Family Business
THE GUIDE FOR FAMILY COMPANIES
www.familybusinessmagazine.com

Eight successful practices to sustain and grow wealth for generations

BY ROB ELLIOTT

The gravest threat preventing a family from passing along its wealth from one generation to the next is poor planning and management.

Creating significant family wealth is no small feat, and serious steps should be taken to ensure that wealth survives not only into the next generation, but also for future generations beyond that. Avoiding the outcome of "shirtsleeves to shirtsleeves in three generations," or the phenomenon whereby inheritors of wealth squander it before it reaches the fourth generation, requires discipline and vigilance.

It is essential that families take a holistic view of their wealth and incorporate a plan that includes investments, taxes, spending, philanthropy, specific methods for communication, and education and development of the next generation. These elements of family wealth are all intertwined, and each is an important part of a successful wealth preservation program.

Below are eight practices we think are essential to sustain and grow family wealth for generations:

1. Diversify wealth to reduce concentration risk. The old adage that "great wealth is best created through concentration and best maintained by diversification" remains as true as ever. The challenge of diversification from a single company (for family business owners), stock (for company executives), hedge or private equity fund (for alternative fund managers) or a particular sector can become difficult given the tax cost of diversification, comfort with that holding and an emotional attachment to the original source of wealth. But there is an abundance of negative examples that must be avoided, including single stock risk (WorldCom, Enron, AIG, etc.), fraud (Madoff, Barings Bank) and hedge fund blowups. Slow and steady wins the wealth preservation race.

Rob Elliott is vice chairman of Market Street Trust Co. (marketstreettrust.com).

2. Foster effective family education and communication. From a wealth preservation and legacy perspective, the family members who share in the wealth must be on the same page. Many families have suffered from an inability to develop an agreed-upon mission and governance system for the family's wealth, which can result in disaster, in terms of both the family relationships and the finances. That kind of agreement from the beginning is important in order to avoid litigation and disastrous breakups, occurrences that are all too common within families. The process generally starts with a respected family member understanding the need to engage the next generation in a dialogue. Often third parties can be helpful in organizing and facilitating these discussions. Outside advisers can help bridge differences and work with different types of family dynamics. Successful family communication must also include having fun with the process and bonding with one another.

3. Develop a rational spending policy that accounts for market downturns, taxes and inflation. These are all issues that present clear challenges to maintaining wealth over multiple generations. But excessive spending, while often less dramatic and immediate, can pose the biggest danger to wealth preservation. Lack of adherence to an appropriate spending policy can erode wealth either quickly, or over time in ways that are almost imperceptible. Most advisers would suggest a maximum annual spending rate of 4% to 5% of investable assets, given historic returns, taxes, fees and inflation. Good wealth advisers are proactive in counseling families about reasonable spending practices and help them set the parameters early.

4. Encourage an entrepreneurial spirit in younger family members. Sometimes the best defense is a good offense. In other words, creating more wealth can mitigate the issues one might have with preserving wealth. New wealth in later family generations will help overcome Malthus' law (the rate of population growth exceeds resources) and give later generations pride in their own wealth creation skills, as well as a feeling of ownership and responsibility for the wealth itself. Thoughtful senior-generation entrepreneurs need to find ways to develop the next generation's skills by mentoring younger family members, providing financial assistance and projecting a positive attitude about risk taking. Limiting younger family members to stewardship of wealth is not empowering enough.

5. Actively focus on income and estate tax minimization. With maximum income tax rates over 50% and estate tax rates over 40%, mitigating the tax burden over multiple generations is a daunting task. However, there are numerous strategies to reduce one's income tax burden that are well accepted by the IRS. These include tax-advantaged structures (partnerships, insurance, 529 plans, etc.), and specific investments (such as municipal bonds and venture capital). To reduce estate taxes, there are many strategies to shift the ownership of assets to future generations with little or no tax liability. Many opportunities, such as Grantor Retained Annuity Trusts (GRATs), can be used repeatedly and can protect large amounts of wealth from the IRS. Good estate planning is an ongoing process.

6. Select advisers who act as fiduciaries by putting the clients' interest first. Many financial firms still take the view that it is acceptable to sell a client an investment they view as "appropriate" or "suitable" given his or her profile. Generally, however, multigenerational families need trusted advisers (both firms and individuals) who are independent, unconflicted and true fiduciaries. A fiduciary must make every decision based on what is best for the family, not just what is suitable for the family.

7. Make philanthropy a part of the family enterprise. Philanthropy is obviously an important vehicle for a family's tax plan, but for families preserving wealth from one generation to the next, it can be much more essential than that. Families who give back to society more often develop a sense of purpose for their wealth, and this can be a cornerstone of wealth preservation and family unity. Family philanthropy should start with a dialogue about shared values and mission, a search for common ground and causes, and a discussion of how the family envisions its legacy. Each generation may have different causes that they wish to support, and those causes can become part of the overall family philanthropic mission. The most important thing is that the whole family supports the passion of each family member.

Many families have suffered from an inability to develop an agreed-upon mission and governance system for the family's wealth.

8. Nurture the family's human capital. The skills, passions and aspirations of each family member must be recognized and encouraged. Successful family meetings include a discussion of younger family members' goals and pursuits.

A balance of considerations

These best practices focus on a combination of financial, family and personal issues. Merely focusing on how to preserve the family's financial capital misses the point—it's their human capital that matters most.

Families must emphasize family connectedness. This requires great communication skills applied consistently and many opportunities to connect, such as family meetings and celebrations. Successful families remind themselves where they came from, what they value and how each family member is unique. FB

Reprinted from *Family Business* Magazine® November/December 2016