

Newsletter 1: Using a Trust or LLC Structure



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COTTAGE PLANNING

Thank you for your inquiry regarding assistance in dealing with ownership succession of family owned vacation property, a process that has been called "cottage planning." I have developed this handout as a brief introduction of the subject. It begins with some frequently asked questions and answers about cottage planning, describes the issues that can be dealt with in a cottage plan, followed by a brief outline of the steps I use to prepare a plan and estimated costs.

I. FREQUENTLY ASKED QUESTIONS AND ANSWERS

• WHAT IS IT?

Cottage planning is the process of providing for the transition of ownership of vacation property, typically from one generation of owners to the next.

• WHY DO IT?

The underlying premise is that you or your family own property that you wish to keep in the family as long as possible. Without a plan for shared ownership, there is no way to restrict ownership to the family and ownership of the property can be muddied by divorce, death and creditors of the current or future owners. More immediately, without a plan there is no structure for making decisions affecting the owners and the property. This can result in more stress than enjoyment. Having a well thought out plan maximizes the chances of the property staying in the family the longest possible time and providing the most enjoyment to the family.

• WHAT'S COVERED IN IT?

There is no one right answer to this question. For most families, the topics include who should be owners, who should make decisions and how should they be made, how the expenses are to be paid and what happens if an owner fails to pay his/her share, what if an owner wants to sell, and how to schedule use of the property.

• WHAT'S INVOLVED IN THE PLANNING PROCESS?

Depending on the desires of the current owners of the property, the planning process usually involves identifying objectives of the plan, selecting topics to be covered, reviewing any property, income and estate tax issues to be considered, selecting the best form of ownership of the property, and then drafting a formal, written document describing the plan and taking the necessary steps to implement the plan.

• HOW LONG DOES IT TAKE TO COMPLETE THE PLAN?

Most families find that a range from 2 to 4 months is adequate to complete the plan. If there are sticky issues that require some time in order to get comfortable with proposed solutions, then it sometimes can stretch out a little longer. Overall, some plans have been completed in less than one month, and others have taken over a year. The pace depends entirely on the owners.

• HOW MUCH WILL IT COST?

The typical plan will cost between \$6,000 and \$8,000 from start to finish. The final cost depends on how diligent the owners are in keeping the project moving forward without getting stalled, how many drafts of the plan are required until the owners are satisfied with it, how many family members participate in the drafting process, and how many subjects are covered in the plan.

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II. REASONS TO HAVE A PLAN

A well-designed cottage ownership succession plan provides the following features and benefits:

1. Prevents a joint owner from forcing a sale of the property through an action for partition. Any joint owner may force a sale of the property at any time by filing a legal action for partition. There is no defense to this action, and the property will be sold under the supervision of a court appointed person if the property cannot be divided into parcels that are equal in value.
2. Provides rules for managing the property that are better designed to accomplish the objectives of the family than the more ambiguous common law rules that apply to jointly owned property. A plan can specify whatever rules the family wishes to impose on the property, giving the family great flexibility to manage the property in whatever fashion fits their specific needs and desires. Without a plan, the common law rules of jointly owned property will apply, and they are not designed to facilitate family harmony in sharing ownership of vacation property.
3. Prevents a transfer of ownership outside the family, either voluntary or involuntary. Voluntary transfers include sales and gifts of ownership, and involuntary transfers include those from divorce, death without appropriate estate planning, and creditors of owners. All such transfers can be controlled by a good succession plan.
4. Establishes a framework for scheduling, financing, operating and decision making affecting the property. Without a plan, the owners are left to resolve these issues on their own. With a plan, a formal procedure can be put into place which specifies how these issues are handled.
5. Provides sanctions for failure or refusal of an owner to pay his or her fair share of cottage expenses. If an owner refuses or fails to pay his or her share of the expenses, the other owners will have to make up the shortfall. If there are no consequences for failure to pay, significant friction can occur. Families have wide latitude in designing consequences that will encourage members to stay current with their expense obligations and provide sanctions if they don't.
6. Provides a "safety valve" method of allowing a sale by an owner who legitimately wants "out" of the cottage, its responsibilities and privileges. Every generation of owners is likely to have at least one owner who wants to exit the cottage, be free of the responsibilities and privileges of ownership, and receive some proceeds from the sale. A plan that includes this can avoid the family friction that comes when someone wants out.
7. Creates a vehicle for an "endowment" (money set aside to pay for future cottage expenses). Some very fortunate families have the resources to leave or create a fund to either generate income to pay expenses, or to be used to pay those expenses so long as the fund lasts. Having a plan in place to deal with this avoids misunderstanding and misuse of these funds.
8. Allocates control of the cottage between or among generations of owners. It is virtually guaranteed that any family with more than 2 owners will have a period of time when ownership rests in more than one generation of family members. A well designed plan can specify how decision making is to occur when multiple generations of family members are the owners.

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III. LIMITED LIABILITY COMPANY VERSUS COTTAGE TRUST

Prior to 2015, I almost always recommended that families use a limited liability company (“LLC”) to own and manage the property as an integral feature of cottage ownership succession. This recommendation was based on the flexibility, continuity, ease of administration, and certainty of legal consequences of using this form of ownership. During this time, Michigan property tax laws applied equally to any form of ownership of vacation property, and the LLC approach, while treated slightly differently from trust ownership, did not present any significant disadvantage in terms of property taxes.

Effective on December 31, 2014, property owned by a trust will avoid uncapping when children or grandchildren of the current owner become beneficiaries of the trust. Unlike the LLC which uncaps the property value when more than 50% of the LLC ownership is transferred, trust ownership of property will avoid uncapping for at least two generations of family members, so long as it is set up properly. This presents an opportunity to avoid the property tax increase from uncapping longer than using the LLC.

There are pros and cons to each ownership structure. The LLC continues to offer advantages over the trust approach for all purposes except property taxes. For those families facing a significant increase in property taxes when the next generation of family members acquires ownership, the trust approach may be the best choice. Each situation is unique and should be evaluated individually. However, from a process and cost standpoint, the two approaches are very similar.

IV. STEPS IN THE PLANNING PROCESS

Here is an outline of the process I have used in assisting other clients in their cottage planning:

Phase I

1. We conduct an initial discussion with the family member making the inquiry;
2. We provide a retainer agreement to the client describing the scope of services;
3. Upon receipt of the retainer and documents from the family, we schedule an “information gathering session,” either by telephone conference call or by office appointment. Once that session is scheduled, we will send you another handout that describes issues that can be covered in a plan and some common solutions to those issues. We will also request a copy of your family tree to ensure that we understand your family structure. We then conduct the information gathering session to collect the data required to prepare a first draft of operating agreement;
4. During the information gathering session we will discuss the pros and cons of using an LLC versus a cottagetrust;
5. We obtain a title search of the property to confirm ownership and identify any title issues;
6. We provide each member with a first draft of the operating agreement (for an LLC) or trust agreement (for a cottage trust);

Phase II

7. We will schedule a follow up telephone call or office conference to get your input on the first draft. This is typically scheduled within one month of you receiving the first draft, but we encourage you to provide your input sooner if you can do so. We need your help in this, and it is important that all family members participating in the drafting process read the first draft in a timely fashion.
8. We respond to questions and prepare additional drafts as required to satisfy all family members;

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Phase III

A. For a Springing LLC

9. We provide your attorney with sample language to be added to the revocable living trust(s) of the current cottage owner(s);

B. For an Immediate LLC

9. We prepare and file articles of organization with the State of Michigan (generally \$50 fee to State of Michigan);
10. We circulate the final operating agreement for signature by each member;
11. We obtain a taxpayer identification number for the LLC;
12. We prepare a deed transferring the real property to the LLC;
13. We prepare a bill of sale to transfer personal property to the LLC;
14. We record the deed (recording fee of \$35 or so per document at your expense);
15. We send the property transfer affidavit to the assessor with a letter explaining that under the current Michigan Department of Treasury policy, the transfer to the LLC will not cause the property to uncap;
16. We issue membership certificates to each member (if a member has a revocable living trust, we recommend that you take title in that trust, and that you make adjustments to your estate plan as required to take into account the trust's ownership of your interest in the cottage);

C. For a Cottage Trust

9. We circulate the final trust agreement for signature by the initial trustees and each initial trust beneficiary;
10. We obtain a taxpayer identification number for the trust;
11. We prepare a deed transferring the real property to the trust;
12. We prepare a bill of sale to transfer personal property to the trust;
13. We record the deed (recording fee of \$35 or so per document at your expense);
14. We send the property transfer affidavit to the assessor with a letter explaining that under the current Michigan Department of Treasury policy, the transfer to the trust will not cause the property to uncap;

Please keep in mind that there is no one "right" cottage plan that is suitable for all families. Instead, each plan should be customized to address the needs, concerns and circumstances that an individual family is most likely to confront. The ideal situation is to handle the issues most likely to arise, and also provide a mechanism for handling those issues that are unknown at the present time. The individual cottage plan is drawn to cover these two objectives.

V. LEGAL FEES

As a further word on your costs; if you wish to have a consultation with me on the subject of cottage succession planning before deciding whether to proceed, the time spent with you will be billed at our regular hourly rate of \$450 an hour. If you decide within 60 days of the consultation to proceed with a cottage plan, the consultation time charges will be applied to the retainer arrangement described below as part of the initial ten hours of work.

The charge for work in Phase I (steps 1 through 6-completion of the first draft of the operating agreement or the trust agreement) is \$4,500 and includes up to 10 hours of work, including a standard title search of the property. This is our minimum fee and is paid at the beginning of the project. Additional work (over 10 hours to reach a first draft of the operating agreement or trust agreement, and all work in Phases II & III) is charged in tenth-hour increments at my current hourly rate. The total cost varies and is based on the time involved, but usually runs in the range of \$6,000 - \$8,000 for the entire project.

I occasionally get asked if the client can do some of the work in order to save on my fees. I have found that this simply does not have the desired effect of minimizing costs. Unless you have written cottage plans before, trying to do the work yourself will be time-consuming, error prone, and has the potential of creating more stress and conflict within the family.

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You can best save on legal fees by doing your “homework” promptly, and keeping momentum moving forward without delays. Keeping all family members focused on responding to drafts when they are sent out is the best money saving approach you can adopt.

I encourage your family to review the information available on my Cottage Law website www.cottagelaw.com. In addition, if you haven't read the book entitled “Saving the Family Cottage, A Guide to Succession Planning” (Nolo Press, 5th ed., 2017), I encourage you to obtain a copy. It is a very readable book that describes common issues that arise with family owned vacation property, as well as a recommended approach to dealing with them. Books may be ordered directly from the Cottage Law website or Amazon.com.

If you are interested in taking the next step, then please call me to provide some family and property information and history. It is always helpful to me if you can collect a copy of the most recent tax bill from the Township and a copy of the deed by which your family acquired ownership of the property. The process is much more efficient if I have background information early in the process. In the meantime, please let me know if you have any additional questions.

With regards,



Mark E. Kellogg