

FRACTIONAL OWNERSHIP

FAQs

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WHAT IS FRACTIONAL OWNERSHIP?

The phrase “fractional ownership” is typically used to describe shared ownership of a vacation or resort property by people in an arrangement which allocates usage rights based on time. In other words, only one owner will be allowed to use a particular home or apartment at a particular time. Fractional ownership arrangements can be applied to a single home or apartment (typically referred to as a “one-off fractional”) or to a multi-unit building or resort development. In multi-unit developments, each co-owner may have ownership rights to all the units, some of the units, or only one unit, and his/her usage rights, and cost obligations, may or may not correspond to his/her ownership rights. Groups can be assembled by a real estate development or hotel company, an individual builder, Realtor or seller, one or more of the prospective buyers/users, or groups of friends or family members.

The terms private residence club (or “PRC”), timeshare, shared ownership, vacation home partnership and fractional co-ownership are also used to describe these arrangements, and there are no consistent distinctions in the use of these descriptions. Since property usage is allocated based on time, this type of co-ownership falls within most legal definitions of a “timeshare”, which means it can be subject to restrictions and requirements applicable to the creation and sale of timeshare property. Nevertheless, there are significant practical distinctions between most arrangements commonly called fractionals and more traditional timeshares, and these are discussed more fully below. Fractional ownership arrangements should not be confused with “destination clubs” (in which participants purchase a temporary right to use without ownership), or a “condohotel” or “condotel” (in which each participant has whole ownership of a particular hotel room or suite).

HOW DOES FRACTIONAL OWNERSHIP DIFFER FROM TIME SHARES?

From a strictly legal standpoint, most definitions of the term “timeshare” encompass any arrangement under which a group of people share 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 fractional ownership arrangements.

Contrary to popular belief, the difference between a fractional and a timeshare is not whether title to property is conveyed to the purchasers. As an attorney who has been involved in shared ownership for more than 20 years, I can say definitively that many “timeshare properties” involve direct, titled ownership, and many “fractional properties” do not. This misconception about the difference between a fractional and a timeshare often leads to two significant problems: (i) an assumption that timeshare restrictions and regulations do not apply to fractional projects, and (ii) failure to evaluate the important elements of an offering to make sure that it really is better than the old-fashioned timeshares with bad reputations.

The meaningful differences between most old-fashioned timeshares and most modern fractional ownership arrangements are (i) the extent to which each participant’s rights and responsibilities are limited to a particular home or group of homes, and (ii) the extent of each participant’s ownership and control. Having deeded ownership to a particular home or condominium does not necessarily mean that a co-owner has the right to use the home he/she owns (as opposed to others in the development) or has expense responsibility which is limited to that home. Nor does deeded ownership give a co-owner any particular level of control over how the home he/she owns will be cared for and managed, what ownership costs will be in the future, or whether there are any meaningful prospects of making money based on increasing property value. These issues must be examined based on the documents governing the shared property, not based on what the arrangement is called and whether or not ownership is deeded. Here are the key questions to ask about a fractional ownership arrangement:

- What is the balance of predictability and flexibility in the usage system? Can the system be changed and, if so, to what extent is each co-owner protected from changes that will diminish the usefulness of the property for him/her? Is the usage system fair, can its fairness be verified and confirmed, and in what ways might an unscrupulous owner or manager manipulate the system?
- To what extent will each co-owner be able to control and predict which home he/she will use on any particular visit? Will he/she return to the same home on each visit? If not, how much variation will there be in size and other amenities, and how much control (if any) will the co-owner have in determining which home he/she will use?
- Are each co-owner’s costs and responsibilities limited to the home or homes he/she will use, or do they extend to homes that only other owners will use? In the latter case, will each co-owner’s costs and responsibilities be proportional to his/her usage rights?
- What is the per-night cost when one adds up all of the annual costs (including management fees and dues) and divides them by the number of days of use each year? How likely is it that per-night costs will increase faster than the costs of alternative lodging? To what extent will per-night costs be influenced by the need to provide services that some co-owners may not want or use, or by the need for a large developer or resort operator to make a profit?
- Will the co-owners have any control over how costs (particularly management fees and dues) increase over time and how the property is managed and maintained?
- To what extent are co-owners free to rent out the shared property and control the rent charged?
- Can a fractional owner vacation somewhere else, and how easy is it to get the desired location and

dates?

- What restrictions apply to re-sale, what competition will a fractional share owner face within the property and the immediate area, and what financing (if any) will be available to the buyer?

WHY WOULD A VACATION HOME BUYER CONSIDER SHARED OWNERSHIP OF A VACATION HOME OR RESORT PROPERTY?

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 each co-owner 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, the owner gives up some of the usage rights and freedoms of whole ownership. 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.

WHY WOULD THE OWNERS OF A VACATION HOME OR RESORT PROPERTY CONSIDER SELLING A FRACTIONAL INTEREST?

Shared ownership is 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 ownership interests to others who will use the home when the original owner does not and will help share the costs and burdens. Besides lowering cost and time burdens, shared ownership can free capital for the purchase of other resort property, or for alternative investments. It can also provide an alternative when selling the entire home proves difficult due to market conditions.

WHY WOULD A DEVELOPER OR BUILDER CONSIDER OFFERING FRACTIONAL OWNERSHIP INTERESTS?

Shared ownership can be a significantly less expensive and more attractive option for some prospective purchasers of a new development, giving some buyers an incentive or opportunity to purchase that would otherwise be lacking. The builder or developer can thus open up a new market and access a different group of potential customers by offering fractional ownership, a particularly attractive opportunity when whole ownership sales are slow. Marketing a less costly ownership option may also increase the overall visibility of, and traffic to, the project sales sites, and increase sales volume of whole ownership. Finally, opening a project to fractional ownership will generally increase overall usage of the property, which can enhance the viability and financial performance of amenities and ancillary services such as a spa, golf course, ski resort, or restaurant.

WHY WOULD A REALTOR CONSIDER SUGGESTING FRACTIONAL OWNERSHIP TO A POTENTIAL SELLER OR BUYER?

The concept of fractional ownership is unknown to many developers, builders, sellers and buyers, and

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even those aware of the concept are often unclear on its potential advantages. A Realtor who understands shared ownership concepts can often obtain a listing or make a sale that other Realtors cannot, open up a new avenue of marketing, or achieve a higher sales price. Knowledge and understanding of fractional ownership can be a particularly useful tool in times or areas where transaction volume for traditional sales is slow or seasonal.

WHAT LEGAL RESTRICTIONS APPLY TO FRACTIONAL OWNERSHIP?

Legal restrictions on fractional ownership can be grouped in four general categories: (i) national or state real estate law, (ii) local real estate law, (iii) private deed restrictions, and (iv) national or state securities or investment law. Even where a group of friends and family is purchasing the property to share, and therefore fractional interests will not be marketed to the general public, legal restrictions on fractional ownership may apply at some point in time, particularly when one of the co-owners needs or wants to re-sell his/her fractional share.

In the US, fractional ownership real estate law varies from state to state. Which law applies depends on where the shared property is located, how and where the interests will be marketed and, in some cases, where the buyers live. To determine which national or state real estate laws apply to a particular fractional ownership arrangement, it is necessary to determine how many interests will be offered, the general structure of the offering, how and where the interests will be marketed, and who will be permitted to buy. When 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 fractional ownership is rare but increasing, particularly in resort communities. Private deed restrictions found in the governing documents of homeowners' associations (such as CC&Rs, Bylaws, Coop Agreements etc.) may also restrict or prohibit fractional ownership arrangements. Most local fractional ownership laws and private deed restrictions are triggered by the usage rights to be offered with the fractional shares, rather than by the number of owners or by the ownership structure. In other words, these restrictions are not imposed because fractional shares of property are being sold, but rather because they are being sold with the promise that one owner will be allowed to use a home or apartment at a particular time. Of course without the promise of some sort of defined and recurrent usage right, the fractional interests are probably unmarketable.

National or state securities or investment law may also apply to fractional ownership 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 may result in expensive registration and compliance requirements, advertising restrictions, securities deal licensing, and requirements relating to the wealth and sophistication of each purchaser.

HOW ARE FRACTIONAL OWNERSHIP USAGE RIGHTS DIVIDED ?

Regardless of whether one is a fractional developer of a multi-unit fractional property, Realtor or seller for a single home to be offered fractionally, or organizing a group of family or friends for a shared property purchase, deciding how the shared property will be used is usually the first step in structuring the fractional ownership arrangement. Usage structure will dictate most other elements of the

fractional ownership arrangements, and become the most important and valuable benefit of ownership for the fractional owners.

In analyzing the various fractional ownership usage options, it is important balance predictability against flexibility, and also to remember that co-owners will exchange usage rights among themselves regardless of which system is adopted. The choice of fractional ownership usage allocation structure should be driven by the property location and size, its seasonality, the likely length of visits, and the manner in which people are likely to travel to the shared property. In addition, consider the complexity and cost of operating the fractional ownership usage system in light of the number of co-owners, and remember that a complicated or labor-demanding system will be subject to failures and manipulation and add to the co-owners' dues.

The most popular model for fractional ownership usage is the "Usage Assignment Approach". Each co-owner is assigned the exclusive right to use a 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. In multi-unit fractional properties, the usage rights can be to a particular home or unit, a group of homes or units (such as all of the three-bedroom units, or all of the sea-view units), or all of the homes or units. Purchase price can be influenced by the amount and/or quality of usage allocated to each co-owner. Usage rights can be restricted to owners only, or extended to family, friends, rental tenants, exchanges, or any combination of these. Different usage rights may apply to different usage periods. Usage periods can be assigned through an annual rotation among the Co-Owners of preset groups of days, weeks or months, an annual selection or draft process based on a rotating system of selection priority, a reservation system, or any combination of these usage systems.

A less popular model for allocating fractional ownership usage rights is the "Pay-To-Use Approach". 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. 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 FRACTIONAL OWNERSHIP EXPENSES DIVIDED?

In shared ownership arrangements involving a single home, 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 jurisdictions where 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.

In fractional ownership arrangements involving multiple units, the developer must first determine whether usage of each co-owner will be restricted to a particular unit or units, or whether all co-owners will share use of all units. In the former case, the developer may opt to have each co-owner contribute only to the costs of operating the unit or units to which he/she has usage rights.

HOW ARE FRACTIONAL OWNERSHIP TRANSACTIONS FINANCED?

Industry surveys have shown that only 30-35% of fractional ownership purchases involve financing, and 65-70% of fractional interest purchasers pay all cash for their fractional ownership interest. Historically, when fractional ownership arrangements involving a single house or apartment were financed, the only available option was to obtain a group mortgage secured by the entire home. Larger projects could obtain fractional financing, where each fractional owner could get his/her own loan secured only by his/her ownership interest. More recently, individual fractional financing became available for fractional ownership arrangements involving a single house or apartment, but events in the lending industry have slowed this trend.

If there will be a group mortgage, the fractional owners 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. 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 vacation home, and plan to buy it with a \$100,000 down payment and a \$400,000 shared 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 with \$10,000 down, meaning they will need to borrow \$90,000 of the \$400,000 group mortgage or 22.5% (90/400). Family #2 will be buying a \$100,000 share with a \$30,000 down, 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 with \$20,000 down, meaning they will each need to borrow \$80,000 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%.

HOW ARE FRACTIONAL VACATION HOMES MANAGED?

It is useful to divide fractional ownership 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.

Usage allocation management is necessary only in relatively complex usage systems, such as those that are based upon reservations or involve a pay-to-use element. Simple usage systems, such as fixed assignments or fixed rotations, do not require any management and are therefore less expensive and more reliable. Keep in mind that systems that are supposedly automated or web-based still require monitoring, upkeep and backup (when (not if) the system fails), so someone must be in charge of

managing even the most automated usage system.

Accounting management involves collecting payments from co-owners, paying bills, and keeping records. To avoid shared ownership disputes and cash shortfalls which could result in credit blemishes and even loss of the shared 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, an owner or manager estimates all of the expenses for the following year, including group mortgage (if any), property tax, insurance, maintenance, repairs, improvements, utilities and management, 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. 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.

Cleaning is a management task with a surprisingly high potential to cause displeasure and discord among fractional owners, particularly in small co-ownership groups sharing one home or apartment. 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 one is supposed to be on vacation when using the home, and may not want to have to spend the last day of vacation cleaning. For all of these reasons, I strongly advise even the smallest and least formal vacation home co-owner groups to employ a cleaner or cleaning service to clean the property on a regular basis. 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 shared ownership is that the cost of this type of service can be spread over the entire group.

Repair management is important because without it, no one person is responsible for keeping the fractional property 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 VACATION HOME FRACTIONAL OWNERS MAKE DECISIONS?

In fractional ownership projects organized by a developer or property seller, the developer/seller must determine how much power to give the owners, how various types of owner decisions will be made (managing board versus owner vote, majority vote versus super majority versus unanimous), and how the transition between developer control and owner control will be handled. Where the fractional project involves multiple units, the seller/developer whether certain decisions should be made by

subgroups of owners (or governing board elected by subgroups) based on divisions of usage rights and/or maintenance obligations. In other words, should decisions about a particular unit or units be made by all owners, or only those owners whose usage and/or payment obligations will be affected?

Regardless of how many owners and homes will be in the fractional ownership group, and whether the shared ownership arrangement has been created by a seller/developer or by the fractional owners themselves, 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 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.

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. 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.

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.

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".

"Pure Second Home" tax treatment is used 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.

“Pure Rental Property” tax treatment is used 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, there could be up to 22 “personal use” days; if there were 100 “rental” days, there could be up to 14 “personal use” days.) With “Pure Rental Property” tax treatment, 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.

“Second Home/Hobby Rental” tax treatment is used when neither of the other categories apply. With this tax treatment, 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 fractionalized, 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. 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 the seller has occupied the property as a primary residence for two of the five years immediately preceding the sale, he/she will not qualify for the \$250,000 single/\$500,000 married exclusion from capital gains tax. But the seller is likely to qualify to have any profit taxed at the lower long-term capital gains rates, and may qualify to complete a tax-deferred exchange. In general, the tax treatment of profit or loss on resale will depend upon how the property was used in the 12 months preceding the sale. When 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.

WHY WOULD AN OWNER OR REALTOR SELLING AN ENTIRE PROPERTY DEVELOP THE FRACTIONAL OWNERSHIP STRUCTURE AND AGREEMENT BEFORE MARKETING? WHY NOT LET THE BUYERS DEVELOP THEIR OWN FRACTIONAL 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 fractional shares is virtually impossible without having a structure and documentation 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 SHARED OWNERSHIP AGREEMENT OR FRACTIONAL GOVERNING DOCUMENT IS NEEDED FOR A 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). The document or documents must be prepared in view of the fact that it/they will only be used if the owners disagree, and will only be useful if it can resolve the disagreement (more on this later).

Where the fractional owners will hold title to the property (a "direct ownership" arrangement), governing documents fall into two general categories: (i) those that are recorded in the chain of title and thereby become binding on each fractional interest owner without that owner's signature, and (ii) those that are unrecorded and bind only those fractional owners 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 shared 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 group financing. A common misconception is that co-owners obtain “separate deeds” only if there are recorded fractional 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 say 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”, “Shared Ownership Agreement”, “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, and the entity may be for-profit or nonprofit. Sometimes the entity actually owns the property and the co-owners own the entity (discussed more fully below), but in most cases 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 exist. 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 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.

SHOULD VACATION FRACTIONAL OWNERSHIP AGREEMENTS BE KEPT SHORT AND SIMPLE?

No one reads co-ownership documents for pleasure. The only time one is likely to read the documents is if there is a conflict that can't be resolved informally. In that situation, one wants the shared ownership agreement 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 one to look at the agreement. The advantage of length is that it allows the co-ownership agreement to cover more issues, and makes it more likely to be helpful. There is no disadvantage to length, as long as the document has a complete table of contents. Simplicity is desirable, as long as it doesn't come at the expense of breadth.

WHAT HAPPENS IF A FRACTIONAL INTEREST OWNER DOESN'T FULFILL HIS/HER OBLIGATIONS?

While co-owner default is a major potential risk of shared 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 shared 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 fractional owner even if he/she has defaulted, it is also important that a fractional 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 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 shared property 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 fractional share 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 fractional 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 that causes a fractional property owner to simply forfeit his/her ownership, investment or equity, is generally unenforceable and therefore useless to the group.

It is advisable for fractional ownership 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 a defaulting fractional interest 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 fractional 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 OWNERSHIP USE A LIMITED LIABILITY COMPANY (LLC), OR LIMITED PARTNERSHIP (LP) OR LIMITED LIABILITY PARTNERSHIP (LLP)?

Owning a vacation home as a limited liability company ("LLC"), limited partnership ("LP"), limited liability partnership ("LLP" which is not possible in the US), corporation, or other entity (rather than in the names of the co-owners) can offer several advantages, including (i) protecting other assets from liabilities arising from fractional ownership, (ii) protecting the shared property from seizure by creditors of 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 through an entity offers additional advantages which are discussed below.

But owning a vacation home through a LLC or other entity also has drawbacks. Creating and

maintaining the entity structure involves extra costs, 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, using an entity may deprive the fractional interest 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 fractional property through an entity must be answered on a case by case basis in light of the particular circumstances of the group and the 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 FRACTIONAL OWNERS BE ALLOWED TO SELL FREELY THEIR SHARES OF THE SHARED VACATION HOME?

Those who own a shared property 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 fractional interest owner to exit the group without selling his/her interest to another fractional owner. The problem with this situation is that no other co-owner may be interested in purchasing an additional fractional 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 the issue of fractional share resale is that personalities change, 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 fractional ownership re-sales be allowed, subject to restrictions intended to protect the group from incompatible or unqualified buyers. These protections may 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 fractional owners to leave the group. Allowing co-owners to sell individual shares is one way to make leaving possible, but selling shared property interests may be difficult or impossible due to market conditions, bad group dynamics, the condition of the shared property, or other unpredictable factors. So even if individual fractional interest 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 shared property.

WHAT KINDS OF RISKS DOES VACATION FRACTIONAL CO-OWNERSHIP CREATE?

Fractional 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 shared 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 shared ownership is to have a thorough, written, signed fractional 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 a shared ownership agreement, these steps will help diminish the risk of fractional 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 fractional ownership agreement and fractional ownership structure.

Owning the fractional property through an entity created in a jurisdiction with a well-developed and familiar legal system, and an effective alternative dispute resolution infrastructure (so that you do not

need to rely on a slow and expensive court process) can help solve many of the difficulties associated with shared vacation property located abroad. This arrangement allows sales and rental transactions to occur in a familiar language and under familiar rules, 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 foreign entity fractional ownership structure enables the relationship of the co-owners to be governed by well-developed and familiar laws, and any disputes the co-owners to be resolved more quickly, reliably, and cost-effectively. 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 available at www.andysirkin.com. Mr. Sirkin has been working with co-owner groups since 1986, and has prepared co-ownership agreements for over 6000 clients. Mr. Sirkin can be contacted via email at DASirkin@earthlink.net. Mr. Sirkin can be reached by telephone at 415-738-8545.