Preparing Heirs for the Challenges of Wealth

Some parents spend more time preparing estate documents than preparing their children for the wealth and pressures that result from those documents

There is a Yiddish proverb that "with money in your pocket you are wise, you are handsome and you sing well too." Similarly, data and research studies illustrate that children who inherit significant wealth often fail to develop the necessary skills, drive and tenacity to succeed in their own right but rather develop a false sense of entitlement based on the wealth that they inherit. They only have the illusion that their pockets are full; the wealth actually hinders their ability to be successful.

CPAs and financial advisors can work cooperatively as part of a team (often with a client's estate attorney) to help clients better prepare their children for inherited wealth. The principles summarized in this article apply just as well to ordinary parents and grandparents who want to help their children become responsible citizens with prudent money skills as they do for parents of true "heirs" who stand to inherit several hundred thousand or more.

Why Do Estate Transitions Often Fail?

Research evidence outlined below suggests that inherited wealth is often more a curse than a blessing. In this context, "preparing heirs" involves teaching them skills which will help them to lead an independent and fulfilled life immune from the dependence and resulting ills and loss-of-initiative which inherited wealth often creates.

Based on conservative estimates, $40.4 trillion will pass to heirs by the year 2052, or about $800 billion per year plus an additional $11.6 trillion will be donated to charities. So preparation to help heirs and families improve their effectiveness is essential.

Research data indicates that approximately 70 percent of estate transitions "fail" where failure is defined as the second generation involuntarily losing control of the family business or a significant part of the family's wealth. More importantly, several of these research studies illustrated that the primary cause of failure in wealth transitions is a high degree of splintering, divisiveness and lack of communication within the family.

One of the most comprehensive studies on wealth transitions and preparing heirs was completed in 1994 by family coach and author Roy Williams and professor Michael Morris, PhD, of Syracuse University's Whitman School of Business. The study was summarized in William's book For ***Love & Money: A Comprehensive Guide to the Generational Transfer of Wealth***. They studied 3,250 affluent families between 1973 and 1994 and confirmed the 65-75 percent estate transition failure rate and isolated the following causes:

- **60 percent of the failures were due to breakdowns in trust and communication within the family unit**

- **25 percent of the failures were caused by inadequately prepared heirs**

- **Less than 3 percent of the estate transition failures were caused by incompetent advisors, lawyers and accountants**

- **Approximately 12 percent of the failures were due to lack of a family mission or purpose that clearly defines the use of the family's wealth**

Heirs Are Ill-Prepared
Not surprisingly, affluent families are concerned with the effectiveness of both their estate plans and the steps that they've taken to prepare their heirs for the challenges of wealth. A recent nationwide survey by U.S. Trust Company indicated that the greatest concern of 83 percent of affluent Americans is that their children will have a tougher time financially. Additionally, 55 percent of those surveyed felt that their children were naïve about the value of money and placed too much emphasis on material things and 34 percent were concerned that their children would find a spouse who was only interested in their affluence.

Affluent parents' concern about the preparation of their children is justified because the evidence is strong that wealth is often built by an entrepreneurial first generation and then dissipated by the second and third generations. In their best-selling classic ***The Millionaire Next Door***, Thomas Stanley, PhD and William Danko, PhD offer the following insights on building and preserving affluence based on numerous studies of affluent families between 1973 and 1996, while both were serving as professors at The State University of New York (SUNY, Albany):

1. 67 percent of U.S. millionaires were self employed entrepreneurs who saved over 20 percent of their annual income

2. 80 percent of millionaires were first generation [i.e. not inheritors]

3. While millionaires lived well below their means, inheritors exhibited the exact opposite behavior by not saving any money and spending more than they earned

4. 80 percent of millionaires have college degrees and 40 percent have graduate degrees

Stanley and Danko found that there was **an inverse relationship between cash gifts to children and both the net worth and wealth that those children were able to accumulate.** They termed these cash gifts "Economic Outpatient Care" (EOC) because the gifts created a dependency on handouts from Mom and Dad. For example, CPAs and attorneys who received cash gifts from their affluent parents had

57 percent and 62 percent of the net worth and 78 percent and 77 percent of the income respectively of their peers who do not receive cash gifts. This inverse relationship between cash gifts and financial success applies over all occupational groups except for professors and teachers who save and invest the cash gifts given to them.

Predictably, the ultra successful kids of the affluent who become corporate executives and physicians became even more financially successful **because they were not given cash gifts**; whereas, their less successful siblings became increasingly dependent on their parents and never developed sound financial habits.

How Some Families Succeed
The following process will help families prepare children and grandchildren for the challenge of managing significant wealth and/or a family business. In part, the discussion focuses on how children, and ultimately grandchildren, can learn to work effectively with professional financial, tax and legal advisors and/or the professional executive team managing a family business when those heirs themselves are not directly involved in the family business.

Research shows how families can cooperate and collaborate to make wise planning decisions for all family members and develop self-sufficiency as opposed to dependency among the younger generation.

In the 30 percent of affluent wealth transitions that were successful, Williams and Morris found three broad common elements:

1. ***Candid Communication***. There was a tremendous degree of trust, openness, cooperation and mutual respect among family members. This was in sharp contrast to the pattern in the families where estate transitions failed where parents communicated more with professional advisors than with their children.

2. ***Independent Achievement / Meritocracy***. Only after achieving independent academic and career success, were heirs allowed to choose to become involved in either managing the family's business or assets. At the time of "transition," these heirs indicated to researchers that they felt "well-prepared" to take over.

3. ***A Written Plan***. Families whose transitions were successful prepared a formal succession plan and family mission statement, which included concrete steps to train (and test) heirs. These families also laid the groundwork for their children to have successful working relationships with competent professional advisors.

Five Basic Steps to Prepare Heirs
In addition to the three steps above, there are several steps that parents should take to help their children avoid the pitfalls of inherited wealth:

1. ***Conduct regular family meetings*** where open dialogue is encouraged and professional advisors are often present to help facilitate discussion and ensure that every adult family member's point of view is heard and a consensus achieved.

2. ***Encourage teamwork*** and a sense of objectivity and fairness within the family so that even when a decision does not go a family member's way, he or she realizes that the decision making process was fair and is able to wholeheartedly embrace the direction that the family decided to take.

3. ***Do not make cash gifts*** to children before they are ready (often age 35+), but rather invest in their and their children's college education. As mentioned, in ***The Millionaire Next Door***; Stanley and Danko found that there was **an inverse relationship between** cash gifts to children and both the net worth and income that those children were able to earn. They suggested teaching children to save 20 percent of their income each month and to live within their means.

4. ***Allow children to learn from failure*** and encourage an environment where all family members, including parents, can candidly assess their own strengths and weaknesses. Don't act as a safety net unless health and well-being is involved.

5. ***Encourage*** your kids to pursue their passion not yours.

Real Communication Examples
On this last point, many experienced professionals are aware of cases where children achieved independent success and then "came back" to run a family business. Two recent examples at my firm:

1. After experiencing success in a "fast paced" career environment, a daughter and her husband came to appreciate the value in returning home to run a family business which was founded in the 1960s;

2. Two successful attorneys returned home to take over a 50-year old business from their ailing father and took the business to a new level as they embraced the information age.

Families should strive to create a culture of openness whereby all family members over the age of 14 are welcomed and encouraged to understand at least some aspects of the family's wealth and to participate in the decision-making process. Additionally, some steps should be taken from a young age to make sure that children learn to appreciate the value of a dollar and develop sound educational, work, saving and money management skills. These skills need to be honed and developed from the time that kids are toddlers through middle age.

This open communication process can be picked up at any point during a child's life cycle and it is perfectly appropriate for elderly parents to work on collaborative decision making and money management and business skills with both their middle-aged adult children and young adult grandchildren. Additionally, all children from a young age should be made to feel that their opinion is valued and respected in important family matters.

The evidence is strong that even a sound estate plan will fail if steps are not taken to prepare heirs. Even if communication within a family is less than ideal, the family's investment manager, attorney and CPA working as a team can help lead a family meeting that encourages mutually productive dialogue. If necessary, experienced family coaches with training in psychology can be brought in to break down barriers and facilitate discussion.