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Generations Spring 2024 - Navigating the Ownership Structure of a Multigenerational Family Residence

Multigenerational family residences offer a unique blend of shared memories, traditions and living spaces. However, ensuring smooth ownership transitions and equitable usage among family members requires careful planning. Without the requisite forethought and clear direction, the home that provided so many great memories over the years can quickly devolve into a source of contention and frustration among family members.

The Dynastic Trust

A long-term or dynastic trust may be the appropriate owner of a family residence. In this scenario, Generation 1 (G1) would gift the property to the trust—along with other income-producing assets that can provide an endowment to cover associated expenses, including real estate taxes, insurance, maintenance and repairs. If the Generation Skipping Transfer Tax Exemption (GST Exemption) is allocated to such a trust, the property can pass from generation to generation without imposition of an estate tax for as long as the applicable state's rule against perpetuities allows. Some states have abolished the rule against perpetuities altogether, allowing property to remain in family trusts forever. The trust can also be structured as a spousal lifetime access trust (SLAT), where the donor's spouse is named as a beneficiary (sometimes with other descendants). This approach allows G1 to maintain access and use of the property. If the beneficiary spouse predeceases the donor spouse, the donor spouse would need to pay rent to use the property or risk an IRS attempt to include the assets of the trust back in the donor spouse's estate. If the trust is structured as a grantor trust, such rental payments would be ignored for income tax purposes and, in fact, can create additional opportunity to shift value outside of the donor spouse's estate. The dynastic trust structure is not without limitations. The trust may run out of funds to cover the property expenses. This may necessitate renting the property to members of the familyor to outside third parties or selling the property and investing in other assets, including a more modest property. In addition, once G1 passes, it is important to address how property ownership continues. Does the property stay in a single "pot trust" for all descendants, or does it divide into separate shares for the different branches at the Generation 2 (G2) level? Even if the trust has sufficient funds to cover the expenses of maintaining the property for the foreseeable future, there are numerous issues that may arise in G2 or later generations regarding usage, design, renovations and management.

The LLC Operating Agreement

One approach to managing the property for the benefit of G2 and beyond is to establish a limited liability company (LLC), providing a structured framework for ownership, usage, maintenance and capital improvements. The LLC operating agreement can address the following:

- **Ownership Structure**
  - Members: Clearly define who the members (owners) of the LLC are. In a family setting, this may include multiple generations or branches of the family.

  - Ownership Percentage: Specify the ownership percentage for each member, which can be based on financial contributions, usage requirements or other agreed-upon criteria.
  - Decision-Making: Outline the decision-making process, including voting rights and procedures for resolving disputes. If G2, for example, consisted of three children and each child's trust owned one-third of the LLC, each trust may have one vote to make decisions or nominate a manager. If one of the G2 members were to pass and their share were to be further diluted among their children, the deceased child's share could be divided proportionally such that each branch of the family at the closest generational level would continue to hold one vote.
  - Managers: Appoint a single manager who has authority to pay bills, sign contracts and efficiently administer the property without the need for family meetings for routine decisions. Alternatively, the LLC operating agreement could appoint a board of managers, with one manager elected to the board by each branch of the family.
- **Usage and Occupancy**
  - Primary or Vacation Residence: Define the property's intended use as a primary or vacation residence for one or more members. Outline any restrictions on subletting or third-party use.
  - Appropriate Usage: Define appropriate usage of the property, perhaps prohibiting commercial usage or large gatherings. If appropriate, address the family's religious or ethical sensitivities, including dietary restrictions, alcohol use, and sleeping arrangements.
  - Time Sharing: Establish a fair system for allocating time among members who wish to use the property for vacations or other purposes. Consider using a calendar or reservation system to manage usage. Certain times of the year may be in higher demand than others, which should be addressed.
- **Expenses and Financial Matters**
  - Maintenance and Repairs: Specify how routine maintenance and repairs will be managed, including who is responsible for costs and decision-making.
  - Operating Expenses: Outline how ongoing expenses, such as utilities, property taxes and insurance, will be allocated among members.
  - Capital Improvements: Define the process for approving and funding major improvements, such as renovations or expansions. Consider establishing a reserve fund for future improvements.
- **Transfers and Succession**
  - Transfer Restrictions: Include provisions that restrict the transfer of membership interests outside the family without appropriate consent from the other members.
  - Succession Planning: Plan for the transfer of membership interests upon the death or incapacity of a member, ensuring a smooth transition to the next generation.
- **Dissolution and Termination**
  - Dissolution: Specify the conditions under which the LLC may be dissolved, such as a supermajority vote of the members or the sale of the property.

- Buyout Provisions: Include provisions for buying out a member's interest in the LLC if a member wants out or is not fulfilling his or her obligations to the other members. The buyout provisions should address the method for setting the price of the interest to be purchased and the terms of payment.

Consider Requiring Rental Payments

As the branches of the family expand, it is likely that certain members of the family will have the opportunity to use the property more than others. This may be a function of location, wealth, time or interest. When one or more branches utilize the property disproportionally, this can result in resentment and friction as to the continued value in maintaining the property for the family. While the LLC agreement can include options for terminating the ownership arrangement, including buyouts, forced sales and the like, requiring rental payments from members of the family for use of the property can help address these tensions. Paying rent ensures that all beneficiaries are contributing fairly to the expenses associated with the property's upkeep, in line with their use of the property. It helps prevent members of the family who do not make regular use of the property from feeling that they are bearing a disproportionate financial burden for an asset that they may not have the desire or ability to enjoy. If the property doesn't have sufficient liquidity, regular rental payments can help fund ongoing maintenance and improvements to the property, ensuring that it remains in good condition for current and future generations. Depending on the structure of the trust, the rent can be set at a favorable rate for a beneficiary. The rent can be fixed at a point where the beneficiary is incentivized to utilize the property, as opposed to another vacation spot, while also experiencing the beneficial ownership of a trust arrangement. At the same time, because the beneficiary is being charged rent, they are unlikely to take the privilege of using the property for granted. Because they're paying rent, beneficiaries are more likely to treat the property with care and respect, understanding the effort and resources required to maintain it. This approach fosters a sense of responsibility and ownership, encouraging beneficiaries to contribute positively to the property's upkeep. In conclusion, establishing a structured framework for ownership, usage, expenses and improvements for a multigenerational family residence is critical. By carefully addressing key considerations up front, families can enjoy their shared property for generations to come.

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