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HIGH-NET-WORTH FAMILIES IN PRESERVATION MODE

Recession has some investors looking for opportunities, others playing it safe

By MANDY JACKSON
CREJ Staff Writer

As the global recession continues to put downward pressure on commercial real estate values in the near term, high-net-worth individuals and families remain focused on preserving their wealth for years - and generations - to come. Investors can take advantage of declining values to reduce the tax burden for the real estate they plan to pass on to their children and grandchildren. They're also assessing opportunities for adding properties to their portfolios at reduced prices.

Brad Cohen, partner in the Los Angeles office of law firm **Venable LLP**, said estate planning generally tends to be countercyclical. For high-net-worth individuals and families, an economic downturn - especially one with the current combination of reduced property values and low interest rates - is the opportune time to take advantage of the reduced value of their assets so that interests in real estate or indirect interests in entities that own real estate can be transferred from one generation to another with a lower transfer tax consequence.

For example, individuals can sell their real estate interests through an entity, such as a limited partnership, at today's reduced values and financed at low interest rates to an intentionally defective grantor trust for the benefit of their children and later generations. The use of defective grantor trusts removes the income tax obligation for the income earned from the properties, putting that obligation on the parents or grantors.

Using a limited partnership or a similar entity to sell the assets to the grantor trust allows the value of the assets transferred to be discounted to account for the children's limited ownership and lack of control of the assets in addition to the market forces that are pushing values lower.

However, President Barack Obama's administration has expressed interest in eliminating discounts that apply to transferring assets among family members. Since it is likely that any change in the law would be prospective, rather than retroactive, there may be a short window of opportunity for families to benefit from those discounts, Cohen said. "We know what the government has a problem with," he said. "We insist that the plan has real substance and that we are not too aggressive with the discounts." Cory C. Grant, chairman and managing partner of financial advisory firm **Grant Hinkle & Jacobs**, and Jeffrey R. Stoke, partner at **Procopio Cory Hargreaves & Savitch LLP**, discussed such wealth transfer structures during a seminar titled "Utilizing Today's Real Estate Market to Increase Your Wealth," which was hosted by the University of San Diego's **Burnham-Moores Center for Real Estate** on May 28 at USD's Joan B. Kroc Institute for Peace & Justice.

Limiting Tax Liability

With falling property values and low interest rates for interfamily loans and sales, Grant said “now is a good time for parents to transfer their real estate wealth to their children. The applicable federal rates are 0.8 percent for short-term loans, 2.1 percent for mid-term loans and 3.6 percent for long-term loans.”

And timing is becoming a more important factor, since tax changes that would affect estate planning are pending, Grant said. The estate tax exemption for assets totaling less than $3.5 million may be eliminated. Also, some discounting techniques for assets that are traded between family entities may no longer be allowed. "Tax policy doesn't favor high-net-worth families and rates are likely to go higher," Grant said. That's why families should be looking at strategies that freeze the value of their assets and minimize the tax liability for future generations.

Stoke said it is important for the limited partnership and grantor trust structure to have a legitimate business purpose of owning and controlling real estate rather than just providing a means of avoiding estate taxes. There should be proper disclosure of property performance with regular reporting to shareholders. Many of these structures are audited, but they hold up well if structured properly.

Jason Kendall, president of Carlsbad-based **Kendall Farms** and **Kendall Investment Properties**, said at the USD seminar that if his parents had not moved the majority of their property ownership into a trust for the benefit of him and his siblings, then when his mother dies the properties would have to be sold quickly at discounted prices in order for the family to pay the estate taxes on their inheritance.

Kim Fletcher, president and chief executive officer of **Investors Leasing Corp.**, said at the USD event that he and his wife own 28 percent of their properties, but the other 72 percent is divided evenly among their six children in a trust. While the assets' values have increased substantially since 1990, the appreciation on the real estate ownership held in the trust is not subject to estate taxes.

While many high-net-worth individuals plan to hold their properties for the long term, others are assessing whether real estate is where they should continue to invest some of their money.
"A lot of investors have made a wrong turn into real estate. It's a great asset class, but in the hands of the wrong person it's not," said Rich Arzaga, founder and chief executive officer of San Ramon-based **Cornerstone Wealth Management**. If investors decide that they shouldn't own real estate, then they have to figure out how to diversify their investments and take advantage of tax treatments for selling properties at reduced values. If they decide to remain in real estate, private investors should analyze whether each of the properties in their portfolio are contributing to their goals, Arzaga said. "If not, this can be a wonderful time to switch out the real estate," he said. "Even if their property is valued lower, so is the next one they want to buy."

Arzaga advises clients to draw down money from existing lines of equity so that they have cash to cover unanticipated expenses or investment opportunities. They also might reduce dividends to family members to preserve cash for debt maturities or to make up for the loss of income in case a tenant moves out of a property.

For those who have cash to invest in real estate, Arzaga said now is the best time in seven or eight years to buy properties because prices are down across the board and capitalization rates have risen to a higher level of return. "People that have money are going out with cash and making these investments," he said. "If you put down all cash and get an 8 percent to 9.5 percent return, if you leverage these properties later on you can get a higher cash flow rate down the road."

Increased Scrutiny

Hale Behzadi, managing director and regional executive at **Citi Private Bank** for the Western United States and Western Canada, said the bank has seen its high-net-worth clients focus on preserving cash. While most feel as though there are good opportunities to buy commercial properties at reduced prices, Behzadi said the consensus is that it is not time to begin buying assets yet. Most lenders are not making debt readily available for such purposes, but she said Citi Private Bank is lending on the right opportunities in the right markets.

What private clients are most focused on now is refinancing debt funded by conduits for commercial mortgage-backed securities and some bridge loans. For the senior debt, they're looking for interim financing before loans reach maturity to get them through the next two or three years when a replacement for the old CMBS market may be ready to fund transactions.

If they don't have to sell, private clients are holding on to assets and maximizing the income that those properties are producing. To free up cash, Behzadi said, those investors are more likely to sell a third or fourth home rather than a commercial property because homes do not produce income and the upkeep can be expensive. "Our clients who have lines of credit with us have all asked to retain their lines," she said. "They want to keep their powder dry."

Many high-net-worth individuals and families have gotten into the business of buying loans or mortgage notes with the intention of eventually taking control of the underlying properties through foreclosure or some other means. "I haven't seen a lot of money go into anything that has a long lock-up [like private equity funds]," Behzadi said. However, private clients are showing increasing interest in hedge funds that plan to invest in assets with financial backing from federal economic recovery programs, such as the Term Asset-Backed Lending Facility provided by the U.S. Department of the Treasury and the Federal Reserve.

Scott Farb, managing principal in the Los Angeles office of **Reznick Group**, said a lot of high-net-worth individuals and families have been spooked by the state of the economy and high-profile investment fraud scandals, such as the $65 billion Ponzi scheme perpetrated by New York hedge fund manager Bernard Madoff. "A lot of these high-net-worth individuals and family offices are very concerned about their investments," Farb said. "I think what they're doing is highly scrutinizing the information they're receiving from various private equity funds and hedge funds that they're investing in." They're keeping in close contact with the sponsors of real estate private equity funds in which they've invested over concerns about investment strategies and the reduced cash distributions that they're receiving. They've also become very reticent to contribute more capital to those funds.

Like institutional investors, high-net-worth individuals and families are looking very carefully at new direct real estate investments, Farb said. He said the only investors who are going to sell in this market would be those who are highly leveraged and running into liquidity issues as a result of their other investments.

"But generally the high-net-worth individuals and family offices are not in a distressed situation and would not sell in a distressed market," he said. "Generally they'll have substantial net worth where they want to wait it out. They're more patient with their investments, assuming the long-term prospects and fundamentals of their investments are solid."

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