

## TRANSFERRING THE FAMILY VACATION HOME TO FAMILY

### *Establishing the Cottage Succession Plan*

*Benjamin Lavin  
Wealth Planner &  
Associate Tax  
Strategist*

*Raymond C. Odom  
Director, Wealth  
Transfer Services*

*June 2016*

The family vacation home is a tangible asset that is intentionally designed to create lasting memories within a group of related individuals. And families that are most effective at creating these geographically-centered joint memories are the ones most at risk of seeing those pleasant memories destroyed by poor planning. Unlike other assets that can be fully characterized by their value in money or money's worth, the family vacation home has much more than just economic value. It has a strong emotional value. Regardless of its size or locale, the family vacation home is not only a residence where related people live; it is a vacation place where families build and strengthen family culture around shared joys.

To capture this sense of special sentimentality we use the word "cottage" as a shorthand reference to the "family vacation home" whether we are referring to a small rural house in Wisconsin, a bona fide mansion on a California beach or a luxurious mountain ski chalet in the Tetons. But, if there is no shared group memory connected to the house – while it may properly be referred to as second, third or fourth home – it is not a family cottage, and the planning dynamics may be much simpler. In this *Insights on... Wealth Planning: Transferring the Family Vacation Home to Family*, we discuss the inherent problems in transferring the family cottage from the senior generation's unified ownership to the complex multiple co-ownership of junior generations and we suggest a planning solution that might keep everyone happy.

### **SOURCES OF CONFLICT**

What is it about the family cottage that has the potential to cause so much conflict? It is the unique nature of the cottage as a costly, joint and sentimental family heirloom that makes it wholly different from a financial asset. The common issues that arise with many family wealth transfer plans, such as unforeseen future creditors (including divorcing spouses of the next generation beneficiaries) and sibling rivalries are magnified in planning for the transfer of the family cottage. With the family cottage geographically distant, beneficiaries may perceive little benefit from its ownership. Additionally, with the increasing costs of maintenance, repairs and property taxes over time, it is easy to imagine how cottage transfers can agitate and inflame resentments resulting from disparate levels of wealth among next generation cottage owners.

Although the family cottage typically represents a place of serene rest from daily conflicts, the best hope to ensure a continuing peaceful environment is to do the hard work of cottage succession planning before conflicts begin. A successful cottage transfer plan must begin to address the following:

- Who is allowed to use the home? And does that group of users, for example, include adult stepchildren of a divorced spouse? Does it include college friends and close neighbor friends or minor children?



- Who pays for what? Taxes? Insurance? Maintenance? Improvements or major repairs (such as a new roof)? Other expenses?
- Who chooses and maintains the furnishings and other matters of interior decoration? Who pays for any esthetic updating that is not related to wear and tear?
- What are the standards of conduct for guests? Pets allowed? Smoking?
- How do you determine who gets the prime time weeks of the year to use the cottage?

Aside from the management issues to address, how does the family deal with significant future co-ownership issues given that it is relatively likely that at least one co-owner will:

- Not want to own the cottage for nonfinancial reasons;
- Be unable to afford to pay cottage expenses; or
- Need money and resent having an inheritance that is trapped in the cottage.

If planning does not align with the expectations of the future transferees – and their economic realities – the current owners’ intentions may be dramatically frustrated as many of the joint ownership court decisions demonstrate<sup>1</sup>.

### FORM OF OWNERSHIP MATTERS

The default solution for a surviving spouse of a jointly owned family cottage is to “leave” or “give” it to the “kids” equally. This is exactly how the problems begin: if the surviving spouse gifts or bequeaths the cottage to multiple children or other beneficiaries, during life or at death, besides the potential gift or estate tax issues, the “default” recipients will probably acquire joint ownership of the property as “tenants in common.”

In general, unless transferees designate otherwise, property owned by multiple unmarried owners is held as a tenancy in common. A tenancy in common is a type of shared ownership of property, where each co-tenant (or co-owner) owns a share – typically equal (but can be unequal) – of the entire property. There are no rights of survivorship in a tenancy in common. Accordingly, in the event of the death of a co-tenant, her cottage interest will pass according to her will or pursuant to the state laws of intestacy if the co-tenant did not have a valid will.

In a tenancy in common, all co-tenants, no matter the size of their individual ownership interest, have the right to occupy and use all of the property. As tenants in common, each has the right to freely sell, pledge or otherwise dispose of her interest in the family cottage to whomever she chooses, for whatever reason she has, without consent from any other co-tenant(s), during life or at death. Each co-tenant’s interest in the cottage may be subject to creditors’ claims, divorce or even court-ordered partition by one or more disgruntled co-tenants who want to “cash out,” which could result in a compulsory sale of the cottage even if the remaining co-tenants do not want to sell. Indeed, it is not uncommon for a disgruntled or cash-strapped co-tenant to sell her interest to a real estate developer who subsequently files a partition action to force a sale<sup>ii</sup> and acquire the entire property for a price below its fair market value.

If the goal is to preserve the family vacation culture and family memories, transferring the cottage to beneficiaries as tenants in common is usually not the answer. A tenancy in common by itself is more likely to lead to family conflict than to family harmony.

## FAMILY COTTAGE LLC

Although a plan to leave the family cottage to the next generation in equal shares as tenants in common may appear to be a simple solution, it often leads to complex problems. In a tenancy in common everybody has to agree on everything with, typically, no written agreement to govern decisions or behavior.<sup>iii</sup> The goal to keep the family cottage *in the family* could be easily frustrated by an ongoing tenancy in common especially as individual fractional shares become more fractionalized as they pass from junior generation members to their descendants. Without a carefully executed plan, the cherished cottage may quickly become the loathed lodge.

This is surely not a desirable outcome. Fortunately, there is a succession planning solution that is customizable, flexible and workable, that can be specifically designed to ensure that the family cottage remains in the family: the family limited liability company.

### Formation Basics

Family limited liability companies (“FLLCs”) are often used in conjunction with other family wealth transfer strategies for purposes of conducting a family business or investment enterprise and for efficiently transferring value to younger generations as part of the overall family wealth transfer plan. FLLCs are particularly useful for dividing family assets among family members when members of the senior generation wish to retain significant management or control despite the associated gift and estate tax issues. For a number of reasons, the FLLC has become one of the preferred legal entities for attorneys specializing in cottage succession planning.

#### Reasons to Consider Using a Family Cottage LLC

1. Avoid operation of default common property law.
2. Prevent a forced sale of the family cottage through an action for partition.
3. Prevent transfer of ownership interests in the cottage outside the family.
4. Shield owners from claims of LLC’s creditors.
5. Provide for an endowment to fund cottage expenses and enforce assessments by and among joint owners.
6. Require alternative dispute resolution options for disputes related to the ownership or operation of the cottage.
7. Allocate control of the cottage between or among generations of owners.
8. Obtain pass-through taxable income and loss to the owners under the federal partnership income tax rules.

The LLC incorporates many of the best attributes of corporations – limited liability – and the simplicity, flexibility and income taxation of partnerships. They are formed under state law – usually, but not necessarily, the state in which the cottage is located – by filing articles of organization with state regulators, and are treated as separate legal entities for state law purposes. Typically, the articles of organization must provide certain data, including:

- The name of the LLC;
- The purpose for organizing;
- The address of the LLC’s principal place of business and the name and address of its

- registered agent in the state; and
- The names and addresses of the manager(s) of the entity if manager-managed, or the members' names and addresses if member-managed.

A word of caution: LLC planning definitely requires a very knowledgeable attorney familiar with business entities and estate planning as each state has its own LLC statute.

In the articles of organization, the organizer chooses whether the LLC will be member-managed and controlled directly by its owners or alternatively, manager-managed and primarily controlled by one or more managers appointed or elected by the other members. With a manager-managed LLC, decision-making can be concentrated in one or more of the owners. For example, Mom and Dad could name themselves as managers of the family cottage LLC but transfer significant ownership interests to their children. As managers, Mom and Dad could retain the rights to decide the use of the cottage, make repairs and/or improvements, and, generally, run the cottage as they have always done.

Formation of the FLLC may be done during life or at death. It may be advisable to form a LLC for the family cottage during life for those who already share ownership or for parents who want to make annual gifts to children as part of their wealth transfer plan. The cottage LLC may also be formed upon the owner's death. Federal and state income, gift, estate, generation-skipping taxes and applicable state and local property taxes must be considered in forming a LLC for the family cottage, and in planning for gifts or other transfers of ownership interests to family members.

The key feature of the LLC for purposes of cottage succession is the "operating agreement." The operating agreement is an agreement among the members that governs the LLC's operation and its members' financial and managerial rights and duties. The operating agreement defines each member or managers' rights, powers and entitlements, and should set forth the cottage operating rules. Ownership transfer restrictions may be incorporated into the operating agreement to ensure ownership remains in the family. Although the articles of organization are publicly available, the LLC operating agreement is not, and it may be amended at any time as provided by the agreement itself.

### ***Creating the Operating Agreement***

Ownership of the family cottage as tenants in common creates a number of issues that will ultimately frustrate the desired goal of keeping the family cottage in the family. As discussed above, these issues generally relate to (i) the transfer of ownership interests in the cottage, (ii) the use of the cottage and (iii) the on-going management of the cottage. By using a LLC to own the family cottage, the family is able to address these issues and any other issues it wants to provide for, by providing a mechanism to manage the family property, resolve family conflicts and facilitate ownership succession with the family cottage LLC operating agreement.

Interestingly, it is the creation of the FLLC operating agreement that ultimately determines whether the succession plan will successfully preserve the intentions of the cottage owners. Creating an effective operating agreement takes at least two steps by two different groups. First, the property owners and their family must understand, discuss and set out the informal rules that have governed or should govern the ownership and use of the cottage. Second, and perhaps most importantly, the cottage owners must communicate those agreed upon rules and

practices to the estate planning attorneys so that they can formally incorporate the family's informal agreements and intentions into the FLLC. A failure by either the family or the law firm could put the family in the same or worse position than the tenancy in common.

#### *Provisions related to the use of the cottage*

The best part about having a cottage is being able to use it. But with multiple owners, who gets to use the cottage and when? Provisions in the operating agreement related to scheduling and use of the cottage are vital to the smooth and satisfying operation of a shared family cottage. These provisions may provide for the use of almost any method to determine the schedule, be it formal or informal. The appropriate system for making the schedule will depend on the particular family circumstances.

Creating a simple and workable system for cottage sharing requires pre-planning and consideration of family traditions, goals and needs. At the least, the sharing system must address (i) how time is divided and (ii) who may use the cottage, including parents, surviving spouses, pets, cousins, renters and guests. For example, time might be divided based on ownership or may be based on a first-come first-serve basis; pets, for example, may be prohibited to accommodate other members' allergies or preferences. A workable and lasting family cottage sharing system should be fair and simple, clearly stated, in proportion to ownership and in accord with the family traditions and culture.<sup>iv</sup>

#### *Provisions related to the management of the cottage*

In forming your family cottage LLC, you have to choose whether to organize as a member-managed or manager-managed LLC. In making this choice, you are able to determine at the outset whether day-to-day decisions will be made by all members or by only the managing members. With the former, each member (or their representative) has a vote on everything from buying new bathroom towels to whether to sell the cottage. This type of decision-making may work well when there are a small number of equal owners, but will likely be unworkable when there are many owners. With the latter, members are able to vote or appoint one or more cottage managers with authority to handle routine management decisions without consultation with the rest of the owners. In the operating agreement, the members can grant the manager(s) as much or as little power as they agree, while also reserving certain matters in which each member would want a say, such as to amend the operating agreement, mortgage the property, permit rental of the cottage or sell the cottage.

The key consideration in deciding the management structure will be the family dynamics of the current and future cottage owners. If there are or will be one or more highly involved family members and others that want minimal involvement, it may work out best to have the involved family members be managers of a manager-managed FLLC. If everyone in the family has an equal commitment to and involvement with the cottage, it may be best to use a member-managed FLLC and provide for cottage committees in the operating agreement.

### **CONCLUSION**

The family cottage LLC, when appropriate, provides a purposeful solution to family cottage succession planning that ensures the family cottage stays in the family. Its use will allow you and your family an opportunity to openly discuss, address and plan to avoid future family conflicts, with the goal of establishing a legal arrangement specifically tailored to your

family's wishes that will provide a smooth transition of ownership and clear-cut guidelines for the use and management of the family cottage. When the family and its trusted advisors engage in purposeful planning with open communication, they will be in the best position to preserve cherished memories and provide for the future enjoyment of the family cottage.

***FOR MORE INFORMATION***

As a premier financial firm, Northern Trust specializes in life-driven wealth management backed by innovative technology and a strong fiduciary heritage. For over 125 years we have remained true to the same key principles – service, expertise and integrity – that continue to guide us today. Our Wealth Planning Advisory Services team leverages our collective experience to provide financial planning, family education and governance, philanthropic advisory services, business owner services, tax strategy and wealth transfer services to our clients. It is our privilege to put our expertise and resources to work for you.

If you'd like to learn more, contact a Northern Trust professional at a location near you or visit us at [northerntrust.com](http://northerntrust.com).

(c) 2016, Northern Trust Corporation. All rights reserved.

**LEGAL, INVESTMENT AND TAX NOTICE:** This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel.

---

<sup>i</sup> One classic example is found in *Peebles v. Peebles*, 40 A.D.3d 1388, 837 N.Y.S.2d 395 (2007), where the court allowed one of four siblings to force partition of the family vacation home even after the defending siblings cited two letters from the parents to the children, dated October 22, 1997 and January 23, 2001, which, while establishing the “wish” and “hope” of the parents that the property remain in the family, did not prohibit partition and sale. *See also Marks v. Stein*, 160 So.3d 502 (Fla. Dist. Ct. App. 2015), where feuding sisters were forced to sell their interests in the house left to them by their mother held as tenants in common.

<sup>ii</sup> Under common law, courts were limited to the remedy of partition in-kind, or partition by allotment, when individuals decided to end co-tenancy. *See* P. CRAIG–TAYLOR, THROUGH A COLORED LOOKING GLASS: A VIEW OF JUDICIAL PARTITION, FAMILY LAND LOSS, AND RULE SETTING, 78 WASH. U.L.Q. 737, 752 (2000). Partition by sale and related powers such as assignment were statutory remedies, created to augment the equitable powers of the courts. *See Blanchard v. Cross*, 97 Vt. 370, 373, 795 A.2d 1191, 1193 (2002) (“The right to partition by allotment was a common law right, but the right to partition by sale is purely statutory. Such a statute [is] an innovation upon the common law ....”); *see also* ACQUIRING PROPERTY THROUGH FORCED PARTITIONING SALES: ABUSES AND REMEDIES, 27 B.C. L. REV. 755 (1986); *Wilk v. Wilk*, 173 Vt. 343 at 345, 795 A.2d 1191at,1193 (2002).

<sup>iii</sup> Tenants in common can, and sometimes do, enter into contracts often referred to as “ownership agreements.” These agreements are, by definition, limited in duration and scope and must be signed by all owners of the property to be effective. This solution is not optimal in most situations unless the property is going to be sold in a relatively short time.

<sup>iv</sup> For a comprehensive discussion on this and other related issues, see Stuart J. Hollander et al., *Saving the Family Cottage: A Guide to Succession Planning for your Cottage, Cabin, Camp or Vacation Home* 137-147 (4th ed. 2013).