only obtain a "charging order" against a member's interest (ie. right to income generated by the property). Furthermore, the FLLC is very flexible and can be amended more easily than an irrevocable trust.

Finally, the New Hampshire transfer tax law was revised in 2016 to allow the transfer of real estate to a FLLC under certain circumstances, without imposing a New Hampshire real estate transfer tax. RSA 78-B:2, XXI. This change in the law makes the use of FLLCs to hold family property more attractive to families.

D. CONSERVATION EASEMENTS

A conservation easement is a permanent restriction on land granted to a qualified non-profit land trust or governmental agency which limits the commercial, industrial and residential use of the property so that it will remain forever in its open space, agricultural, forestry and non-developed state. Families should consider placing a conservation easement on their undeveloped property, in order to permanently protect the natural resource as scenic open space, wetland and wildlife habitat. Conservation easements have other advantages as an estate planning tool.

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