# THE LEGACY COTTAGE

This strategy lets wealthy clients keep their cherished hideaways under family control for multiple generations. BY R. HUGH MAGILL AND RAYMOND C. ODOM

In the fall 2016 issue of *Private Wealth* ("The Cottage Succession Plan,") we discussed the use of a limited liability company (LLC) for transferring ownership of, and managing, the family cottage for the use and enjoyment of next generation family members. This structure has significant advantages over a tenancy in common arrangement by limiting alienation and partition rights, and reducing the risk of creditor claims inherent in tenancy in common ownership. An LLC structure also provides flexibility for addressing issues common to these types of properties: shared usage, expense allocation maintenance, and the redemption/liquidation rights of individual family members.

For some families, however, a cottage's unique role in family legacy is so important that the current generation may wish to provide for its sustained use by multiple, future generations. This type of legacy cottage is not viewed as part of the financial inheritance of descendants because it has exponentially more intrinsic, rather than financial, value. For such a family, while the legacy cottage is categorized as part of the family's financial capital on their balance sheet, its role in sustaining and strengthening a family's human and social capital outweighs its pecuniary value as an inheritable asset. This type of property requires more than a simple LLC.

## THE IRREVOCABLE, MULTIGENERATIONAL TRUST

A viable plan for such a legacy cottage would still involve an LLC to hold title to the property and provide an operating agreement for the regular maintenance and management of the cottage. But the LLC's sole member would be an irrevocable, multigenerational trust. Such a trust would describe the cottage's distinctive legacy role for the family through a carefully drafted statement of intent. The unique characteristic of this memorialized intent is that it clearly describes the purpose behind ownership while taking into account the cottage's recreational benefits. These benefits, however, do not come without costs.

In a one-generation cottage LLC, the operating agreement typically provides for the family members to share expenses with a very minimal, if any, cash endowment. For a legacy cottage trust, an endowment managed by the trustee would provide cash flow for the maintenance, management and periodic improvement of the property. Ideally, the trust would be exempt from the generation-skipping transfer (GST) tax to guard against diminution from future transfer taxes, and it would not be subject to the rule against perpetuities (see sidebar).

One family developed a unique plan for their lake compound, placing cottages in separate LLCs aligned with family branches, all of them owned by an irrevocable trust. The individual LLCs allow each family to work independently on usage and maintenance, costs of which are funded through an endowment held in the trust. The trust includes a purpose-driven statement of intent describing the compound's unusual history, its role in facilitating individual and family well-being and the grantors' hopes for its future. This purpose is strengthened by a unique provision that would permit sale of a cottage only in rare circumstances, upon which the proceeds of sale pour over to the family foundation. This pour-over provision serves as a disincentive to attempt to alter the grantors' plan for the cottage's role in sustaining the family's human capital: Monetization of the cottage will increase the family's charitable, rather than financial, capital.

## SUPPORTING LONG-TERM GOALS

Discussing long-term goals for legacy properties with descendants is vital to ascertain their commitment to the cottage. If family members support the goal of maintaining the cottage for future generations, they should be involved in long-term planning for the cottage. Otherwise plans can easily go awry. For example, in one case we are familiar with, a grantor developed a plan for an irrevocable trust to maintain the family's mountain retreat. To ensure its regular use, the trustee was required to sell the property if the family did not use it at least 120 days per year. This was a high bar that the grantor had not discussed with his family. The four children, all of whom were young working adults, would have found this requirement onerous, even without life events such as international work assignments, health issues, etc. Fortunately, the grantor drew the family into the planning process. Family members were unable to convince the grantor to eliminate the use requirement, they were able to encourage him to reduce it to a more realistic number.

The usage requirement for the mountain retreat illustrates one of the challenges in working with grantors to assist them in crafting a meaningful, yet workable, statement of intent. We believe that these statements play a central role in expressing what the Uniform Trust Code calls the trust's "material purpose." A well-crafted statement of intent will: (1) express the family's values and aspirations related to the cottage; (2) connect these values and hopes to the beneficiaries' well-being; (3) provide guidance and a means of dealing with future circumstances, both anticipated and unforeseeable; and (4) provide a mechanism for resolving conflict among beneficiaries.

Long-term, multigenerational trusts of any kind navigate the tension between freedom of disposition, the potential of which has been greatly extended by the repeal of the rule against perpetuities and the increase in the GST tax exemption, and the growing desire of beneficiaries to deal with trust assets as if they were their own. This tension is not new, but it must be resolved in every long-term trust by finding the proper balance between grantor intent, beneficiaries' well-being and the need for fiduciary flexibility to address rapid demographic changes.

## ALLOCATING BURDENS AND BENEFITS

One of the common aphorisms about trustees is that they bear the burdens of ownership so that beneficiaries might enjoy its benefits. The irrevocable trust/LLC structure we propose provides an ideal arrangement for allocating burdens and benefits of legacy cottages among the trustee and family members. A viable approach to trusteeship will usually include an institutional trustee (with experience in real estate management) and individual trustees representing branches of the family. The institutional trustee will be responsible for ensuring implementation of the grantor's intent and managing the endowment. The family co-trustees will be responsible for coordinating

### Recreational Real Estate

In referring to the family "cottage," we mean to include what we call the "C" properties: cottages, cabins, vacation condominiums, family camps and compounds. While these differ in location and size, they all share common attributes as income-consuming, personal-use properties. We distinguish cottages from quasi-recreational properties such as ranches, vineyards, hobby farms, plantations and similar properties, which could be described as agricultural/investment properties with a lifestyle component. These latter properties usually produce income and have different operational and risk attributes, placing them outside the scope of this article.

### The Rule Against Perpetuities

The duration of private trusts in the United States has been limited, until very recently, to a period of time not to exceed "lives in being (at the trust's creation) plus 21 years." This common law rule served to limit grantors' control over property to ensure that it would periodically be subjected to transfer taxation. Many states have now either repealed the rule, made its applicability optional or extended vesting for very long periods of time. This movement, along with substantial increases in the GST tax exemption, makes it possible to design trusts that can hold legacy properties for extensive periods of time.

the management and use of the cottage through the LLC operating agreement.

Family members, working together through an operating agreement under the LLC, will be responsible for maintaining the property, developing a policy of access and usage, preparing an annual budget for the cottage's annual operating expenses (subject to review and approval by the trustees), and ensuring that the cottage's use sustains the family's legacy and contributes to the well-being of family members. The operating agreement provides maximum flexibility for family members to participate in the cottage's management to the extent they desire. Each family may determine, subject to the trustees' oversight, appropriate structures, such as committees or a family council, for the cottage's management. The grantor may choose to establish a governance structure within the operating agreement, while providing flexibility for future modification.

A vital element of a multigenerational plan for a legacy cottage will be an endowment, sufficient in size to provide for the property's annual operating expenses (maintenance, utilities, insurance, taxes and assessments) as well as periodic improvements and modifications to adapt the property as the family grows and its use changes. The management of endowed funds is a core competency of a trustee and is one of the compelling reasons why the legacy cottage will benefit from a professional trustee. One of the most common areas of conflict with legacy cottages is the allocation of the property's expenses. Without an endowment, families struggle to develop an allocation plan that accommodates varying levels of use, and recognizes different contributions to the property's maintenance and management. Covering the cottage's expense through cash flow from an endowment largely extinguishes this area of conflict.

A family limited liability company is an ideal structure for ownership of a cottage by multiple family members, where maximum flexibility is desired and the plans for the cottage extend for one or perhaps two generations. Where a family desires that its treasured gathering place serve the family for two or more generations, a better structure will include an irrevocable trust with institutional and family trustees, a carefully crafted statement of intent, and an LLC to both hold title to the property and facilitate family participation in the ongoing maintenance and management of the cottage. Thoughtful trust design balancing unique intent and flexibility, and an operating agreement tailored to each family's circumstances, will be vital to the effective use of this technique. RW

## Cottages And Changing Family Structures

While freedom of disposition provides grantors with substantial autonomy in the transfer of their wealth, American patterns of gifting and inheritance consistently favor surviving spouses and blood or adopted descendants. The structure of the American family, however, is rapidly evolving through changing practices of marriage, divorce, reproduction and family and parental relationships. These changes must be taken into account as advisors assist families in planning for legacy cottages. The trust's statement of intent may provide broad guidance (or narrow guidance, for that matter) but a well-drafted trust will provide the flexibility to address changing family structures through a power to modify, usually held by a trust protector.

**R. HUGH MAGILL** is chief fiduciary officer and global director of trust services and **RAYMOND C. ODOM** is director of wealth transfer services at Northern Trust.

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