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How to choose the correct entity for your family cottage

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Family cottages are a fixture of Michigan life. Owners typically want to keep a cottage in the family for generations to come, but thinking about how to do so can be overwhelming.

Many owners focus on the big picture. Which child(ren) will own and maintain the cottage? How will they manage this family asset in the future?

Although these are important decisions, the manner in which these decisions are implemented is equally important.

Last year, we presented an overview of cottage succession planning ("Protecting memories, making new ones," *Michigan Lawyers Weekly*, Oct. 26, 2009), where we suggested the use of a limited liability company (LLC) or trust regarding future management of the cottage. But how does an owner decide which entity is best suited for their family?

The answer depends on each individual family's circumstances and objectives. Taxes, gifting, control and liability protection all play roles in the decision. So, here are some primary issues to consider when choosing between a trust and an LLC, starting with taxes.

Real estate taxes

There are two primary issues to address with regard to real estate taxes:

Is the cottage classified as a "principal residence"?

It is not uncommon for an owner to claim a cottage as a principal residence. If so, the cottage should not be transferred to an LLC now because doing so will result in the loss of the principal residence exemption.

Here, a trust might be a better option.

However, if the owner desires to have an LLC in place for future generations, a revocable trust can direct the cottage to an LLC (which is created, but not funded, during the owner's lifetime) when the owner dies. This is known as a "springing LLC."

Is "uncapping" a concern?

In general, when a cottage passes from parent to child at death, the property is reassessed for real estate tax purposes. Most planning does not change this fact. However, Michigan law currently allows — in limited circumstances — an "original owner" (generally one who owned the property when last reassessed) to add joint owners to whom the property will pass — without reassessment — upon the original owner's death.

Although this might solve basic real estate tax concerns, it doesn't address most management issues related to cottage succession. Therefore, joint ownership may not be the "silver bullet" the cottage owner seeks for future management.

Income taxes

If a cottage has been owned for a long period of time, its sale could result in hefty capital gains taxes. However, if the cottage is the owner's principal residence, the owner is not subject to capital gains tax on the first $250,000 of gain (or $500,000 for a married couple).

In this case, an LLC should not be used to hold current legal title to the cottage as the principal residence exemption will be lost. Here, the owner's revocable trust — perhaps combined with a springing LLC — is the better planning entity.

Estate taxes

A common estate tax minimization technique is to make "annual exclusion" gifts (up to $13,000 annually, or $26,000 for a couple) to descendants. Not only does this reduce the owner's taxable estate, but it also assists in transferring ownership of the family cottage to the next generation.

However, recording deeds each year can be arduous and confusing. If an owner intends to transfer interests in the cottage annually to her children and/or grandchildren, such gifting is more easily accomplished by transferring the cottage to an LLC and then gifting "membership" interests through unrecorded Assignments.

Qualified personal residence trust

This is another common estate planning minimization technique for cottages. A QPRT is an irrevocable trust which owns the cottage for a set term; when the term expires, the property is distributed to the trust beneficiaries (i.e., the settlor's descendants).

While the QPRT can be beneficial in minimizing taxes, the owner does lose some degree of current control over the property. Moreover, the owner might end up renting the cottage from her children at the expiration of the QPRT, which may (or may not) acceptable to the owner.

Additionally, if the owner's children have sufficient wealth for estate taxes to be a concern in their own estates, the owner may want to provide — in her revocable trust — for long-term trust ownership of the cottage which would allow assets to avoid inclusion in the children's (and grandchildren's) estates.

Such planning can be coordinated with an LLC to facilitate gifting and long-term estate tax planning, if desired.

Control

Tax concerns aside, an owner must consider the amount of control she desires to have over the future use and management of the cottage. Does she want to maintain total control until her death? How much flexibility should future generations have?

An LLC provides more flexibility and control for the future owners of the cottage because the future owners usually can amend the terms of the governing document. Conversely, a trust typically offers greater control for the current owner over the future use and management of the cottage while the future owners often have less (or no) flexibility to change the terms of the agreement.

Liability protection

The owner also should consider whether the cottage will be used by non-family members or renters. In this situation, an LLC is more advantageous as it offers the owners liability protection in the event a person is injured while staying at the cottage. Revocable trusts will not offer that protection; personal assets may be subject to such liability.

These considerations can help a cottage owner focus on how to accomplish his or her cottage succession plan. However, each family and each situation is unique. In certain cases, one option will be obvious; in others, some factors may argue in favor of an LLC, but other factors suggest the use of a trust.

Careful consideration of all of the various concerns should lead the owner to the appropriate entity for her family.

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