

Planning Ahead for Transfer of the Family Vacation Home: Easing the Transition to the Next Generation

by

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You currently own an out-of-state vacation home that has been in the family for years. It's a treasured tradition that has brought together generations of family. Perhaps you own it jointly with siblings or cousins, all owning interests inherited from parents. Fractional ownership has worked well enough so far, but should you be planning ahead?

Among the questions presented are:

- With more potential owners by inheritance in the younger generation, how will ownership work in the future?
- Is there a strategy to avoid ancillary probate in the state where the vacation home is located at the death of members of the senior generation?
- Can ownership in increasing smaller multiple undivided interests be avoided – simplifying ownership of the vacation home?
- How can the younger generation be involved to ease succession, yet provide for effective and efficient management?
- Is there a strategy that will allow flexibility to make transfers of interests during the lifetime of the senior generation for estate planning purposes?

There is a strategy that addresses all of the above concerns, yet assures the vacation home will stay in the family. The solution is to transfer ownership of the vacation home to a family limited partnership. As we will see, ownership by an entity – the family limited partnership – offers a great deal of flexibility and solves the problems associated with ownership in undivided fractional interests.

A. Brief Description of the Strategy

With a family limited partnership ("FLP"), the senior generation transfers its interests in the vacation home to the FLP in exchange for general and limited partnership interests. Managerial control is retained by selected members of the senior generation through ownership of the general partnership interests. Family members who are limited partners have no role in management of the FLP, and are shielded by limited liability protection.

The general partners, who will own small percentage general partnership interests, will have unlimited liability with respect to the activities of the FLP. However, this risk is minimized by maintaining liability and casualty insurance policies on the vacation home in the name of the FLP as the insured owner. Since the FLP does not engage in a business involving risk, this will provide adequate protection for the general partners and is likely no different than the situation that already exists.

Thereafter, the senior generation, if desired, may transfer limited partnership interests to younger family members. Through the use of *valuation discounts*, the value of the FLP interest conveyed to younger generation limited partners may be substantially less than the actual percentage share of the value of the vacation home transferred by the senior generation to the FLP. However, this estate planning aspect of the FLP (achieving estate reduction by transferring partnership interests at discounted values) is not a primary objective under these circumstances.

B. Choice of Entity

A threshold issue is the choice of entity to own the vacation home. In many states, including Tennessee, the fee payable upon formation of a limited partnership is less than that for a limited liability company. Limited partnerships often are not required to file annual reports and incur annual filing fees, as are limited liability companies. Although the general partners have unlimited liability for acts of the partnership, ownership of a vacation home should not present unusual risks and insurance can be purchased to minimize risk, as noted previously.

C. Advantages

Ownership of the family vacation home can accomplish the following objectives:

1. Avoidance of Ancillary Probate. For out-of-state vacation homes, absent ownership by a FLP entity, an ancillary probate proceeding will need to be opened in the out-of-state probate court to transfer ownership to the intended heirs at the death of each partial owner. With ownership by a FLP, the partial interests in realty as a legal matter are converted into interests of personal property – the limited partnership interests. Each

owner's respective limited partnership interest (representing ownership in the vacation home) can be left by Will to intended beneficiaries.

2. Avoidance of More Fragmented Ownership in the Future. Ownership of a vacation home in a partnership entity will avoid more fragmented ownership by individuals in undivided partial interests in the future. Going forward, the FLP will own legal title to the house, and the individual family members will own partnership interests in the FLP.

3. More Structured Management. The general partners of the FLP will be responsible for management of the partnership and the vacation home, thus establishing a more structured management framework. This also provides a legal structure for succession by members of the younger generation to assume management responsibilities.

4. Ease of Conveyance of Ownership Interests. If desired, a FLP will allow ownership to be transferred to members of the younger generation more easily during the lives of the senior generation, if desired. Rather than requiring preparation and recording of a deed to transfer an ownership interest prior to death, all that will be necessary is to execute a simple one page assignment of partnership interest (which need not be recorded in any land records).

D. Disadvantages

Beyond the expense of initial formation of the FLP, the principal "disadvantage" will be a more structured approach for dealing with the "business" of the vacation home matters. For the partnership to be respected as a legal entity, it will need: (1) to establish a partnership checking account; and (2) deposit contributions for payment of expenses, and write checks for vacation home expenses, from the partnership account. This may involve somewhat more formal approach than in the past, but is not overly burdensome.

The FLP should maintain a minute book containing the partnership organizational documents and minutes of any meetings of the general partners, significant decisions by the FLP and meetings of all the partners. There is no requirement that the partnership conduct annual meetings, and partnership actions can be taken by written consent without a meeting. Individual funds should not be commingled with partnership funds, and the general partners should execute partnership documents in their capacity as "General Partner" rather than individually.

E. Strategies to Address Specific Issues

As with any common endeavors by families, problems can arise. Set forth below are some provisions that can be included in the partnership agreement to address certain issues that may arise.

1. What If Different "Family Units" Own Interests in the Vacation Home? This situation could arise, for example, if the vacation home was inherited in partial interests by siblings of the senior generation or their offspring. This can be addressed by dividing the limited partnership units into classes (e.g., Class A and Class B units) owned by members of the respective family units. Each class of partnership units (the respective family units) are given the right to select or remove a corresponding Class ___ General Partner. Actions in the name of the partnership will require consent of all General Partners.

2. What If Some Partners Fail to Contribute Their Pro-Rata Share of Expenses? Owners of the limited partnership units are obligated to fund their respective pro-rata shares of upkeep expenses (including utilities, maintenance costs, taxes and repairs). Flexibility for funding upkeep expenses can be provided if a partner fails to fund his proportionate share. In this event, funds can be loaned to the partnership at a prevailing rate by an "advancing partner." If the defaulting partner fails to fund his proportionate share of upkeep expenses plus accrued interest to repay the loan within an agreed upon period of time, the loan may be converted by the advancing partner into additional limited partnership units and the number of limited partnership units of the defaulting limited partner will be correspondingly reduced.

3. How Can Ownership Be Assured to Remain in the Family? This is addressed in the partnership agreement by imposing restrictions on the sale of partnership units by partners. The remaining partners (with priority for remaining partners of a particular class as to partnership units of the same class) are given a right of first refusal to purchase any partnership units proposed to be offered for sale by any partner. This assures that ownership of the vacation home will not be available to "outsiders." However, transfers by a partner to descendants free of restrictions are permitted.

F. Summary

A family limited partnership can be a flexible ownership vehicle for a family vacation home to avoid complications upon the death of the senior generation. If you have any questions, please feel free to contact Chris Was at 744-8527 or cwas@millermartin.com, or any other member of Miller & Martin's Estate Planning & Administration Practice Group.