

The Challenges and Opportunities of Real Estate Families



Insights from Bank of America’s Specialty Asset Management team¹ and the Merrill Center for Family Wealth™



Families often view real estate as an essential part of their portfolio of assets and often a core aspect of their family identity. However, many families are challenged when it comes to passing these assets to future generations.

Many of our clients own investment real estate. The reasons for owning property vary. Some use property as leaseholds in their operating businesses. Some hold properties for cash flow. Others seek capital appreciation. Many hold real estate to balance economic risk. Yet all of these families view real estate as an essential part of their portfolio of assets and often a core aspect of their family identity. Wealth creators spend a lot of time and effort creating these successful real property assets, but they often struggle with how best to transition them to future generations. This white paper outlines the challenges and opportunities associated with real estate investments, and offers insights as to how families can work together to protect their interests.

¹ The Specialty Asset Management team includes employees of Bank of America, N.A. and its agents.

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The three critical challenges

1. Common interest

Often the rising generation isn't interested in collectively owning and managing real property. The reasons for this lack of interest is sometimes difficult to discern.

Even when the rising generation recognizes the theoretical value of the assets, managing real estate takes a substantial amount of time that some family members are unwilling to commit.² They see managing their parents' real property assets as taking away from the time they want to spend building their families and creating rewarding experiences for themselves. They would prefer to hold wealth in forms that allow hands-off management.

A lack of interest often stems from the perceived complexity of managing the assets themselves. Most family members rightly understand that managing property well takes a set of skills that they may not have developed. Sometimes the lack of interest is rooted in deeper family dynamics and concerns about divergent interests. Each family has its unique concerns about whether it will continue to manage assets collectively. It is important to understand what lies at the bottom of their trepidation.

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While some assets hold deep emotional ties within the family (such as "the family farm"), others are primarily viewed as economic opportunities (a warehouse). Some holdings can provoke ideological controversy within the family and between generations (for example, mining, oil and timber interests). These differing responses to the real property can create difficult family dynamics or ambivalence. With the rise of ESG³ investing and sustainability concerns, Gen X, Millennial, and Gen Z family members are often more interested in the externalities generated by the capital structures of their parents and grandparents and even their siblings and cousins.



Meet the O'Malley Family

In this real estate family, the patriarch had been a developer and held a number of apartment buildings and some commercial properties. When he passed, his six children were tasked with managing the properties. They meet twice a month to discuss numerous issues including marketing, rental/vacancy rates, financing and federal and state tax matters such as like-kind exchanges, Qualified Opportunity Zones, conservation easements and proposed tax law changes. Two members of the family are employed in a small family office dedicated to managing the family's commercial real estate.

² While the patterns and issues of the families discussed in this paper are common to the client families we work with, they do not reflect the realities of any single family.

³ ESG stands for Environmental, Social and Governance and focuses on corporate policies and impact beyond simple performance metrics. There are an increasing number of studies that demonstrate that paying attention to stakeholders actually enhances investment performance.

2. Daunting complexity

Real property takes time to manage properly. This becomes exponentially more complicated as assets are passed down to rising generations.

There are inherent complexities in managing any form of real property. The family members must understand things like capitalization rates, lending structures, macro-economic cycles, commercial liability, property insurance, taxes, regulatory strictures, and so on. Residential properties are subject to landlord-tenant laws and local rent control ordinances. Some commercial and undeveloped properties are subject to state and federal laws such as The Clean Water Act, The Clean Air Act, CIRCLA, The Endangered Species Act, The Migratory Bird Act, The Coastal Zone Management Act as well state level forestry and environmental laws. Developing the skill set to address this complexity can be daunting. Many families that manage their assets directly must become knowledgeable about all of these issues, and work with legal, tax and banking advisors to ensure compliance with applicable laws, ordinances and regulations.

As if this were not enough, most assets passed to the rising generation will come wrapped in legal structures. Rarely will an inheritor acquire such assets shorn of structures. Instead, they will inherit structures such as LLCs, FLPs and beneficial interests in trusts. There are good reasons to hold real estate in these structures — they work to compartmentalize and limit potential liability, and facilitate administrative flexibility and efficiency. Importantly, these structures often generate very substantial estate, generation-skipping, income and gift tax benefits. Understanding these structures — why they exist and how they work — can feel like a full-time job.

These structures all have singular governance processes and rules related to legal ownership or control, on the one hand, and beneficial or economic ownership on the other. This bifurcation of who controls the assets and who benefits from them can set off some challenging family dynamics. The beneficial owners will often seek more distributions of income and capital while those who control the assets will often want to preserve the capital and reinvest income to grow the entities. When family members are compensated for their roles, or make decisions deemed ill-advised by the beneficial owners, disputes can arise and could threaten the family's peace and harmony as well as their shared wealth.



Meet the Petrocelli Family

They own multigenerational agricultural and timber property as well as a diverse set of commercial and residential properties in several states. These properties are held in a series of 48 entities which are further held by two holding companies. In turn, these various entities are held in four irrevocable long-term trust vehicles. The family created a family office to administer the trusts and the underlying entities, and, of course, to manage each real estate property. When they came to us, the family was divided over the time and energy required to manage the assets, the fairness of the distributions, costs, salaries and administration. Some family members had retained lawyers and it looked like litigation might be around the corner.

3. Cohesion

With competing interests, differing visions and daunting technical challenges, it is no wonder that creating family cohesion can be difficult. In many second-generation families, siblings are not used to working as a team. They often don't share a common vision, and roles are often confused or not well-defined. With a lack of conflict resolution skills, what should be rational conversations often end up as disputes. These problems only become more complicated when the third generation comes on board—cousins may not know each other and yet share ownership or interests in entities established for them by their grandparents and parents, in many cases before they were born. Different family members might have different lifestyles or economic circumstances and needs. One sibling might be trying to put children through private school, another might be wealthy in her own right, while some are working and others are not. Some have younger children at home and their attention is focused on the challenges of raising their family. Beyond that, families often have to address different values and perspectives on investing in general. They might have to address ideological differences or varying views and risk tolerance about markets and the timing of decision making. Creating a tailored successful approach to managing the common interests can be challenging when there are so many variables and issues at play.



Meet the West Family

The family owns five apartment buildings, which they inherited from their developer father. All were in agreement on the big decisions, such as whether to retain or sell the assets and how best to finance them. However, even though they were close, the three siblings have very different ideas about managing the buildings. Two want to do minimal upkeep to boost profitability, while the other wants to ensure that the apartments are nicely appointed to increase capital value and marketability. They tend to have endless, exhausting meetings on what fixtures to purchase, what colors to paint the buildings, and what upgrades to provide when a unit becomes vacant. While they seem to ultimately arrive at a decision, they are tired of the endless wrangling over every detail of property management.

The three golden opportunities

1. Economic vitality

Perhaps the most obvious opportunity lies in the fact that real property is often a stellar investment. While it is possible to get better than market returns in equities, it requires substantial risk and keen insight. Real estate tends to follow a slower and longer market cycle and carry with it more easily identified risk-return calculations. Capital appreciation in real estate can be substantial and cash flow can create significant income. Real assets, like commercial and residential real estate and natural and mineral resource properties, can be an attractive alternate asset classes for ultra-high-net-worth families to generate diversification.

Capital appreciation in real estate can be substantial and cash flow can create significant income.

2. Family culture

Many of our client families who created their wealth through real estate understand how it works and feel comfortable with it. These families often live and breathe real estate. Often, members of the rising generation are managing some of the real estate and are learning the complexities on the job. Others may have worked as they grew up doing jobs related to the family-owned real property, such as helping out on the farm, or doing odd jobs in an apartment building. Real estate is thus an integral part of the family identity and culture and, as such, becomes a rallying point for generational continuity and cohesion.



3. Developing the rising generation

Because real estate is tangible, it often provides the opportunity to teach the rising generation about personal finance, wealth structuring, governance, business and even philanthropy. Even more importantly, it can help foster a work ethic and the spirit of teamwork in each generation, with various branches of the family coming together to manage the family's entities which in turn hold the real estate. In many families, the entities themselves become a kind of “glue” that keeps different parts of the family in contact and in sync — enriching relationships as they face common challenges.

Three keys to success

While the challenges are substantial, there are workable solutions. We believe that these include creating a shared and enduring vision, appropriate education, scaled support and ongoing development of family culture.

1. Creating an enduring vision

Families do well over generations when they commit to four core principles.⁴ First, they should commit to continue. What tends to hold families together is recognizing that they are better off together than they are individually. This level of well-being includes both the economic and the social side of the equation. Many families believe that they are better when their children know their aunts, uncles and cousins, and when family culture is sustained in ways that allow all family members to flourish. They believe that they will do better when they use a broader base of capital and intellectual thought leadership to build financial wealth.

The second commitment is to care for one another. Families tend to follow the motto “One for all and all for one,” in that the best way to ensure the well-being of each individual is to ensure the well-being of the whole family system.

Third, families should commit to being honest and open with each other. These families have robust, frank debates and encourage different perspectives on the assumption that every family member’s opinion has value and is worth sharing with others.

And finally, families should commit to curating a learning environment. They believe that some failures and mistakes are inevitable, but if they continue to learn, grow and evolve, they will ultimately succeed.

Beyond the four commitments outlined above, families should forge a shared vision that protects both the individual and collective interests of the family, now and for future generations.⁵ This vision should recognize that there are tradeoffs, with individuals having to give up a bit of autonomy to gain greater economic and personal freedom. A vision for the family enterprise (in this case, real estate) is often forged in family meetings, discussions and working groups. The governance required to create the vision lays the foundation for the teamwork that will be needed later. Often the family leaders in the incumbent generation will help the next generation forge its agreements, alignments and accountabilities.

Families should forge a shared vision that protects both the individual and collective interests of the family now and for future generations.⁵

⁴ The qualities of successful families are explored in the Merrill Center for Family Wealth’s *The Learning Family: An Approach to Family Development* whitepaper, 2018.

⁵ While this sounds idyllic, we all know that it is easier said than done. While some family members may align, others may want to go their own way. Wealthy families realize that keeping people in the family enterprise against their will is neither good for the individual’s nor for the family’s well-being and economic vitality. Therefore, families will develop exit strategies that allow family members to go their own way. Rare, but just as important as creating these off-ramps, is the value of creating on-ramps for those who want to come back either in the generation that exited or the following generation. We have seen cases when a parent in the second or third generation makes a decision that affects their children and then those children later want the opportunity to re-engage.

2. Engaging in appropriate education

As discussed above, families must master a lot of information and skills. Some family members will go through formal training and others adopt informal approaches. Almost all families benefit from hands-on experience with real scenarios they will eventually have to manage. Perhaps, to start, a sibling group takes on a single apartment building or is responsible for refinancing. Over time, their tasks can become progressively more complex. They will work with lawyers, accountants, bankers and other professionals. This gradual process can not only teach the siblings about the technical aspects of their properties and structures, but also reveal how much of their time they wish to commit to the family business and what roles suit them best.

3. Developing scaled support

While many families will find themselves managing real property in the second generation, most have delegated that responsibility to a professional non-family member. In Latin America, the wealthiest family enterprises often own a vast array of business entities, real estate and other investments. These are called grupos.⁶ Rarely do the children manage any of these entities directly. Instead, as trustees and board members of various entities they retain professional managers who can run them. This provides several benefits for the families. They don't have to become experts at everything — instead, they hire the experts. And by giving up day-to-day management and short-term tactical decision-making, they can focus on strategic long-term growth. Perhaps most importantly, they free up time to live their lives. In practice, most third- to sixth-generation families in the U.S. end up using a similar model.⁷ This approach allows the family to become truly great at one thing — governance — which is the key to sustaining and growing wealth.

Delegating responsibility to a professional

The O'Malley and West Families engaged the Merrill Center for Family Wealth and a Merrill Wealth Strategist to hold a series of family meetings to forge a common vision and learn about the various structures in play. After extensive discussion and exploration, they decided to engage Bank of America's Specialty Asset Management team¹ (SAM) to provide professional day-to-day management and oversight of their real estate.

⁶ Grosse, Robert, *The Role of Economic Groups in Latin America, Can Economic Firms Compete?*, Oxford Press, 2007.

⁷ See Jaffe, Dennis, *Good Fortune: Building a Hundred Year Family Enterprise*, 2013.

When families seek these solutions, they will either create a family office or outsource property management and trustee services to an institution they trust. While creating a family office might sound attractive from the perspective of perceived control, it is often a suboptimal solution. Family offices are expensive and are only rarely able to replicate the best-in-class advice they will receive from professionals. The economies of scale typically do not pencil out for families with less than \$200 million in investible assets. Even families with large fortunes, find that a family office with robust capabilities only adds to the organizational complexity they already face. Retaining corporate management is often less expensive and more efficient. Moreover, when all the day-to-day technical management and compliance work is left to professionals, the family can focus on higher-level strategic decisions. Bank of America's Specialty Asset Management team¹ is adept at managing complex real estate and other specialty assets and can help ensure compliance. In addition, outsourcing to corporate trustees or managers could help shield the family from risk and liability.⁸ Finally, they can also bring investment opportunities to the family that they would not otherwise be able to access.

Outsourcing the day-to-day to focus on other opportunities

The Petrocelli Family decided to retain Bank of America's Specialty Asset Management team¹ (SAM) and outsource the administration of their trust to Bank of America Private Bank. This freed up hours of time, quelled family disputes and allowed the family to invest more strategically. Through SAM, the families also discovered other opportunities beyond their local markets, which they might not have otherwise known about.

Conclusion

While the challenges are daunting, families that can align, learn and grow as real estate families often do better over multiple generations than other families. When they can create and maintain a shared vision, develop the requisite skills and work well with non-family professionals, they tend to avoid issues that can sometimes plague families who are not prepared. Often real estate families raise children with a solid work ethic, develop deep intergenerational bonds within the family and create vibrant economic wealth that supports family members as they seek to realize their dreams.

⁸ It is important to note that family members who are trustees are personally liable for their actions and are therefore putting their own assets on the line if they make a substantial mistake.

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