

---

THE LAW FIRM OF  
**BOVE & LANGA**  
A PROFESSIONAL CORPORATION

---

TEN TREMONT STREET, SUITE 600 – BOSTON, MASSACHUSETTS 02108  
Telephone: 617.720.6040 – Facsimile: 617.720.1919  
www.bovelanga.com

THE GREAT ESCAPE:  
CHARTING THE COURSE FOR THE VACATION HOME

Melissa Langa  
langa@bovelanga.com

Boston Bar Association  
May 22, 2008

---

**Income Tax Issues:**

- Mom and Dad rent the Cape house for a few weeks a year to help pay expenses: Is the vacation home rental property or personal use property?
  - *Primary Personal Use:* Vacation home is rented more than 15 days a year and used by the client more than the lesser of 14 days or 10 percent of the total days rented for the year. §280A(d)(1). Code calls it “dwelling unit used as a home”.
    - *Example of 10% Rule:* Client rents house on cape for three months, or 90 days. Client’s family uses the house for 10 days at Thanksgiving each year. The client’s use is primarily personal, since the 10 day use is MORE than the LESSER of 14 days or 9 days (10% of rental days).
    - *Days Used for Repairs and Maintenance:* Any day that the client spends working substantially full time repairing and maintaining (not improving) the vacation property is not counted as a day of personal use even if family members use the property for recreational purposes on the same day.
    - *Expenses & Primary Personal:*
      - Expenses can only be used to offset income. §280A(c)(5)(A). Must apportion between rental use and personal use. §280A(e)

- Excess expenses can carry forward to offset future income. §280A(c)(5)(B).
- *Rental Use:* Vacation home is rented more than 15 days a year and use by the taxpayer does not exceed 14 days or 10 percent of the total days rented for the year. §280A(d)(1).
  - *Losses:* Subject to passive activity rules, losses can be used to offset other income, such as salary. §280A(c)(5). Carry forward of losses. §172(b).
  - *Presumption of Profit Motive:* Rental income is more than rental expenses for at least 3 years out of a period of 5 consecutive years, the taxpayer is presumed to be renting the vacation property to make a profit. Taxpayer can choose to postpone the decision of whether the rental is for profit by filing Form 5213.
  - *Depreciation:* §168. Client recovers the cost of income producing property through yearly tax deductions. Vacation property held for rent during the year is subject to the depreciation rules. Form 4562 is used to determine and report depreciation. Depreciation reduces basis even if not claimed as a deduction on the clients tax return. The cost of land cannot be depreciated. In general, the recovery period for residential rental property is 27.5 years. If client used the property for personal purposes before changing it to rental use, its depreciable basis is the lesser of its adjusted basis or its fair market value when you change it to rental use.

§280A(g)(2) Short term rental income exclusion

- 100% exclusion for rental income if residence is rented for fewer than 15 days in a tax year.
- No deductions can be taken for expenses incurred in the production of this income.

§1031 Like-Kind Exchange

- *General Rule:* No like-kind exchange for personal use property. Rev. Rul. 59-229.
- *Rev. Proc. 2008-16:* Sets out §1031 safe harbor under which IRS will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment purposes. (Release Date: February 15, 2008). Effective for exchanges

after March 10, 2008.

- *Relinquished Property and Replacement Property*: (i) 24 month ownership; (ii) in each 12 month period the property is rented to another person at fair rent for at least 14 days; (iii) taxpayer personal use is lesser of 14 days or 10% of number of rental days within the 12 month period.
- *Fair Rent*: Facts & circumstances test applied at time the rental agreement is entered into.

Ranch (or farm) as vacation property

- *§183*: Can you deduct the ordinary and necessary expenses incurred in running the ranch as a business expense, or are the expenses deductible only to the extent of income because the ranch is a hobby?
- *Profit Motive*: State of mind and commitment to the success of the activity. Facts and circumstances test.
- *Hobby*: No carry forward of excess expenses

Vacation Home Held by Self-Directed IRA: Don't do it! Self-dealing prohibitions, among others.

IRS Publication 527: Residential Rental Property. Good general resource.

### **Asset Protection Issues:**

Insurance

- Umbrella coverage of \$3 - \$5 million
- Special coverage (flood, hurricane, etc.)

Homestead and Tenants by the Entirety:

- *Massachusetts Homestead Applies to Principal Residence Only*: M.G.L. Chapter 188 provides creditor protection for the principal residence of Massachusetts residents. It

protects up to \$500,000 of a debtor's equity in his or her principal residence provided that the debtor has previously filed a declaration of entitlement to this protection with the Registry of Deeds in the county where the principal residence is located.

- *Massachusetts Tenants by the Entirety Applies only to Principal Residence:* M.G.L. Chapter 209, §1 applies tenancy by the entirety protection only to principal residence. If acquired prior to February 11, 1980 client must record an election to have greater protection under §1A to apply.
- *Multiple Properties in Massachusetts:* What is the harm of holding all T by E? Clients may make Cape property principal residence without letting lawyer know.
- *Florida Tenants by the Entirety A Haven?* Barry Nelson, Florida Surprise in Trusts & Estates (May 2008). Non-resident of Florida use Florida tenants by the entirety statute to protect Florida property not subject to Florida homestead.

Rural Property: Post “No Trespassing” and “No Hunting” notices

Limited Liability Company and Limited Partnerships

- *Inside Liability:* Vacation property at risk for creditors of the entity, but personal assets are protected.
- *Outside Liability:* Vacation property, if rental property, is protected from personal liability of entity owners. Charging orders. Respect the entity!
- *General Partners:* Unlimited liability. Use of corporate general partner.
- *Rental Income Essential*

Moving the Immovable: Alexander A. Bove Jr., *Moving the Immovable: Protecting U.S. Real Estate From Creditors*, 37<sup>th</sup> Annual Heckerling Institute on Estate Planning (January 2003)

## Transfer Tax Issues:

Gift tax: Mom and Dad let the adult kids use the vacation home rent free. Is this a taxable gift?

- §2511(a): The gift tax applies to “ ... transfers [of property] in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.”
- *Dickman v. Commissioner*, 465 U.S. 330 (1984): Held: Interest free demand loans were gifts from Mom and Dad to son of the use of the loaned funds (foregone interest).
- *Dickman at 341*:

“Our laws require parents to provide their minor offspring with the necessities and conveniences of life; questions under the tax law often arise, however, when parents provide more than the necessities, and in quantities significant enough to attract the attention of the taxing authorities. Generally, the legal obligation of support terminates when the offspring reach majority. Nonetheless, it is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case.”

- Foregone rent covered by §2503(b) annual exclusion

Estate Tax Lien: M-792 or Certificate of No Tax Due. Out-of-state property must look to that state’s law.

Estate Tax: Tax apportionment

Lifetime Gifts for Estate Tax Reduction

- *Fractional interest gifts*
  - §2503(b) annual exclusion for present interest gifts, perhaps coupled with use of all or a part of lifetime \$1 million gift exclusion.
  - GST: An outright direct skip to an individual that qualifies for the annual gift tax exclusion is not subject to GST tax. §2642(c)(1) and §2642(c)(3)(A). Where the transfers are into a trust for the benefit of a skip person, the exclusion applies only if two criteria are present: (i) the skip person must be the sole income and principal beneficiary of the trust (or trust share) during that individual's lifetime, and (ii) if the trust does not terminate before the individual dies, the trust property is included in that individual's gross estate. §2642(c)(2)(A)-(B)
  - Nominee trusts
    - Make sure nominee trust is recognized in jurisdiction where vacation home is located.
  - Limited liability companies
    - §2036 issues with personal use only vacation homes
    - Selection of jurisdiction to increase discounts (Ex: Delaware)
    - Avoids rule against perpetuities limitation for trusts
    - IRS looks for implied agreement among owners to void gift.
- §2702: *Qualified personal residence trusts*
  - Husband and wife individual QPRT with fractional shares

- Issue of passage of remainder interest to trust for future generations.  
Sale of remainder interest?
- §2702: *Split interest purchase*
  - Uses QPRT format
- §2702: *GRAT and GRIT*
- *Outright gift using \$1 million lifetime exclusion*
  - The exclusion is only applicable for donors who are citizens and resident aliens. §2505 & §2010(c)

Modified Carryover Basis

- §1014 provides that property transferred at death is given a date of death fair market value basis. This is often referred as a “step-up” or “fresh start” basis.
- §1014(f) states that the step-up in basis will not apply to decedents dying after December 31, 2009. In 2010, new § 1022, establishes a modified carryover basis framework.
- §1022 is similar to current § 1015 in which a donee of a gift takes the donor’s basis (with an increase for gift tax paid attributable to net appreciation). Under § 1022, the recipient of property transferred at death from a decedent is treated as if the property was acquired by gift. The basis in the property is the *lesser* of: (i) the decedent’s adjusted basis or (ii) the date of death fair market value of the property.
- Up to \$1.3 million in additional basis may be allocated to appreciated property owned at death by the decedent. This includes property held in a revocable trust, decedent’s share of joint property, and the surviving spouse’s share of community property.
- TRAP: May NOT allocate additional basis to property which the decedent acquired by gift within 3 years of death from a person other than the decedent’s spouse

- In addition to the \$1.3 million of basis, there is \$3 million additional basis for property which passes to a surviving spouse either outright or as “qualified terminal interest property” (“QTIP”).
- The \$1.3 million additional basis is increased by any capital loss carryover under §1212(b), the amount of any net operating loss carryover under §172, and “the sum of the amount of any losses that would have been allowable under §165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent’s death.”

Charitable Gifts

- Mom and Dad want to leave the vacation home to child for life, remainder to a donor advised fund. This appears possible. A charitable contribution deduction for a remainder interest is permitted for a remainder interest in a personal residence or farm. §2055(e)(2); Reg. §20.2055-2(e)(2). This may apply to a vacation home not used as the primary residence of the decedent. Reg. §20.2055-2(e)(2)(ii).
- Many other ideas beyond scope of this outline.
- Amount of deduction (fair market value or adjusted basis) and limitations on deduction vary as to type of recipient charity. See IRS Publication 526 on Charitable Donations.

§2055(e)(2) Conservation Easement

- Lifetime conservation easement. Use tax savings to purchase life insurance policy to fund estate tax payment, post-death maintenance costs, or both.

## **Non- Tax Issues:**

- What is your client’s reasons for wanting to preserve the vacation home down the generations?
- Registered land requires a new “Certificate of Ownership” issued if vacation property passes through an estate.

Family harmony and Endowment of Maintenance Costs

- Second-to-die insurance
- GRAT if funding through child generation only
- Conservation easement: Sale or Gift coupled with insurance
- Charitable lead trust

Number of generations involved

LLC v. Trust v. Joint Ownership

Usage agreement

- Control and governance
- Transfer restrictions (death, disability, divorce, outside bloodline, etc.)
- Buy-outs and exit strategies
- Repair and maintenance
- Development
- Financing
- Sale
- Rental
- Dispute resolution - Mediation
- Holiday Usage: “Christmas” v. “December 22 – December 27”

- Special Restrictions: Ex: maintenance of a kosher kitchen, prohibition of alcohol, limits on unrelated adults (Party!!)

Title 5: Inspection issues if septic system is involved - 310 CMR15.300-15.305

Divorce

Letter of Wishes

Home Swapping

### **Massachusetts Client Owns Vacation Home Out-Of-State:**

Special out-of-state real estate transfer excise tax issues

- New Hampshire imposes a real estate transfer tax on the sale, granting, and transfer of real property or an interest in real property whether or not for consideration. RSA Chapter 78-B. The NH Department of Revenue's administrative rules are at N.H. Code of Admin. Rules, Rev 800.
- The tax is imposed on both the buyer and the seller at the rate of \$.75 per \$100 of the price, value, or consideration for the sale, granting, or transfer. There is a minimum tax of \$20 for each.
- Appears to apply to the transfer of a vacation home into a limited liability company for no consideration.

Avoidance of ancillary probate through trust or entity ownership

### **Non-Massachusetts Clients Owning Vacation Home in Massachusetts:**

Avoidance of Massachusetts estate tax for out-of-state decedent owning vacation home in Massachusetts

- Transfer vacation home into a limited liability company.
  - Proposed Regulation 830 CMR 65C.2.1: Must be rental MA real estate to have a chance
- Gift of Vacation Home By Non-Resident Non-U.S. Citizen: Dad is a U.K. citizen and wants to buy a home at the Cape and give it to his daughter who lives in Massachusetts.
- U.K. Dad is subject to the gift tax on transfers of real property situated in the United States at the time of the transfer. §2501(a)(2). If U.K. Dad purchases the vacation home and gifts it to daughter the gift tax applies.
  - U.K. Dad can make gift of cash from banks located outside of the U.S. to daughter without being subject to the gift tax. Best practice is to wire the funds into an offshore bank account for the benefit of child.
  - Thereafter at a future date daughter might use the cash to purchase U.S. real property.
- Non-Resident Non-Citizen Owns U.S. Vacation Home at Death: U.K. Dad owns Cape vacation home. Can he avoid the estate tax?
- NRA is subject to the U.S. estate tax for property which has a situs in the U.S. §2103.
  - Real property has a situs in the U.S. Reg. §20.2104-1(a).
  - Some practitioners advise that there is a possibility of transferring the vacation home to a foreign corporation in exchange for stock, thus transforming the real estate into property (stock in a foreign corporation) that does not have a U.S. situs. This does not work. §897 and the Foreign Investment in Real Property Act of 1980 (FIRPTA).