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Keeping the Vacation Home in the Family—Another Use for Limited Liability Companies

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While purchases of primary residences are declining, purchases of second homes are taking off as buyers take advantage of the soft real estate market. Housing statistics indicate 1 in 10 homes in the United States is a seasonal or vacation home that serves as a regular family vacation destination.

Vacation homes take many forms. They may be: a beach destination in California, Hawaii, Massachusetts, or Florida; a lake getaway in Missouri, Minnesota, Michigan, Texas, or New Hampshire; or a mountain escape in Colorado, Utah, Montana, or Tennessee. They may also be yachts or luxurious motor homes. As baby boomers start to think about passing their assets to the next generation, questions many families are facing are: (1) How do we ensure the family vacation home remains in the family; and (2) How do we establish rules for its use?

One principle is clear: traditional forms of joint ownership—tenancy in common and joint tenancy with rights of survivorship—do not work well with family vacation homes. The main risk is that, as the ownership interest becomes fractionalized passing down to subsequent generations, a family member owner will use his or her right to partition the property and force the sale of the vacation home. The family member might be a sibling who did not have good experiences at the vacation home or one who lives too far away to want to use it, a grandchild who would prefer cash to the cottage or cannot afford the share of the upkeep costs, or an ex-spouse who wants to force the sale out of spite.

Another risk is that co-ownership of the vacation home may lead to family conflicts over how the vacation home is operated, maintained, and improved. How will operating and repair expenses be shared? What if someone is late or does not make his or her contribution? How will prime season dates be allocated? What if a family member wants to rent his or her week to a third party? What if a family member wants to sell his or her interest? Are pets allowed? Are non-family members allowed to own the vacation home?

How to Own a Vacation Home

Because of the need for an easily transferable form of ownership and an operating agreement delineating the use of the property, limited liability companies (LLCs) are emerging as one of the preferred ownership vehicles for vacation homes. LLCs can: protect owners from lawsuits by vacation home creditors and users (limited liability), prevent owners from using a right to partition (force a sale of the property), and promote shared governance and use of the property through a well-drafted operating agreement tailored to the unique goals of the family.

Corporations can provide similar protections but they are usually more expensive than LLCs to form and operate, can result in double taxation, and require following more state-imposed formalities. Although LLC interests may wisely be transferred to family and revocable trusts, trusts alone do not offer the asset protection of an LLC or the possibility of shared governance, as trusts usually have no more than two co-trustees.

Common Terms to Include in an LLC Agreement

1. Because the original owners (the grandparents in our nightmare scenario—see sidebar) almost always intend that family members retain the vacation home, the LLC agreement should give family members first right of refusal before the vacation home can be transferred to a non-family member, including spouses (possible ex-spouses) of direct lineal descendants of the original owners. The purchase price can be based on an appraisal or a formula, including discounts for partial interests, lack of marketability, and lack of control. These restrictions can also be effective in reducing the value of a vacation home interest in the original owners' estates.
2. The LLC agreement should allocate responsibility for the expenses of owning, maintaining, and improving the property, and provide decision procedures to determine which maintenance and improvement expenditures to undertake. The most common approach is to establish an annual budget and divide expenses among the family members. The agreement should provide an enforcement mechanism if a member does not pay his or her contribution, such as imposing a finance charge and penalty similar to a loan, restriction on the use of the property, and/or involuntary transfer of ownership to remaining family members.
3. The LLC agreement should establish a calendar system of occupancy, with an equitable allocation of the most desirable dates, such as high seasons, holidays, and school vacations.
4. The LLC agreement should provide for an accountability system for damage to the property caused by members, guests, or pets.
5. The LLC agreement should address whether, and to what extent, the property can be rented to non-family members. Unless vacation homes are going to be rented primarily to third parties, tax benefits passing to owners are subject to the vacation home and passive loss rules. However, collectively, the members can rent the vacation home for up to 14 days annually without having to report the income on a tax return. If members individually rent their allocated time, they should bear responsibility for the tax reporting and additional costs, such as increased liability coverage, damages, and housekeeping.

When to Set Up the LLC

Ideally the LLC is set up by the original owners with input from the family on the terms of the operating agreement. After forming the LLC in the state where the original owners reside or where the property is located, the LLC interests can be transferred to the family members over a period of time, taking advantage of gift tax annual exclusions and minority and marketability discounts, or the LLC interests can be transferred after the death of the survivor of the original owners from a revocable, QTIP, or bypass trust to the family. With the transfer and control restrictions, the LLC interests should be eligible for an estate tax discount.

Alternatively, the vacation home can be transferred to a qualified personal residence trust (QPRT), with the original owner(s) taking a gift tax discount for retained use of the vacation home. The responsibility for transferring the property and setting up the LLC would then fall on the beneficiaries when the trust terminates.

Family vacation homes are treasured assets with significant sentimental and monetary value. Helping our clients devise ways to keep these treasures in the family is an important part of our "wealth management" calling.

References

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Sidebar

A Family Vacation Home Story (Nightmare)

The Smith getaway at the lake was purchased by the grandparents in 1968. It was the family's paradise, enjoyed by the 5 Smith children and 13 grandchildren every summer until the death of the surviving grandparent in 2006. At that time, the getaway, valued at $1 million, passed to John and the other four children as tenants in common. John and his family lived 1,500 miles from the getaway and rarely used it, while the other four children used it on alternating weekends for more than half the year. After a few years, John reluctantly asked his siblings to pay him $200,000 for his interest in the vacation home. The siblings declined. Faced with trying to sell a partial interest to a third party or forcing the sale of the vacation home, John forced the sale of the vacation home. His branch of the family tree has been disowned by the remaining four siblings and their families.

Sidebar

Five Reasons a Limited Liability Company (LLC) Is Preferable to Tenancy in Common as the Way to Own a Vacation Home

- An LLC can limit the owners' exposure to lawsuits by vacation home users and creditors (limited liability).
- An LLC can impose transfer restrictions and prevent an owner from unilaterally selling an interest in the vacation home, making it easier to keep the vacation home in the founder's line (no right to partition).
- An LLC, as an entity rather than a property interest, can hold operating funds and effectively report sharing of income and expenses among the vacation home owners at tax time.
- An LLC has perpetual existence.
- An LLC operating agreement can establish rules for expense sharing, scheduling, dispute resolution, and agreement modification without court intrusion.