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This FIST Can Knock Out Multigenerational Family Wealth

Beware of number of family members, inflation, spending and taxes

George Isaac | Sep 04, 2019

Many families desire to perpetuate their family's wealth for the benefit of future generations. Typically their first action is to engage a top-notch estate-planning attorney and update estate and gift plans.

While tax planning for generational wealth transfer is essential, current and next generation family plans need to be developed. The plans should be designed to meet both the donor and beneficiaries' needs. They also should address family investment and risk management policies, future wealth creation strategies and spending/distribution protocols. Once these plans are agreed on, family leadership should prepare a multi-year financial plan, computed *in real dollars,* to determine implementation feasibility.

A plan requires regular updating to adjust for changes in the family's wealth portfolio, tax laws and current and future beneficiary needs. In addition, families increase in size over time, which may impact distribution plans per family unit. Best practice is to develop the plan so each family beneficiary understands what share of distributions will be received in the future, so expectations don't get out of whack or result in problematic family dynamics.

The Hard Economics

There are four headwinds that systematically erode family wealth. They can be remembered by my acronym, FIST.

<u>Perpetuation of Family Wealth Headwinds</u>

- **F**—the number of *family unit*s supported by the family's wealth

- **I—***inflation*, the "silent killer" that erodes wealth over time
- **S—**the *spending* rate expressed as a percent of assets that the family consumes
- **T—***taxes*—income, capital gain, estate and gift

FIST often shocks families of wealth when they're confronted with the financial impact of these four elements. Even though the concepts are easy to understand, the degree of their collective consumption on a family's wealth is staggering.

Number of family members. The concept is simple. Gen 1, representing one family unit, has two children, creating two additional family units. Gen 2 has two children each, creating four more family units in Gen 3. From Gen 1 to Gen 3, there would be an increase from one to four family units participating in the family's wealth. This is without considering the fact that many families support two or more generations today.

Inflation. Inflation's compounding feature over time significantly erodes a family's real wealth—that is, wealth measured in *real dollars*. It's rightly deemed the "silent killer" because inflation has significant impact but isn't quantified and reported in investment statements.

Spending. Spending is determined by the amount of a family's wealth distributed to the family stakeholders each year. It should be evaluated as a *percentage of investable assets*. Spending policies can be difficult to gain consensus among family members because individuals often have sharply divergent financial circumstances and needs.

Taxation. The biggest spending partner in a family is probably Uncle Sam. It's common, particularly for California and other high tax states, to see 40% of investment income consumed by taxes.

The FIST Knockout Punch

The following illustrates the impact of FIST on multigenerational wealth. While simple to communicate and understand, it shows a recurring elimination of family wealth.

Wealth Perpetuation Illustration*

Element	Annual Percentage of Investment
Income generation	7.00%
Income taxes (no estate taxes)	(3.00%)
Inflation	(2.75%)
Spending	(3.00%)
Real $ Annual Gain/(Loss)	(1.75%)

*Excludes any reduction in wealth portfolio due to estate and gift taxes.

At a 3% spend rate, the family's real dollar wealth portfolio doesn't retain its value, decreasing every year by approximately 1.75%. Coupled with an expanding family, the future impact on available spending in real dollars per family unit is devastating.

Six Mitigation Strategies

There are six important strategies that can help mitigate the depletion of family wealth for future generations that you should discuss with your clients:

1. Minimize income and transfer taxes on the client's wealth (you and other tax professionals can help with this).
2. Retain, don't sell, a successful family business (unless your client receives an offer too good to turn down). The loss of capital from taxes coupled with lower investment returns in the public markets on the business's net sales proceeds significantly evaporates family wealth.

3. Manage a family business as an “investment” asset with a strong culture of growth coupled with prudent equity capital management. Periodically release excess equity in the business into other entities and reinvest into other assets to create a diversified family wealth portfolio.

4. Allocate assets and measure and report investment performance after accounting for management fees, taxes and inflation.

5. Manage family spending as a *percentage of assets*; report wealth *in real dollars* and communicate whether it’s accumulating or being consumed.

6. Encourage entrepreneurship, self-confidence, personal responsibility and advanced education (that is, intellectual capital) with the next generation.

Adopting the above strategies and developing next generation wealth creators is your client’s best approach to perpetuating multigenerational family wealth.

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