KEEPING THE CABIN IN THE FAMILY: A GUIDE TO JOINT OWNERSHIP AND USE

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The purpose of this presentation is to address some of the legal issues and challenges involved in passing on ownership of the "family cabin" between generations, which itself is actually a very emotional and sociological issue for most families. In doing so, I will show how the taxes, insurance and maintenance will be funded while maintaining harmony among owners following the transfer.

I. PRELIMINARY ISSUES REGARDING OWNERSHIP AND USE

A. Families transferring the cabin, which often carries with it extreme emotional value, not to mention monetary value and the possibility of exponentially increasing property taxes upon transfer, need to consider both sociological and legal concerns.

B. The extreme challenge is to transfer the cabin without disturbing family solidarity since there may be many choices but only one (1) solution, such as:

1. How will the cabin be maintained?

2. How will taxes, insurance and maintenance be funded?

3. How will its use be divided among the family?

C. In some cases, the "family cabin" may be just that, a cabin on little property in the area or perhaps a few hours away where the family gathers or gathered at one time for recreation, solidarity, family time, etc.

D. In other cases, the family cabin may be a ski resort in Colorado or a ranch in Montana, or ever more popular today, property out of the country or in such places like British Columbia or on other publicly owned property. These properties and the issues specific to them are outside the scope of this presentation and these materials but many of the problems are the same and need to be addressed with the same care and understanding.

E. Remember that if done correctly, transferring the cabin will be promoting rather than disturbing family solidarity for the generations. But if done incorrectly, this action, or lack thereof, could be the single greatest threat to the continued harmony for your family and their families, regardless of the monetary value of such cabin.

II. CREATING A MASTER PLAN

A. When creating a successful plan involving multiple generations, consider the following:

1. Family members should be informed of the various options to divide their land, such as:

    a. The family may set aside a parcel of land for conservation purposes (assuming we are talking about a sizeable piece of real estate).

    b. Portions of the land may be sold to raise capital to support the remaining property.

    c. The family may want to transfer different parcels of the land to succeeding generations or different members.

    d. The property may be held in Trust or in an entity for the use and enjoyment of the family instead of actually transferring ownership to the individual members.

2. Sometimes, the senior generation's understanding of how they think the junior generation members will deal with the property after their demise is clouded. Many times the value that the property had to the current owners may not be there for the next generation, or it certainly may not be there for all of the members of the next generation. This can cause problems of mass proportion and thus, it is crucial that the client determine exactly how the intended beneficiaries feel about the situation.

3. After the information and insight are identified, it may be helpful to create a mission statement to address the family's goals including:

    a. What is important to the family about the cabin?

    b. What does the family value most about how it uses the cabin?

    c. How would the family like to see the ownership of the cabin affect the ways the various members interact?

    d. How is an individual family member's interest in the cabin to be handled for the in-laws in the event of a divorce, death, etc.?

4. Plans drafted by the senior generation for the junior generation are rarely successful without communication among the generations.

III. <u>ADDRESSING UNDEVELOPED PORTIONS OF YOUR PROPERTY</u>

Although certainly not applicable to everyone, or even to most, there are times when the property in question has vast amounts of undeveloped property, especially when we are talking about properties in more remote areas.

A. Creating a conservation easement is a great way to preserve space and reduce taxes if that is your goal. Often owners of property, especially vacant property that is being unused, are reluctant to sell the same out of fear that the purchaser may develop the property, or at a minimum, develop the property in a way that will interfere with their use and enjoyment of their property or the property values.

1. A conservation easement is a permanent restriction that prevents most types of land development.

2. The tax benefits include:

   a. Income and gift or estate tax deductions;

   b. Reducing real property tax and transfer tax costs (since the value of the property is normally decreased).

3. Must meet the criteria below to qualify.

   a. Property contributed must be a "qualified real property interest."

   b. Property must be donated to a "qualified organization."

   c. The contribution must be exclusively for one of three "conservation purposes."

      i. Preservation of a natural habitat of fish, wildlife or plants. (A common selection since families normally do not want to open their land for use by non-family members.)

      ii. Preservation of land for recreation or education of the general public. (Also common.)

iii. Preservation of open space, including farmland and forestland, for the scenic enjoyment of the public, or pursuant to a clearly delineated federal, state or local conservation policy that will yield a "significant public benefit."

4. There are two ways that allow retention of certain development rights.

   a. "Reservation method," which permits the grantor to convey an easement over an entire parcel, and reserve a right to develop a discrete number of lots on the property; or the

   b. "Carve-out method," which permits the grantor to carve out specific parcels for development that leads to an increase in market value because of their proximity to the parcels subject to the easement.

5. Determining value to a conservation easement may be done by any of the following methods:

   a. Fair market value difference before and after the contribution (more common); or if available

   b. Sale prices of comparable easements (less common).

   c. Fair market value of the entire contiguous parcel before and after the restriction to account for the donor's economic benefit on other parcels.

   d. If an easement increases the value of the their property, the value of the contribution is reduced by the amount of the increase in value of the other property whether or not the property is continuous.

6. Note that if a decedent did not specifically provide for a gift of a conservation easement, an executor or inheriting “family member” can grant a conservation easement on estate property.

B. Donating land to a charity is another great way to preserve open space and reduce taxes.

1. The tax benefits include:

   a. An income and a gift tax deduction for an inter vivos gift.

   b. An estate tax deduction at death.

2. Donations are usually given to local land trust and land banks or possibly a government agency.

C. Gifts to a charitable entity are a great solution if you would like non-family members to be able to benefit from your land as well.

1. When donating to private foundations:

   a. A family may control the management of the foundation;

   b. Is exempt from income tax; and

   c. Must follow many strict requirements; such as

      i. A family cannot use or have access to the property in any manner that is more advantageous.

      ii. The property must be used for charitable or educational purposes.

iii. A family may participate in but not control the supporting organization in exchange for additional tax benefits.

2. When donating to supporting organizations:

a. The tax benefits are more generous than those of a private foundation, however the donor does not retain as much control over the use of the property. (Donor may participate in but not control the property.)

b. Must follow many strict requirements; such as

i. Identify the charitable organizations or purposes it will support; and

ii. Affiliate with an established public charity.

IV. ISSUES AND OPTIONS WHEN TRANSFERRING THE CABIN FROM ONE GENERATION TO THE NEXT

A. Making an outright gift transfers the value of the property and all future appreciation, thus reducing the taxable estate value of the senior generation. If the gift is given as an undivided interest in real property, it may also be possible to apply minority and other discounts to further reduce the value of the gift for gift tax purposes.

1. Outright gift tax benefits include an annual exclusion from gift tax and allows an individual to transfer up to $11,000 per year, per donee, without incurring any gift tax consequences. I.R.C. §2503(b). Married couples can “split” gifts made to third parties allowing one spouse to donate a $22,000 gift. I.R.C. §2513. And of course, each individual also currently has a $1,000,000 lifetime gift tax exemption that can be applied to larger transfers.

2. Estate tax benefits include an applicable credit at death equal to $555,800 that allows each taxpayer to transfer $1,500,000 at death. This amount is currently scheduled to increase in the coming years and under current law.

3. The basic difference between giving gifts at death or during life is that at death, estate tax is assessed on both the value of a gift and the funds actually used to pay the tax, while during one's life, gift tax is paid with funds not otherwise subject to gift tax. Against this benefit though, it is necessary to take into consideration that gifts at death are entitled to a full stepped-up tax basis determined by fair market value at the date-of-death. I.R.C. §1014(a). Inter vivos gifts, on the other hand, only retain a carry-over basis equal to the basis in the hands of the donor, plus the amount of gift tax paid on the appreciation. I.R.C. §1015. Thus, in a nontaxable estate, it may be best to hold onto property until death, in order to take advantage of the stepped-up basis.

B. Qualified personal residence trusts ("QPRT") permit a homeowner to make an irrevocable gift of his or her personal residence (including a vacation home) to a trust for the benefit of children or other beneficiaries at a reduced gift tax cost. I.R.C. §2702. The grantor is allowed to reserve the right to live in the house for a number of years. The residence will not be included in the grantor's estate for federal estate tax purposes. The QRPT enables the grantor to remove the value of the residence, plus any appreciation, from the (taxable) estate for a lower transfer tax cost than would be imposed if the residence were a part of the estate.

1. The benefit is that the value of the gift is the fair market value at the time of transfer to the QPRT, decreased by the value of the

reserved term of years. As a result, all appreciation that occurs during the trust term is “shifted” to the children free of gift or estate tax.

2. Disadvantages of a QRPT are the following:

   a. If the grantor wishes to continue to occupy the residence after the reserved term, the grantor must pay market rent to the beneficiaries, which would be taxable income. However, the amount of rent paid by the grantor would be removed from the (taxable) estate; because the estate tax rate generally exceeds the income tax rate. For those interested in reducing potential estate tax liability, this represents further overall tax savings.

   b. If the grantor fails to survive the trust term, the entire value of the trust’s interest in the residence at the grantor’s death will be included in the grantor’s estate for estate tax purposes. However, the effect will generally be the same as if the QPRT had not been established.

   c. If a residence was transferred using a QPRT, it would not be entitled to the step-up in basis that would otherwise be available at the time of the transferor’s death, because the stepped-up basis is available only if the property is included in a decedent’s estate. I.R.C. §1014(a). Therefore, in some circumstances, it may be advantageous to transfer the residence at death (e.g., where the parent’s estate is not expected to be taxable even if the residence is included or when the property is expected to be sold by the younger generation upon the death of the senior generation).

3. To determine if a QPRT is appropriate you should do the following:

   a. Balance the estate tax savings against the capital gains tax rate that will be applied if the property is sold.

   b. Capital gains tax applies to the difference between the fair market value and basis of the property, and is paid at the time of sale of the property.

   c. Estate taxes are imposed on the entire fair market value of the property and are due nine months after death, regardless of whether the property has been sold by that time.

C. An Irrevocable Trust (other than a QPRT) owning real estate, can be a great way to give gifts to younger generations during the senior generation's lifetime.

   1. Benefits include being able to name the beneficiaries, give power to expand the number of beneficiaries, and have $22,000 in annual gift deductions in the trust owning the real estate. Similarly, parents can also give their children larger lifetime gifts that consume a portion of their applicable exclusion amount.

   2. Many of the problems include the following:

      a. If the grantor chooses to remain in the home he must pay fair market rent for that right, or the value of the house will be included in his or her estate at death. I.R.C. §2036

      b. Duration may be limited by the applicable rule against perpetuities.

c. If the trust is established with an endowment to cover future expenses, it may be insufficient as the value of the property increases (which it often does in desirable vacation spots).

d. Trust terms are difficult to amend to adjust to unanticipated changes of circumstance or desire. This situation may warrant a tenancy in common or LLC agreement.

e. Trusts raise fiduciary duty issues where a duty of loyalty could be violated if all interests are not served.

D. Revocable Trusts can be revoked or amended prior to the death of the grantor/grantors and are usually a good first step. Often, these Trusts can be drafted in a way that the property remains in the Trust or gets allocated to a separate Trust which obviously becomes irrevocable upon the Grantor's death, and can provide terms for how the property will be maintained and administered for a period of years beyond the Grantor's death. Often Grantors will provide that the Trustee maintain the property for a period of time with funds from the main Trust for the use and enjoyment of a specific class until the occurrence of a specific event. This, if nothing else, usually buys the family some time to sort things out or to truly determine everyone's interest in the property when the time comes.

E. Family limited liability companies (LLC) allow the manager to transfer ownership interests to other family members while maintaining control in one or a few.

1. Benefits of an LLC include:

a. Being able to transfer LLC interests each year giving only a small percentage interest to each recipient. If given a gift in excess of the gift tax annual exclusion, the excess can apply against and use part of the lifetime gift tax exemption amount (currently $1,000,000 per donor).

b. A reduction in the valuation of LLC interests because of the discounts normally available for minority interests and lack of marketability associated with an LLC. Such an entity can permit the transfer of assets at a lower gift tax cost than is generally available with respect to direct transfers. The value is done by appraisal and value of the fractional membership interest, which requires a second appraisal that is likely discounted at a value of 20%.

c. Protections from creditors in the event of a lawsuit, bankruptcy of a member, court judgment, tax lien, or forms of a non-family member in the event of a divorce. The LLC agreement may contain transfer restrictions to prevent the sale to an outside party without unanimous consent of the members.

d. Unlike trusts, LLCs can have perpetual existence, controlling documents are much easier to amend and there is ability to alter ownership.

2. Disadvantages of LLCs are:

a. The senior generation might have been able to treat the cabin as their principal residence and exclude the capital gain on sale under Section 121 of the Internal Revenue Code, assuming a sale was ever contemplated.

b. In addition, there are legal and accounting fees in order to establish and maintain the entity.

3. Estate Freezes are beyond the scope of this presentation, but are a useful planning tool to consider in connection with structuring an LLC.

F. Outright sales are also an option and can occur in a number of ways, including the following:

1. An outright sale for cash.

2. An installment sale.

3. An installment sale with a self-canceling installment note that will cancel on the death of the senior family member.

4. An exchange for a private annuity. The primary advantage is that the annuity amount can be determined from IRS valuation tables, eliminating the speculation as to the amount of the periodic payments to be made. A disadvantage is private annuities cannot be secured, putting the annuitant at risk that the buyer may default.

V. SOME COMMON PROVISIONS TO CONSIDER FOR ONGOING MANAGEMENT OF THE CABIN REGARDLESS OF THE MODE OF TRANSFER

A. Written agreements will need to address a mechanism to manage the property, resolve conflicts, and facilitate maintenance of the property.

B. Issues to be addressed for managing the cabin include:

1. Determining the use of the cabin.

2. Determining what visitors (outsiders or third parties) may be welcome, and/or whether charged rent.

3. Establishing rules during use.

4. Determining maintenance and repairs.

5. Establishing annual member dues or rent (normally equal in amount per member).

6. Levying special assessments if annual membership dues are insufficient.

7. Establishing usage fees to promote fairness between those who frequently use the property.

8. Deciding who serves as manager? Should a successor manager be identified? If multiple families own the property, should there always be a manager from each family?

9. Determining whether non-family members may become owners.

10. Determining whether family members are allowed to withdraw and/or determining value if family members do withdraw.

11. Establishing procedures to resolve future disputes.

12. Determining what happens to use restrictions and ownership interests upon the death of a member or a divorce, remarriage, etc.

13. Establishing a fund for payment of taxes (which in many cases may increase dramatically after the transfer due to years of property tax caps).

C. Some common provisions may include the inability for a manager of an LLC to be removed without his or her consent if the client is adamant about who controls the management of the property after the transfer.

D. Other provisions may include a predetermined sale price should any member/owner determine he or she is interested in selling. Most clients agree that the family members should not be able to financially benefit off of the other family members or “hold up” the others for more money, etc. This can be resolved by predetermining in the controlling documents that the transfer price to any family member desiring to sell or transfer his or her shares will be for “X” or more commonly, for the State Equalized Value at the time, or some variation thereof, with payments extended over a period of years at minimal interest. This will ensure that there is no unnecessary discord among the family in determining an unreasonable price in the event of a voluntary sale or transfer.

E. Other provisions may discuss the inability for the property to ever be sold to a third party without every family member’s consent, or at a minimum, without giving each of the members a first right of refusal.

F. Family Homeowners Associations can also be considered, if there is a possibility that several residences could be built, to maintain common areas and facilities, and enforce covenants and restrictions. This could be the most beneficial to retain facilities such as a dock or swimming pool.

1. A homeowners association can be formed as a partnership, LLC, or a non-profit association.

2. Tax exemptions may exist for revenues received from its members if the association is funded by dues or assessments from the owners.

3. Rules can be created by the senior generation or allow the junior generation to develop its own rules as well.

VI. LIFE INSURANCE AND IRREVOCABLE LIFE INSURANCE TRUSTS

Keep in mind that often the best plan may be to combine the aspects of one plan with the best aspects of another. In determining how to fund the maintenance, property taxes and other continued costs for future generations, consider the use of new or existing life insurance policies specifically set aside to provide the funds, and do so in a manner that reduces your estate taxes. For instance, maybe it is undesirable to transfer the property itself into an Irrevocable Trust but the same can be used in conjunction with an LLC for funding of costs and expenses.

A. An Irrevocable Trust can provide an effective means of creating a fund to support maintenance and other expenses associated with cabin ownership.

B. The taxation of life insurance proceeds can be avoided under present law if a trust, instead of the insured, owns the policy known as an Irrevocable Life Insurance Trust or “ILIT.” This can by done by allowing the trustee to use the cash to purchase life insurance on the life of the grantor, while beneficiaries are given withdrawal rights each year so that each transfer from the Grantor to the Trust in order to fund the premiums qualifies for the annual exclusion.

C. The Grantor can also allocate a portion of his or generation-skipping transfer tax exemption (or “GST” exemption) (currently $1,500,000) to the trust each year when the gifts are made, and by these allocations, the entire trust corpus (including the insurance proceeds payable upon the insured’s death) can be sheltered from the GST tax.

D. Of course, other issues must be reviewed when using existing life insurance policies such as the survivorship for 3 years in order for the value of the policy to be excluded from the Grantor’s estate and evaluating the gift tax due on the transfer of the policy based on current cash values, etc.

VII. CONCLUSION

A. The family cabin often embodies strong emotions and requires certain guidelines depending on the family's goals.

B. Being aware of the law and family desires are essential in order to assist in transferring the cabin.

C. Early planning will benefit the family financially, avoid many future disputes, and most importantly it will keep the cabin in the family.