

Vacation Home Fractional Ownership

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What is vacation home fractional ownership?

Vacation home fractional ownership (sometimes also known as vacation home partnership or fractional co-ownership) is an arrangement where a group (most often complete strangers but sometimes family or friends) share the costs and use of vacation property. These groups can be assembled by a real estate development or hotel company, an individual builder, Realtor or seller, or one or more of the prospective buyers/users. Typically, each co-owner owns a percentage of the property and is shown on the title and deed as an owner. In some cases, the deed actually specifies particular days, weeks or months when the co-owner may use the property, while in other cases, the usage arrangements are described in a separate document. Where the property is located outside the United States but the owners reside in the United States, the property is generally owned by a U.S. nonprofit homeowners association formed for the purpose of holding title, and the co-owners own the association. A detailed co-ownership agreement (sometimes called an operating agreement, user agreement, shareholder's agreement or bylaws), a recorded declaration of covenants conditions and restrictions (or "CC&Rs"), or a combination of such documents, allocates usage rights, costs and responsibilities among the co-owners.

Why co-own and share a vacation home?

Although many people dream of owning vacation property, most either can't afford the type of property they want, or reason that they would not use the vacation home often enough to justify the expense. Fractional ownership provides a solution to these problems by allowing you to pay only a fraction of the costs and ongoing expenses of vacation home ownership, and share the risks of unforeseen maintenance problems and value depreciation with others. Of course, in exchange for spreading the costs and risks, you give up some of the usage rights and freedoms that you would have if you owned the property alone. But job and school commitments prevent most people from using a vacation home more than a few weeks or months each year, and some loss of freedom and control is often an acceptable sacrifice for the huge cost savings.

Vacation home sharing is also increasingly popular among those who already own a vacation home (or even a primary residence in a resort community) but feel burdened by the expense, upkeep and management of a property they use infrequently or are regularly absent from during certain seasons. Rather than sell a home they love, these people opt to sell one or more fractional interests to others who will use the home when the original owner does not and will help share the costs and burdens.

How does fractional ownership differ from time shares?

Both the arrangements known historically as timeshares, and the arrangements now referred to as fractional ownership, fall within the legal definition of a "timeshare" in most U.S. states. From a strictly legal standpoint, the term "timeshare" refers to any arrangement under which a group of people shares use of a property based on time, regardless of whether they own the property and regardless of whether a management company or developer is involved in organizing or operating the property. But from a practical standpoint, there are significant differences between most of the arrangements historically referred to as "timeshares", and most modern vacation property fractional ownership arrangements.

Put simply, the meaningful difference between most old-fashioned timeshares and most modern fractional ownership arrangements is the extent of ownership and control given the users of the Property. Old-fashioned timeshares typically did not involve direct ownership of real estate, meaning that the users of the property did not actually own or control it. Modern fractional ownership almost always involves direct ownership, meaning that each user has a deeded interest, and this usually means greater owner control. Moreover, even in instances where a modern fractional vacation home arrangement does not involve direct ownership (typically when the property is outside the U.S.), the users own and control the entirety of the tiny company or association that is formed to hold title. But generalizations about the distinction between old-fashioned timeshares and modern fractionals can be misleading, and it is important not to be misled into complacency by the way an arrangement is named or advertised, or even by whether ownership is deeded or not. For example, contrary to popular misconception, having deeded ownership does not necessarily mean you have any particular level of control over how the property will be managed, what your ownership costs will be in the future, or whether you have any meaningful prospects of making money based on increasing property value. These issues must be examined based on the documents governing the project, not based on what the arrangement is called and whether or not ownership is deeded. Here are the key questions to ask yourself about a fractional ownership arrangement:

- What is my per-night cost when I add up all of my annual costs (including management fees and dues) and divide them by the number of days I can use the property each year?
- Will I have any control over how my costs (particularly management fees and dues) increase over time and how the property is managed and maintained?
- To what extent am I free to rent out the vacation home and control the rent charged?
- If I want to vacation somewhere else, how easy is it to get the location I want at the time I want it?
- What restrictions apply to re-sale, what competition will I face within the property and in the immediate area, and what financing (if any) will be available to my buyer?

What legal restrictions apply to vacation home sharing arrangements?

Several types of legal restrictions can apply to fractional vacation home sharing arrangements. These can be grouped in four general categories: (i) state real estate laws and regulations, (ii) local real estate laws and regulations, (iii) private deed restrictions, and (iv) federal and state securities laws.

The state real estate laws and regulations applicable to vacation home sharing vary from state to state. Most states determine whether regulatory approval is required based on either the number of owners in the co-ownership group or the amount of usage allotted to

each co-owner per year. For example, California requires regulatory approval if there will be more than 10 co-ownership shares. Florida requires approval if there will be more seven co-ownership shares. Hawaii takes the alternative approach, requiring approval if any owner will be allotted less than sixty days of usage per year. When state regulatory approval is required, the cost and delay associated with obtaining the approval can be significant, and in some cases approval may be denied based on the location of the property or other restrictions.

Local regulation of vacation home sharing arrangements is rare but increasing, particularly in resort communities. These rules are often triggered based on number of co-owners or usage allotment, but can also be based upon zoning or building codes. When the regulations apply, they can be in the form of approval requirements, but more often are in the form of outright prohibition.

Private deed restrictions found the governing documents of home owners' associations may also restrict or prohibit vacation home sharing arrangements. These restrictions are not permitted in all states.

Federal and state securities law may also apply to vacation home sharing arrangements. In general, these regulations will apply where rental income is pooled among the owners, management responsibilities are delegated completely, or the purpose of the co-ownership is primarily investment. Application of these laws will often result in expensive registration and compliance requirements.

How do fractional vacation home co-owners allocate usage?

Deciding how the vacation home will be used is usually the first step in structuring the co-ownership arrangement. Focusing on usage first usually makes the rest of the organizational process easier. This is because a co-owner's right to use the home, or his/her right to earn rental income, are the most important and valuable benefits of ownership.

There are two basic models for allocating usage rights. The first (and less popular) model for allocating usage rights is the "Pay-To-Use Approach". In this arrangement, co-owners pay a pre-agreed "usage fee" for each day or week of usage. The usage fees, along with any rental income generated if the home is also rented to non-owners, are used to pay the expenses of ownership. If the usage fees and rental income together exceed the expenses, the surplus is divided among the owners; if there is a shortfall, each owner must contribute. When the Pay-To-Use Approach is used, the purchase price and ownership of the home can be divided based on what each co-owner can afford, their investment goals, or any other criteria the group finds useful, but purchase price and ownership need not have any relationship to usage.

To fairly administer the Pay-To-Use Approach, a manager (who could be a co-owner) or management company should be in charge of reservations and collections. Usage costs/rental rates must be established for each year in advance. These can vary depending on length of stay, time of year, and whether or not the user is a co-owner. If co-owners pay less than rental tenants, it can be useful to allocate a maximum number of "discounted" days, weeks or months that each co-owner can use (which can also be seasonal), and whether co-owners can assign these "discounted" periods to family or friends. There should be a specific time of each year when co-owners can reserve usage blocks for the following year, based on a rotating preference system. The co-owner reservation period should occur before the home is offered for rent to non-owners. Of course, co-owners should also be allowed to use the home during periods that have not previously been reserved by other owners or renters, generally on a first-reserved-first-served basis.

The second (and more popular) model for allocating usage rights is the "Usage Assignment Approach". In the "Usage Assignment Approach", each owner is assigned the exclusive right to use the home during a specified number of days, weeks or months each year. The usage periods can be fixed (such as "the month of February" or "the first two weeks of February and July"), variable (meaning they change each year), or a combination of fixed and variable. During each co-owner's assigned usage period, he/she can live in the home, allow family and friends to use it, rent it out (and keep the rental income), swap it, or leave it empty. When the Usage Assignment Approach is used, the purchase price of the home is generally shared among the co-owners based on the amount of usage allocated to each co-owner. To the extent some or all of the usage periods are permanently fixed, price allocation may also be influenced by the quality of each owner's assigned usage dates and, in some cases, it may be possible to show the specific days, weeks or months assigned to a particular owner on that owner's deed.

Variable usage periods can be determined by establishing preset groups of days, weeks or months which rotate among the Co-Owners annually so that, for example, Co-Owner #1 gets "Usage Package #1" the first year, "Usage Package #2" the second year, and so on until he/she has had all the usage packages, at which time he/she begins again with "Usage Package #1". This type of variable usage assignment allows for unlimited predictability and advance planning and, of course, a co-owners can simply trade with another co-owner if his/her usage for a particular year does not work for his/her schedule. Alternatively, variable usage periods can be selected annually by the co-owners based on a rotating system of selection priority.

There are a large number of variations and hybrids on these basic usage rights allocation models, and each group needs to find an approach that works for them and their property. For example, it is possible to employ the Usage Assignment Approach, but still allocate a certain number of weeks each year as "Pay-To-Use" weeks, meaning that during those times the home will be rented out to owners or to non-owners and the resulting income split among the owners in proportion to ownership. In another variation, it is possible to employ the Pay-To-Use Approach but still give co-owners preferences or discounts for a certain number of weeks each year.

How are vacation fractionals financed?

Historically, purchasers of vacation fractionals in small (2-12 share) groups obtained a group mortgage, and purchaser of vacation fractionals in large projects obtained individual financing from the project developer. Today, individual fractional financing is available even for small co-owner groups purchasing a single house or condominium that is not within a fractional or timeshare development.

If there will be a group mortgage, the group will need to calculate how to divide the mortgage payments. If the down payment is shared in the same proportion as the price, the mortgage will also be divided in proportion to price. So, for example, if five families each buy an equal share of a \$500,000 home, and each put down \$20,000, they will divide the mortgage payments equally. Where the mortgage will be divided in proportion to ownership, the mortgage payments can be lumped together with the operating expenses and handled as described in the preceding paragraph.

On the other hand, if some co-owners contribute more down payment than others (relative to their price), the mortgage division will be different than the ownership division. To illustrate, imagine five families want to equally share a \$500,000 home, and plan to buy it with a \$100,000 down payment and a \$400,000 mortgage. Now suppose Family #1 has only \$10,000 for down payment, Family #2 has \$30,000 for down payment, and the other

families each have \$20,000. Family #1 will be buying a \$100,000 share of the property with a \$10,000 down payment, meaning they will need to borrow \$90,000 of the \$400,000 mortgage or 22.5% (90/400). Family #2 will be buying a \$100,000 share of the property with a \$30,000 down payment, meaning they will need to borrow \$70,000 of the \$400,000 mortgage or 17.5% (70/400). Each of the other families will be buying a \$100,000 share of the property with \$20,000 down payments, meaning they will each need to borrow \$80,000 of the \$400,000 mortgage or 20% (80/400). In this situation, all mortgage payments will be divided according to amount borrowed, meaning Family #1 will pay 22.5%, Family #2 will pay 17.5%, and each of the other families will pay 20%. Where the mortgage will be not divided in proportion to ownership, the mortgage payments should be calculated separately from the operating expenses.

How do fractional vacation home co-owners share expenses?

Operating expenses such as insurance, maintenance, repairs, improvements, utilities and management are usually divided in proportion to ownership, so that a 20% owner will pay 20% of each of these expenses. When using the Pay-To-Use Approach, owner usage fees and rental income would be offset against expenses, and the 20% owner (after paying the usage fees for any days or weeks he/she spent in the home) would get 20% of any surplus if income exceeds expenses, or pay 20% of any deficit if expenses exceed income.

In states (such as California) where resale triggers reassessment, the starting point for allocating property tax among the co-owners should be the amount that each co-owner paid for his/her interest. When the property tax is increased as the result of the resale of a fractional share, the buyer should pay the entirety of the increase. A resale by one co-owner should never increase a non-selling co-owner's property tax burden. In states where resale does not trigger reassessment, property tax can be allocated like other operating expenses.

How are fractional vacation homes managed?

It is useful to divide fractional vacation home management tasks into four categories: usage allocation, accounting, cleaning, and repair. Any of these jobs can be handled by either co-owners or outside professionals, can involve compensation or not, and can be combined as needed for efficiency or convenience.

The tasks involved in usage management will be different depending on whether the group is using a Usage Assignment Approach or a Pay-To-Use Approach. If the Usage Assignment Approach is employed, usage management will involve administering the usage assignment system for each year and keeping track of the results. If the Pay-To-Use Approach is employed, usage management will involve administering the advance co-owner reservation system, soliciting and managing rentals by non-owners, and tracking (and possibly collecting) co-owner usage fees and rental payments.

Accounting management will involve collecting payments from co-owners (and possibly from rental tenants), paying bills, and keeping records. To avoid disputes and cash shortfalls which could result in credit blemishes and even loss of the property, it is absolutely essential to collect co-owner payments based on a budget and regular assessment system rather than "as needed". This means that at the end of each year, the accounting manager estimates all of the expenses for the following year, including mortgage, property tax, insurance, maintenance, repairs, improvements, utilities and management, offsets those expenses against any anticipated income from co-owner usage fees or rental income, and

determines the amount, if any, that will be needed from each co-owner to pay the bills. The anticipated expenses should include some reserves for long-term recurring expenses such as painting, roofing, system upkeep, and furniture and appliance replacement. The amount required from each co-owner should then be divided into equal monthly or quarterly payments, and each owner should be required to contribute his/her payment on schedule. In this way, each co-owner knows with a fairly high degree of precision what will be expected of him/her in the coming year, and it is easy to track whether a co-owner is meeting his/her obligations before a significant problem develops. Obviously, unforeseen expenses can always arise, but it is still critical to budget for the expenses you know you will have. It is very risky, and an awful lot of work, to wait until funds are needed and then attempt to reach each owner to try to collect.

Cleaning is a management task with a surprisingly high potential to cause displeasure and discord within the group. Most co-owners enjoy using their vacation home much more when they arrive to find it clean and orderly, and cleanliness is essential for successful rental to non-owners. Unless an unusually consistent and high standard of cleanliness and order prevails among all of the co-owners in the group (and their families and friends), it is likely that resentment and even anger will develop over the condition of the home when certain users leave. It is also true that you are supposed to be on vacation when you use the home, and you may not want to have to spend the last day of your vacation cleaning. For all of these reasons, I strongly advise vacation home co-owner groups to employ a cleaner or cleaning service to clean the property on a regular basis. This can be done most efficiently when the usage blocks are fairly uniform in length, and the cleaning corresponds with the end of the blocks. The cleaning person can also monitor the condition of the property, and inform the co-owners when a particular co-owner or guest has damaged, broken or stolen something. One of the best things about vacation home co-ownership is that you can spread the cost of this type of service over the entire group, rather than paying for it yourself.

Repair management is important because without it, no one person is responsible for keeping the home in good repair, and small inexpensive problems can develop into large expensive ones. The repair manager should be responsible for periodically inspecting the property, fielding comments and complaints from co-owners, and arranging for and supervising repairs. If the repair manager will be doing any major repairs him/herself, it is important to establish, before beginning work, whether the repair manager will be compensated and, if so, how much. "Time and materials" compensation should be avoided because it often leads to disputes, particularly where the repair manager is not a professional contractor and may not use his/her time and/or the materials efficiently. A much better approach is to establish a scope of work, time for completion, and payment amount in advance. This avoids most potential disputes and allows the group to compare the repair manager's proposal to bids from outside contractors.

How do fractional vacation home co-owners make decisions?

Regardless of how many co-owners will be in the group, it is useful to establish certain mandatory duties, things the group will be required to do unless all owners otherwise agree. These mandatory duties should include allocating usage, paying the recurring operating expenses, and maintaining the building in good condition. Establishing mandatory duties prevents an individual owner (in a group of only two owners), or a majority of owners (in a group of three or more owners), from taking actions that endanger the group investment.

For actions that are not mandated by the co-ownership agreement, the group needs to vote. In groups of only two co-owners, voting is obviously problematic. If the co-owners do not agree, the outcome depends on how the co-ownership agreement treats the item under consideration. If the agreement states that the action under consideration requires the consent of both owners, no action will be taken since the owners did not consent. If the agreement is silent on the issue, the co-owners will need dispute resolution assistance, typically mediation and/or binding arbitration.

Groups of three or more co-owners typically have tiered voting systems where certain decisions are made by a majority or a subgroup such as a board of directors, and certain decisions require unanimity (or alternatively, a larger majority). Decisions requiring a higher level of approval are typically those involving major physical changes to the property, large expenditures, changing usage rights allocations, selling the entire property, and borrowing money against the property, and could also include anything else the group thinks is particularly important. When analyzing how decisions should be made, keep in mind that allowing a decision to be made by a majority allows the majority to take usage rights away from, or add cost burdens to, the minority (and you could be that minority). On the other hand, requiring a decision to be made by consensus can paralyze the group if there is a co-owner who is uninterested, unreasonable or angry. The personalities and relationships of the original co-owners may change over time, and new people may come into the group through resale or death, so don't assume that the level of cooperation, ease of consensus-building, and rationality you experience now will continue into the future.

One particularly important but often overlooked area of decision making and potential dispute is the layout and furnishing of the shared vacation home. The property can become an overly cluttered repository for all of the co-owner's unwanted furnishings, or an unpleasant maze of clashing tastes. I suggest that the co-owners initially agree on a furniture layout and, if items must be purchased, a budget and plan for how purchasing decisions will be made. Once the initial furnishing and decorating is completed, any additions or changes should require group approval.

Are payments on a fractional ownership vacation home tax deductible?

Tax treatment of vacation homes depends on how often the property is used for "personal use" and how often it is used as a "rental". There are three possible tax treatments, each with their own rules on tax deductions: "Pure Second Home", "Pure Rental Property", and "Second Home/Hobby Rental".

You qualify for "Pure Second Home" tax treatment if the property is a "rental" for no more than 14 days in a particular tax year. With this tax treatment, mortgage interest and property taxes are generally tax deductible, but other expenses are not. Rent income is entirely tax free.

You qualify for "Pure Rental Property" tax treatment if both of the following two things are true: (i) the property is a "rental" for more than 14 days in a particular tax year, and (ii) the total number of "personal use" days is either no more than 14 or no more than 10% of the total number of "rental" days. (For example, if there were 220 "rental" days, you could have up to 22 "personal use" days; if there were 100 "rental" days, you could have up to 14 "personal use" days.) With this tax treatment, you need to divide the year in two parts, "rental" and "personal use", and allocate each expense proportionally. For the "rental" portion, expenses (including mortgage interest, property tax, insurance, maintenance,

repairs, improvements, utilities, management, and even depreciation) are deductible to the extent they exceed rental income, but the deduction cannot be taken against all types of income, and in some cases must be carried forward and deducted in future years. For the "personal use" portion, only property tax is reliably deductible; other expenses, including mortgage interest, generally are not.

You qualify for "Second Home/Hobby Rental" tax treatment if you do not qualify for either of the other categories. With this tax treatment, you again need to divide the year in two parts, "rental" and "personal use", and allocate each expense proportionally. For the "rental" portion, expenses (again including mortgage interest, property tax, insurance, maintenance, repairs, improvements, utilities, management, and even depreciation) can offset income, but are not otherwise deductible. For the "personal use" portion, mortgage interest and property taxes are generally deductible, but other expenses are not.

When determining how often the property is used for "personal use" and how often it is used as a "rental", these rules apply:

- Use by a co-owner, even when the co-owner pays a usage fee, is "personal use".
- Use by a relative of an owner, even if the relative pays full rent, is "personal use".
- Use by a non-owner under a vacation home exchange or swap arrangement is "personal use".
- Days spent primarily repairing or maintaining the vacation home are not "personal use", but need not be counted as "rental" days either.
- A day when the home is available for rent but is not actually rented cannot be counted as a "rental" day.

When vacation property is co-owned, IRS Regulations seem to contemplate that usage of all the co-owners (and their relatives, non-paying friends, and swappers) should be added together to determine the total number of "personal use" days, and the days when the property was rented to paying tenants who are not owners or relatives (regardless of whether the rent went to an individual owner or was shared by the group) should be added together to determine the total number of "rental" days. The tax treatment should then be determined. If the home qualifies as a Pure Second Home, each owner can then generally deduct all of the mortgage interest and property tax he/she paid. If the home does not qualify as a Pure Second Home, the group will need to determine the collective "rental"/"personal use" expense allocation ratio. Each owner will then need to apply that ratio to the expenses he/she has paid, offset any income he/she received, and apply the appropriate tax deduction rules as outlined above.

Nevertheless, at least one article that explores this topic in detail has concluded that this approach may not be either workable or fair in practice, and that it would be reasonable for each owner to determine his/her tax treatment separately based on his/her usage and rental of his/her interval.

This discussion of tax issues is intended as an introduction to the general rules only. You should consult a qualified attorney or accountant for complete and personalized tax information.

How will I be taxed when the fractional vacation home is sold or I sell my share?

Unless you have occupied the property as your primary residence for two of the five years immediately preceding the sale, you will not qualify for the \$250,000 single/\$500,000 married exclusion from capital gains tax. But you are likely to qualify to have any profit taxed at the lower long-term capital gains rates, and you may qualify to complete a tax-deferred exchange. In general, the tax treatment of your profit or loss on resale will depend upon how the property was used in the 12 months preceding the sale. If you are contemplating a sale of a vacation property (or just your share of one), it is wise to consult a tax expert at least a year before the planned sale.

How do vacation fractional groups start?

In many cases, vacation home sharing starts when a group of buyers create the co-ownership structure. For example, an individual buyer might assemble a group of family or friends, use a qualified Realtor to locate a home or condominium, and then work with an attorney with vacation home co-ownership experience to create the usage and ownership arrangements, and create the co-ownership agreement.

In other cases, a builder, property owner or his/her Realtor makes an elective decision to market a property as fractional interests, either because he/she thinks this is the best way to maximize the sale price, or because he/she wishes to sell only part of the usage rights. This type of formation works best for when the seller or Realtor develop the co-ownership structure and agreement before marketing (as discussed below), and each buyer is given the opportunity to review and approve the structure and the agreement before becoming committed to purchase.

Finally, there are real estate developments designed specifically for fractional ownership, or which include a fractional ownership component. In these arrangements, there will be more than one house or unit participating in the fractional structure, and both amenities (such as recreational facilities, for example) and management is shared by many fractional ownership subgroups. In some cases, the dwelling a co-owner uses during a particular stay is determined by availability rather than by ownership, so that the co-owner does not necessarily use the home he/she owns.

Why would an owner or Realtor selling an entire property develop the co-ownership structure and documentation before marketing? Why not let the buyers develop their own agreement?

Although it is theoretically possible to gather an entire buyer group, have them prepare a single offer as a group, then allow them the time and flexibility to create their own structure and agreement prior to close (while the property is held off the market), this approach fails much more often than it succeeds and consumes a huge amount of effort and time even when successful. Most sellers and Realtors find it much easier and more productive to accept individual offers from prospective buyers of each fractional share even when they intend to simultaneously close the sales to all the buyers at once. (Note that closing the sales one at a time is also possible.) Accepting individual offers on the vacation home shares is virtually impossible without having a structure and agreement in place. The structure created by the agreement is necessary to avoid the uncertainty and risk that would otherwise be associated with a series of purchase contracts for percentages of the property.

What type of documentation is needed for a vacation fractional ownership arrangement?

Every fractional ownership group needs a document or group of documents detailing their rights (especially usage/rental, alteration, financing and resale) and obligations (especially cost allocation, dues structure, repair/replacement, and rules). Each document must be prepared in view of the fact that it will only be used if the owners disagree, and will only be useful if it can resolve the disagreement (more on this later).

Fractional ownership documents fall into two general categories: (i) those that are recorded in the chain of title to the co-owned property and thereby become binding on each subsequent owner without that owner's signature, and (ii) those that are unrecorded and bind only those that sign them. The principle advantages of recorded documents, often called "Declarations" or "CC&Rs" (which stands for "Covenants, Conditions and Restrictions"), are that they reduce the risks of co-ownership (particularly the risk that there will be a co-owner that is not bound by the documents because he/she has not signed them), and facilitate collection in the event of non-payment of co-owner obligations. The principle disadvantages of recorded documents are that they may violate a local or private regulation, are more difficult to modify, and are generally not compatible with subsequent group financing. A common misconception is that co-owners obtain "separate deeds" only if there are recorded co-ownership documents. In fact, all fractional ownership arrangements involving direct ownership can have separate deeds, regardless of the type of documents used and whether the documents are recorded or unrecorded.

Most vacation fractional arrangements involve a combination of recorded and unrecorded documents, and it is difficult to make generalizations about what the documents are typically called or what documents (as opposed to what content items) are needed. Some common names (aside from "Declaration" and "CC&Rs" mentioned above) are "User Agreement", "Bylaws", "Co-Ownership Agreement", "Owner Agreement", "Management Agreement", and "Usage Rules", but there is no pattern as to what is in a document with a particular name, or how the various necessary provisions are distributed among the documents when a project has multiple documents. The key is to make sure all the important content items are present, and to assess the extent to which a particular content item will be enforceable against current and future owners.

Some fractional ownership arrangements involve the creation of a legal entity such as a corporation, which may be for-profit or nonprofit. Sometimes the entity is created to hold title to the property and the co-owners own the entity rather than the property (discussed more fully below), but in most cases title is held by the owners and the entity is formed just to manage and operate the property. When an entity is formed, a formation document, often called the "Articles" or the "Certificate", will exist, and annual filing and tax reporting requirements may apply. The benefits of forming an entity for the management and operation of vacation fractional property is debatable, and the decision is often driven by group size.

Do vacation fractional co-owners who are close friends or family really need formal documents?

People and circumstances change in unforeseeable ways, and new people can come into a co-ownership group at any time as a result of death or other unexpected events. When

these changes occur, even the best of friends, the closest of families, and the most agreeable and easygoing people in the world, can disagree. The purpose of an agreement is to help resolve these conflicts quickly, inexpensively, and without ruining the personal relationships of the group members.

Even a well-prepared co-ownership agreement should be used only in the event friendly relations among group members break down. While it is useful to have owners' rights and duties well defined, relying on the agreement to dictate a response to actual events is unwise. Even the best agreement will rarely anticipate all circumstances, and applying a formulaic response that does not quite fit the situation may not reveal the best course of action. Such an approach encourages group members to adopt firm positions based on agreement interpretations, and an impasse may develop. A better strategy is to rely first on discussion. The goal should be to develop a consensus that all owners can accept even though some may believe that the agreement dictates a more personally advantageous decision. If a consensus cannot be reached, the co-ownership agreement can provide a final resolution.

Should vacation fractional ownership agreements be kept short and simple?

No one reads co-ownership documents for pleasure. The only time you are likely to read the documents is if you have a conflict that you can't otherwise resolve. In that situation, you want them to provide a specific and clear resolution. The shorter a fractional ownership agreement is, the less likely it is to address the specific problem that caused you to look at the agreement. The advantage of length is that it allows you to cover more issues, and makes the agreement more likely to be helpful if you need it. There is no disadvantage to length, as long as the document has a complete table of contents so that you can find what you need quickly. Simplicity is desirable, as long as it doesn't come at the expense of breadth.

What happens if a co-owner doesn't fulfill his/her obligations?

While co-owner default is a major potential risk of co-ownership, it is important to keep the problem in perspective. In my experience, the type of default that co-owners are most worried about, failure to make a required payment, is extremely rare. Far more common, but still rare, are defaults related to usage of the property, such as damaging the property, failing to keep it clean, using it at unauthorized times or in improper ways, and altering or cluttering it without group approval.

While it is necessary (from both a legal and an ethical point of view) to protect the rights and equity of each co-owner even if he/she has defaulted, it is also important that a co-ownership agreement give the group the power to deal with a default quickly and effectively. The group can always decide not to use all of its the power if the circumstances warrant leniency, but the group should not be forced to be lenient if one member is ignoring the rules or putting the property or the investment at risk.

A typical co-ownership agreement will provide that an owner who has been accused of a violation be given notice of the accusation and a limited time to either contest it or cure it. If the accused co-owner chooses to contest the allegation, the matter is submitted to dispute resolution, which is typically mediation, or if that is unsuccessful, binding arbitration. If the accused co-owner does not cure the violation or initiate dispute resolution

within the specified time, his/her interest in the property is sold at market price using a carefully described procedure. Sale proceeds are applied to pay any arrearages, transaction costs, legal fees and penalties, and any remaining amounts go to the defaulting co-owner. Note that a procedure which causes a co-owner to simply forfeit his/her ownership, investment or equity, is generally unenforceable and therefore useless to the group.

As mentioned above, it is advisable for co-owner groups to establish a default reserve fund that will be used to pay mortgage interest, property tax or insurance if a co-owner fails to contribute his/her share. But it is important to understand that this fund is not intended to be a pool from which an defaulting co-owner can borrow at will. If a co-owner fails to make a payment, and the group chooses to use a portion of the fund to make up the shortfall, the defaulting co-owner has still defaulted and the group should still have the power to take the same remedial action that it would be entitled to take if the default reserve fund had not been used. In other words, the defaulting owner should not be able to escape responsibility by claiming that since it was his/her own money in the default reserve fund that was used, he/she has not really defaulted.

Should the shared or fractional vacation home be held in a limited liability company or limited partnership?

Owning a vacation home as a limited liability company ("LLC"), limited partnership ("LP"), corporation, or other entity (rather than in the names of the co-owners) can offer several advantages, including (i) protecting your other assets from liabilities arising from ownership of the vacation home, (ii) protecting the vacation home from seizure by your creditors (or the creditors of other co-owners), (iii) increasing flexibility for ownership changes, and (iv) adding the structure created by the large body of law that is applicable to these entities (but doesn't otherwise apply to co-ownership). For properties located outside the United States, owning the shared vacation property as a U.S. LLC or other U.S. entity offers additional advantages which are discussed below.

But owning a vacation home as an entity also has drawbacks. Creating and maintaining the entity structure involves costs that you would not otherwise incur, including formation fees, special taxes, and the annual cost of preparing tax returns for the entity (which is required even if the entity doesn't owe any tax). In addition, owning the group vacation home as an entity may deprive the co-owners of some of the income tax benefits of vacation home ownership, such as the ability to deduct mortgage interest and property tax as a second home. Ultimately, the question of whether to hold a vacation home as an entity must be answered based on a case by case basis in light of the particular circumstances of your group and your property. The vast majority of groups consisting of U.S. residents co-owning U.S. vacation property opt for direct ownership rather than ownership as an LLC or other entity.

Should vacation fractional owners be allowed to sell their shares of the vacation home?

Those who purchase a vacation home with friends or family are often concerned that allowing co-owners to re-sell their shares will cause incompatible or unqualified co-owners to enter the group. But prohibiting individual re-sales, or requiring unanimous consent for them (which is really the same thing), may mean that there is no way for a co-owner to exit the group without selling his/her interest to another co-owner. The problem with this

situation is that no other co-owner may be interested in purchasing an additional share. Moreover, even if another co-owner or group of co-owners is willing to purchase, there is little incentive for them to pay fair market price since the seller has no choice but to take whatever is offered. (Requiring that the price be based on an appraisal will not be helpful if the effect is to dissuade the other co-owners from purchasing.)

An important thing to keep in mind when considering this issue is that personalities and lives change in ways that no one expects or can predict, and it is inevitable that people will need or want to leave the group over time. Examine the issue both from the perspective of someone who might be forced to accept a new co-owner, and from the perspective of someone who might need to sell because of financial difficulties or illness. Also remember that it generally hurts the group dynamic, and makes decision making and management much more difficult, to force someone to stay in the group when he/she needs or wants to leave.

I strongly recommend that individual re-sales be allowed, subject to restrictions intended to protect the group from incompatible or unqualified buyers. These protections typically include rights of first refusal (the right of one or more of the existing co-owners to purchase the seller's interest at market price) and rights of rejection (the right of the other co-owners to reject a proposed buyer if they can articulate a reasonable basis for rejection).

Should fractional vacation home co-owners be able to force a sale of the entire vacation home?

As I mention above, it is critical to recognize that the lives of each of the co-owners will change in ways they do not expect, and there must be a way for co-owners to leave the group. Allowing co-owners to sell individual shares is one way to make leaving possible, but selling partial interests may be difficult or impossible due to market conditions, bad group dynamics, the condition of the property, or other unpredictable factors. So even if individual sales are permitted, it makes sense to create a realistic, guaranteed exit strategy. Typically, this means picking a time in the future when it will become possible for any of the co-owners to insist that the others either buy them out based on fair market value, or sell the entire property.

What kinds of risks does vacation fractional co-ownership create?

Fractional co-ownership involves the risks of sharing use of property with others and relying on them to fulfill their obligations to you. Sharing use means that you will not be able to do what you want when you want, and that others may do things that displease you. Sharing obligations means that necessary maintenance and management might not be completed, or worse, that as the result of a co-owner failing to make a payment, a mortgage lender could foreclose on the entire building causing all of the other co-owners to lose use of the vacation home and possibly all of the money they have invested. There is no way to eliminate these risks, but there are ways to lower them. Perhaps the single most important thing you can do to lower the risk of co-ownership is to have a thorough, written, signed co-ownership agreement that deals with all of the issues, including events you don't expect to happen, the possibility that people you don't know will be in the group as the result of a death or re-sale, and the reality that people change and you might not get along with the other co-owners as well as you do now.

Besides having an agreement, these steps will help diminish the risk of co-ownership:

- Carefully investigate the background and financial qualification of potential co-owners.
- Use a monthly assessment system for collecting payments from the group, and pay all bills from a group account.
- Assign each of the essential management tasks to a specific person either within or outside the group.
- Have each co-owner contribute to a default reserve fund that will be used to pay mortgage interest (if there is a group mortgage), property tax or insurance if a co-owner fails to contribute his/her share, and make sure you don't accidentally spend the money on maintenance or repairs.
- Give the group the power to quickly force out a co-owner who is not fulfilling his/her obligations, and use that power before the group is in serious financial trouble.

What additional risks arise if the fractional vacation home is located in a foreign country?

Where the fractional vacation property is located abroad, prospective co-owners are less likely to be familiar with either the real estate market or the local real estate transaction system. This lack of familiarity creates risk of overpayment for the property or its improvement and furnishing, or of wasting money and time in connection with the transaction formalities. In addition, the laws of many foreign countries do not offer the same level of consumer protection as U.S. laws. Ongoing management, enforcement of the co-ownership agreement, and resale transactions can also be problematic. All of these difficulties can be compounded by a language barrier. To manage these risks, it is essential to involve both a U.S. attorney, and an attorney licensed in the country where the property is located, in the formulation of the co-ownership agreement and ownership structure.

Owning the vacation property as a U.S. LLC or other U.S. entity can help solve some of the difficulties associated with shared vacation property located abroad. U.S. entity ownership allows sales and rental transactions to occur in the United States, avoiding the formalities and costs involved in transferring real estate in the country where the property is located as well as the expense and inconvenience of foreign lawyers, real estate agents and notaries. In addition, use of the U.S. LLC or other U.S. entity enables the relationship of the co-owners to be governed by U.S. law and any disputes among them to be resolved in U.S. courts or U.S. arbitration rather than through the legal system of the foreign country. In some cases, certain types of transfer and inheritance taxes can also be avoided.

About the Author

D. Andrew Sirkin is a recognized expert in fractional ownership and other co-ownership arrangements including shared vacation homes, TICs, equity sharing, co-housing, and legal subdivisions such as condominiums. His practice areas include transaction planning, offering materials, co-ownership agreements and CC&Rs, entity formations, regulatory approvals, fractional lending and mediation. Although based in San Francisco, he regularly works on projects located throughout California, and has also worked on projects in nine other U.S. states, Italy, France, Argentina, Nicaragua, Belize and Mexico. He is an accredited instructor with the California Department of Real Estate, and frequently conducts co-ownership workshops for attorneys, real estate agents, corporations, and prospective home buyers. Andy is the co-author of *The Condominium Bluebook*, published annually by Piedmont Press, and *The Equity Sharing Manual*, first published by John Wiley and Sons in November 1994 (download the current edition in PDF). He has written numerous articles on related topics, including "Vacation Home Co-Ownership", "Questions and Answers on Tenancy In Common", "Owner-Occupancy and Ellis Evictions", "Condominium Conversion in San Francisco", and "Unmarried Couples and Property Ownership", all of which are

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