White Paper - Nº 3

The Transferring of Wealth to Future Generations –

Have we got the recipe right?

Covisory

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The same is true of our plans to pass wealth onto future generations. The current wave of baby boomers nearing retirement age is giving rise to many individuals to reflect on when and how to transfer their amassed wealth to future generations, let alone how much. Often the wealth is not insignificant, particularly if a family business or farm has been sold or is still owned. The wealth available is usually far in excess of what Mum and Dad will be able to spend or enjoy in their lifetimes.

The traditional New Zealand approach to wealth transfer has been simple and straight forward. Usually it involves a visit to an accountant and a lawyer to set up a family trust and draft a memorandum of wishes. This is in the mistaken hope that a few vague instructions and a couple of professionals acting on an ongoing self controlling fashion will enable Mum and Dad to control from the grave, with the children "administered" by the professionals.

While this may not be the best preparation it is far better than the alternative which is simply to divide everything equally among the children once Mum and Dad have died. If the assets are owned by trusts, the usual variant on this is to have the assets resettled directly onto either new or existing trusts for each child.

While these two approaches, which in our opinion comprise the majority approach to wealth transfer in New Zealand, are simple, they ignore several key measures which are just too important to not take into consideration. These are:

1. The fact that often children are left reporting to and administered by professionals. Often these professionals will be of a similar age to Mum and Dad which just makes the position worse as they plan for their own retirement, or even die before Mum and Dad. Moreover, who controls the professionals?

   Typically the power to hire and fire trustees will revert back to the trustees themselves after the death of Mum and Dad. Sometimes as a partial solution a child is added as a trustee on the death of Mum and Dad. Sadly this usually achieves little as the professionals will still have control and the child may be naive in trust and financial matters.

2. That the children themselves are not financially literate. This is a major problem if they are to inherit significant wealth when Mum and Dad choose the "give it all to the kids approach" to wealth transfer. Often Mum and Dad are self made.

They may have had little formal financial or school education, but were very successful in business given hard work, a frugal or at least moderate lifestyle and the reliance on third party advisors like lawyers and accountants to make up for their lack of knowledge in certain areas (especially finance).

The thought of Mum and Dad acknowledging their wealth and openly discussing it with their children can be both daunting and frightening.

3. The increasing failure rate of marriages and de facto relationships in New Zealand and overseas causing Mum and Dad to have concerns about wealth ending up with in laws upon separation and divorce.
4. Mum and Dad's concerns over the spending and debt propensity of the now generation, who expect all the benefits without the hard work, and in return for a promise to pay at a later time
5. Imprecise decisions by Mum and Dad about how much to give or leave to charities, and which charities to benefit. Often Mum and Dad will be reluctant to give significant sums to charities as they do not want to be seen to be wealthy.

So while each of the traditional approaches will address some of these factors, there will always be a lack of certainty that will remain.

A Better Future

While each family situation is different and accordingly needs to be handled differently there is, in the writers' opinion, a better way to handle inter generational wealth transfer.

At the outset we do condone and recommend the use of trusts in New Zealand to own income producing and capital appreciating assets given the flexibility they provide and the ability to offer protection of assets from personal creditors to the extent there are not debts owing from the trusts to individuals.

Modern trust deeds are very flexible and offer solutions which typically can be tailored and modified to suit specific family requirements and situations.

The key differences in our opinion however are the need for open discussion within the family and a formal progressive financial education program for the children.

This approach usually starts by getting to know the family. This includes gaining an understanding of how Mum and Dad have amassed their wealth, the ages and stages of the children and a basic outline of what Mum and Dad see as the future wealth distribution.

From these discussions a more formal plan can often be developed, in conjunction with the children, which may involve some or all of the following steps:

1. Forming a new family trust for each child who is legally old enough and whom is considered mature enough. Historically Mum and Dad and their lawyers and accountants would have been amongst the trustees of this, although we consider this is inappropriate. Rather, we would prefer to see the children select their own professional advisers to assist in the set up and administration of the trusts. This could involve more junior / younger partners within the existing professional firms of lawyers and accountants being selected and used, which has the added bonus of creating succession within the firm. Geographical location may also make it more sensible for children to select their own advisers when they are living in different towns, cities or even countries.

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Whether a spouse or de facto partner should be included as a trustee is a question of personal opinion. However care must be taken to ensure matrimonial laws are carefully considered before this step is taken, and indeed, if the spouse or de facto partner should even become a beneficiary of the trust.

2. Often Mum and Dad will hold some indirect control over the trust, conceivably by retaining the power to hire and fire trustees although this should be structured so it is divestible by deed or will in order that the power can be vested in the children at the appropriate time. The act of setting up and administering a trust is part of the financial education process.

3. The next step is for each child's trust to be "loaned" an amount of seed funding by Mum and Dad's trust. This capital is to be invested by the trustees of each child's trust in suitable investments. Some guidance can be provided by Mum and Dad on this.

   It is the decision of the trustees of each child's trust as to how to invest this, be it in the share market, unit trusts or at the bank. It is also for them to decide whether to manage the investments themselves, or to utilise the services of a financial planner, investment adviser or bank, although some influence can be exerted by Mum and Dad.

   These advances are also separate from any made to assist in the acquisition of a house etc. Each child's trust gets to retain the income, and either spend it or reinvest it. The use of an advance from Mum and Dad's trust also provides protection for matrimonial purposes. Over time, as Mum and Dad (and their trustees) feel more comfortable with the financial education of each child further sums can be advanced, and subject to any relevant New Zealand and foreign tax laws, distributed.

4. As a variation on Point 2 above, we have also worked with clients using a similar structure where each child's trust either distributes all or part of its income to charitable purposes, or receives a distribution of beneficiary income from Mum and Dad's trusts which it is then required to distribute to charities. The aim here is to teach the child philanthropy, by requiring them to identify and benefit worthy charitable causes.

   That leaves and leads onto the final issue for Mum and Dad to address which is how much should go to the children and what to do with the rest.

   While there is usually a desire for the children to be comfortable, Mum and Dad will often have difficulty reconciling this with the cold hard reality of what each child will likely "inherit" upon their deaths. The problem of what to do with the rest again comes back to Mum and Dad being uncomfortable if they are seen or perceived to be rich. There is also the issue of when to give to charity.

There are no easy answers to these questions but there are a variety of options and points to note:

a. It is more tax effective to give to charitable causes out of income as the charities will usually not be subject to income tax, although imputation credits are non refundable.

b. Mum and Dad can look at establishing a charitable trust of their own. The accumulation of this income in the charitable trust will over time grow to a sizable fund, the income from which can then be also used for the charitable purposes.

c. The children may also be involved in the running of the charitable trusts, its investments and selection of worthy causes to benefit.

d. If there are still companies operating, a donation to a charity, including any charitable trust set up by Mum and Dad, will be tax deductible limited to the profits of the company for tax purposes.

e. As to how much to transfer to charities, this is easier if Mum and Dad establish their own charitable trust. They can loan funds to it and have them repaid if the need arises.

   I. For families where wealth is tied up in farms and farming assets like livestock, issues of succession can be more complicated, especially if one child wants to retain the farm and operate it. However, these situations are not unique and can usually be accommodated by considering options like:

   II. Continuing to own the land in a trust and farming it as an effective partnership; or

   III. Selling off some lifestyle blocks to provide some cash for the payment of non participating children; or

   IV. Some bank debt is used to free up funds for non participating children.

The Benefits

The key benefit of all of this is the children are being better trained to manage the monies that they will one day inherit. They will be supported by a group of professionals that they can relate to and are comfortable with. The need for Mum and Dad to control from the grave is arguably greatly reduced.

If a child does not progress through this process to the satisfaction of Mum and Dad, the more traditional governing from the grave measures can still be used in respect of that child.

The key is however that there needs to be a transparency and openness within the family for this to work. Mum and Dad must feel able to talk to the family about what they would like to see happen to their wealth and more importantly which non family charitable causes they want to support.

We will all die one day, so we may as well accept that fact and at least be prepared to openly plan for what will happen when we do. There is no set solution, but we believe that there is a better vision and process which can be applied.

Nigel Smith & Marcus Diprose.

About Covisory

The Covisory Group specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, The Covisory Group has grown from one business to four with a diversity of clients. Covisory clients are owners of family businesses, operating both in New Zealand and globally. Our team of specialists work either one-on-one or alongside our clients' team of professional advisers to develop appropriate short- and long-term solutions.

We build strong relationships with our clients based around trust, accessibility, and responsiveness. There is no 'one size fits all' about our services. Our solutions are bespoke to each client, drawing on our up-to-date specialist knowledge and our years of experience. providing one-on-one expert advice.

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