A Closer Look

Building a Lasting Family Legacy: Holding Real Estate Investments in Trust

Andrew M. Feder
Head of Real Estate Advisory

Wally Hachil
Real Estate Asset Manager

In Brief

- **Holding real estate investments in trust can be a central part of a family legacy, providing income, appreciation, and portfolio diversification for current and future generations.**
- **Many trustees, perhaps misunderstanding the regulatory framework and the unique economics of holding these assets, are reluctant to include directly held investment real estate within a trust.**
- **For experienced trustees with the requisite knowledge and specialized skills, it is possible to hold real estate investments in trust successfully and without incurring excessive risk.**

When it comes to estate planning, placing real estate in trust can provide valuable benefits, including minimizing estate taxes and avoiding probate, among others. Income-producing real estate in particular has the potential to provide meaningful income, appreciation, and portfolio diversification for current and future generations.

But managing such assets in trust is not straightforward. Regulations, both federal and state, are not friendly to real estate investments held in trusts. Moreover, unlike typical trust assets, such as stocks and bonds, real estate can have rental income that needs to be appropriately allocated and ongoing capital requirements that need to be funded. Meeting these obligations poses a variety of complexities and challenges when the assets are held in a trust.

This doesn't need to be a deterrent, but it does mean that it's important to work with trustees skilled in the diverse — and at times conflicting — aspects of handling income-producing real estate assets in trust.

Dealing With Complex Regulations

Federal regulations complicate long-term investment in real estate. Although the OCC (Office of the Comptroller of the Currency) guidance recognizes that real estate assets are hard to value, a trustee, unlike a typical owner, is required to value assets on a periodic basis, typically every three years. There is no consideration of adverse market conditions that can result in large fluctuations in market value. These frequent revaluations — due to appreciation and the use of other trust assets to fund capital improvements for the real estate assets — can increase the percentage, or concentration, of these assets in the trust over time, distorting intended asset allocations.

In addition, the Uniform Principal and Income Act and various separate state regulations complicate this issue by not explicitly dealing with the nature of capital investment in real assets. Without going into all the detail of these regulations, it can be relatively easy for an

inexperienced trustee to misinterpret the guidance when examining the many constraints and responsibilities for managing this type of asset. For example, a trustee can inadvertently allocate rent inappropriately and distribute gross rent as income to the income beneficiary, unintentionally concentrating the trust. In most cases, it would be more appropriate to distribute net rent (see Determination of Net Rental Income below). Unfortunately, this mistake is common and can lead to a host of potential ills beyond concentration, including effective distribution of principal, perception of lease income as an outsized yield (which can influence leasing strategy and asset retention), dilution of the residue, and a perception of outsized risk.

Capitalization for Real Estate Held in Trust Adds to the Complexity

Real estate requires reinvestment since improvements — such as structure, equipment, roofs, and fixtures — depreciate over time. To successfully retain real estate within a trust over the long term, a trustee needs to understand the capital consumption and reinvestment fundamental to real estate life cycles. There are two components to this: (1) planning for and funding from available capital resources the expenses necessary to lease and extend the useful life of the asset, and (2) understanding how to allocate a portion of gross rent receipts to repay capital investment by the trust.

As we mentioned above, the way trusts are capitalized is, in general, different than it is for typical owners of real estate managing their balance sheets as active investors. Unlike most owners of investment real estate, a trust holding investment real estate generally needs to look to its own resources for capital, and most trustees will typically be cautious in using anything more than modest amounts of debt to provide funds for capital expenditures. Recognition that a trust will need liquid investments available to provide for capital reinvestment is critical. Let's use an example to illustrate these concepts:

A trustee is managing a trust with $60 million in total assets of which investment real estate comprises 20%, or $12 million. The balance of the portfolio consists of securities. The real estate owned by the trust consists of several properties including a 200,000-square-foot industrial building that is leased to a single tenant who is vacating the premises at the end of its lease.

To attract and secure a new tenant, the costs associated with re-leasing vacant space — such as tenant improvement costs, brokerage commissions, and legal fees as well as other capital improvements (such as replacing the HVAC system or roof, or repaving) — will need to be covered. Let's assume that all of these capital expenditures total $750,000.

The trustee has to decide whether to sell the asset or raise the funds necessary to pay for these capital improvements. Unless there is an alternate use, a sale of a vacant property is likely unattractive, and re-leasing the building may be the better long-term option. (Consideration also needs to be given to prevailing market conditions, including discussion with qualified local brokers and review of market comparables to determine the net effective rent that can be achieved on re-leasing as well as projection of cash flows and yields on investment.) To raise the necessary funds, the trustee can either borrow the money or liquidate other trust assets. Conceptually, the trust would be lending money to the asset, which would lead to potential issues regarding the interests of income and residuary beneficiaries as well as some regulatory considerations. Over time, ignoring these issues could result in a trust having an unwanted concentration in real estate and potentially reduce the residual, or terminal, value of the trust.

Going back to our example, let's assume the trustee decides to liquidate certain securities to fund the $750,000 in improvement costs to re-lease the building. Not only may the sale of other trust assets expose the trust to other issues, such as capital gains taxes, but it may also impact the total return on the trust portfolio, potentially resulting in lower distributions to the income beneficiaries.

In order to avoid this trap and to provide for the ongoing capital needs of this type of asset, portions of the gross rental receipts received should be reserved in an amount sufficient to provide for a return of — and return on — the capital invested in the property.

Are You Hoping to Keep a Cherished Home in the Family?

Retaining a personal residence in the family for future generations to enjoy is a frequent and understandable desire — but doing so comes with its own set of challenges.

For instance, some of the same funding issues that apply to income-producing investment properties would still pertain as the home ages — and maybe pose even greater challenges since family homes in most cases do not produce any income of their own. Often, strong emotional connections to the property are involved as well, and you would need to grapple with the relationships between family members, the diverse financial capabilities of individual family members, and the inevitable differences of opinion about how to keep, use, and improve the home. In our experience, such efforts are rarely successful, and we typically advise against it.

That said, a trust arrangement can offer greater control of property management and decisions regarding the use of the property. It can define roles and expectations for the next generation, and it can provide protections for the property in the event of divorce, family disputes, and actions by creditors. For more information about multigenerational retention of family homes, please see our A Closer Look, "The Real Estate Legacy Challenge: Keeping Your Home in the Family."

Determination of Net Rental Income

Determining how much of the rent can be distributed as income and how much should be retained by the trust to pay for maintaining or improving the property is a complex process, and failure to do so effectively can have negative implications for the long-term health of the trust.

For instance, when receiving rent, trustees need to adjust the net effective rent available for distribution as income by deducting the value of the costs incurred to secure the lease — such as administrative, management, and legal expenses, and others.

Allocation of rent in improved real estate will also require an understanding of how to determine the net distributable income to ensure the appropriate allocation is made to principal and income. Gross rent from improved real property is comprised of a return of and a return on invested capital, including land and improvements. Improvements (buildings, paving, infrastructure, plant, and other equipment) are wasting assets. The retirement over the useful life of the asset is a typical real estate investment concept and is reflected in the tax treatment of these assets through depreciation.

Added to the retirement of improvements in the real estate are leasing costs, which may, to the extent they are not expensed, include landlord concessions (free rent, for example), tenant improvement allowances, leasing commissions, and legal costs. Accounting for the expenses and capital needs of investment real estate requires special consideration. Each of these expenditures would need to be deducted in whole or part in order to determine distributable net cash flow or net effective rent available for distribution as income.

Holding Real Estate Investments in Trust Can Provide Long-Term Benefits

While it may pose a number of complexities, long-term real estate investment by trusts is possible with appropriate trust capitalization and an understanding of the limitations posed by the regulatory environment. In the end, holding real estate investments in trust can prove to be a cornerstone of a family legacy, providing income and appreciation for many generations to come. Having a trusted advisor with the ability to manage investment property can facilitate your long-term goals.

Bessemer's skilled real estate and estate planning professionals have long experience managing investment real estate assets in trust. If you would like to discuss this subject further, please reach out to your client advisor.

Our Recent Insights

Maximizing the Power of Old Annuities Through Private Placement — Wealth Planning Insights (October 2021)

Changing Your State of Residence — A Closer Look (August 2021)

Retirement Planning for the Self-Employed — A Closer Look (July 2021)

Do Roth IRA Conversions Still Make Sense? — A Closer Look (July 2021)

Premarital Agreements and Their Alternatives: What to Consider — A Closer Look (June 2021)

Planning for Incapacity — A Closer Look (June 2021)

When Your Child Becomes a Legal Adult — A Closer Look (April 2021)

Planning for Today's Residential Construction Project — Wealth Planning Insights (February 2021)

Managing Your Oil and Gas Interests — A Closer Look (February 2021)

Making Changes to Irrevocable Trusts — A Closer Look (January 2021)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

This material is for your general information. It does not take into account the particular investment objectives, financial situation, or needs of individual clients. This material is based upon information obtained from various sources that Bessemer Trust believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation. Bessemer Trust or its clients may have investments in the securities discussed herein, and this material does not constitute an investment recommendation by Bessemer Trust or an offering of such securities, and our view of these holdings may change at any time based on stock price movements, new research conclusions, or changes in risk preference.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • STUART • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

Visit us at bessemer.com

© 2021 Bessemer Trust Company, N.A. All rights reserved.