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Can The Kids Afford The Cottage?

An attorney and a financial advisor provide answers

BY DAN A. PENNING AND DENNIS PROUT, CFP®

Dan Penning, attorney, The Penning Group Advisors and Attorneys:

Before assisting families in their cottage succession planning needs, there are two questions that need to be asked: Do the children actually want the family cottage after mom and dad are gone? If so, can they afford it?

To determine the answer to the second question, families should sit down and do a comprehensive analysis of what costs are generally incurred in order to maintain the cottage. Consider other factors that may contribute to new or increased costs such as capital improvements that may be accruing, or increased property taxes resulting from the uncapping of the taxable value of the property upon transfer from mom and dad to the children.

Whatever the costs are to maintain the cottage, families must honestly assess current/potential costs and then, like any financial decision, they must determine if they have the sufficient resources to pay the expenses.

Like a marriage, the key factor of financial hardship can cause a fracture among common owners of the family cottage and, in spite of otherwise good planning, lead to the unwanted sale of the property. Families should consider the anticipated current and future disposable income of the next-generation members as well as other assets mom and dad could provide as an extended resource to pay expenses. These assets can be in the form of a formal endowment to the cottage LLC, a cottage trust, or perhaps just a simple transfer of assets upon death to their children.

Planning for the payment of expenses is critical to the survival of the family cottage. With any cottage plan, three primary provisions to assist in the payment of ongoing cottage expenses should be addressed. First, a listing of the primary recurring expenses that should be included in an annual budget, and provisions that require the budget be distributed to the owners by a specific date each year for approval and notice of when payments of the expenses are due. Second, a provision requiring at least some minimum contribution to a capital improvement or rainy day fund so there are some resources being accumulated for more significant periodic repairs or expenditures necessary to maintain the cottage. Third, there should be plans addressing what consequences occur in the event an owner does not contribute a share of expenses. These consequences can range from a forfeiture of use to an actual forfeiture of ownership percentage.

In other words, financial planning after identifying the financial costs of keeping the cottage in the family is equally as important as the legal framework that's put in place for the succession planning.

Dennis Prout, CFP®, Prout Financial Design:

As an extended part of the financial package of cottage planning, the next question is: Which assets are more appropriate to provide the income (or lump-sum equivalent) to satisfy expenses incurred? To answer this question it is probably best, from a financial standpoint, to first determine the potential tax liability on those income-producing assets. This point will become more relevant as tax rates continue to rise. In general, the categories of assets that provide income include:

– Non tax-qualified accounts, which may include stocks, mutual funds and non-qualified annuities.

– Life insurance proceeds, which would flow into the above but mentioned separately because of its potential importance.

– IRAs, 403(b)s, 401(k)s and 457 plan tax-qualified accounts.

– Real estate owned individually (income-producing). This asset may be

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very appropriate to hold as a productive asset to cover expenses on the cottage as long as management of the same does not overburden the heirs in management time or effort.

Among income-producing assets, the following are generally the most advantageous when used for income purposes:

– Income-producing assets that require little direct management or other professional oversight, such as utilities or higher-quality bonds.

– Life insurance proceeds, completely tax-free to recipients as long as no estate taxes are imposed.

– Roth IRAs owned in trust for that very purpose may be among the best assets to provide tax-free income.

Much like retirement, the ordering of assets for income is among the more critical components of covering expense-related needs for long-term income, hopefully in perpetuity. Thinking this through with the assistance of a financial advisor can be a very profitable endeavor toward making most efficient use of the proceeds one has worked a lifetime to acquire and grow.

Another concern related to retirement and thus the income needed for cottage maintenance is: What is an appropriate withdrawal rate? For assets held for what may be a very long time, a more conservative approach than assumed by retirees in today's low interest rate is most appropriate, generally two to three percent of assets. As a further note, one may decide to provide an investment policy statement as a guideline for those to follow for the proceeds. This is very similar approach used by nonprofit organizations to aid members in determining proper asset/income allocation. Using these investment policy guidelines can be very helpful and may go a long way as an additional guide for your children (or yourself as well) in planning endeavors.

Rest assured that, regardless of the final allocation decisions, the planning effort put in today will certainly help protect assets and preserve and grow memories for tomorrow's generations.

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