Preserving Wealth and Family Values:
Reality Collides with Conventional Wisdom

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I spend my days advising clients to transfer property in trust for their children, for a variety of reasons: tax planning, control over the assets for minors and others, creditor protection, managing and passing on a family business.

There are many that believe trusts can do so much more, such as:

- Making children and grandchildren responsible and self-sufficient
- Keeping the family together
- Keeping the assets away from spouses
- Passing down and enforcing "good" family values

I suggest that, in general, these objectives may not be worth pursuing, and that doing so through trusts and estate plans frequently does not make sense in every instance. Building structures, family offices and constitutions to "keep the family together," "keep the business in the family" and "preserve family values" may be fine for one generation, but not necessarily beyond that.

I. Estate taxes preserve family businesses and should make surviving spouses and children happy

According to LexisNexis, approximately 55 percent of American adults do not have a will or other estate plan in place. Among minorities, the numbers are higher than in the general population: 68 percent of black adults and 74 percent of Hispanic adults do not have one. And that's with an estate tax in place. Without an estate tax, even fewer people would have an estate plan. I have clients walk in the door that are worth tens of millions of dollars, and have no estate plan. They came in at someone's urging-- child, CPA, insurance agent, financial advisor-- to get a plan put in place, especially to plan around the estate tax. Even then it's one of the last topics anyone wants to discuss-- ranking just below scheduling a root canal. Without the estate tax they would have put it off further. So, estate tax most commonly spurs the discussion and plan in the first place.

Second, without an estate tax, children of wealthy families would be waiting a lot longer to inherit any money. If the estate tax didn't exist but assuming the gift tax stays in place (to prevent shifting assets for income tax purposes), parents will not transfer wealth to their children because doing so could trigger gift tax, and there'd be no estate tax if they wait. Besides, they prefer to just keep the money. If the parents live an *average* life expectancy or so (81 for women, 76 for men),[1] the children could be in their 50s or 60s before they inherit anything-- or even later. Wealthy people tend to have good health care and live longer than average.

[1] According to Centers for Disease Control and Prevention, National Center for Health Statistics.

Third, without an estate tax, there would be no tax incentive to leave anything to a surviving spouse. State laws may provide a spouse with a forced share (known as the "elective" share in many statutes-- elective by the surviving spouse, forced upon the deceased spouse!), typically being one-third or one-half of the estate, but even that can be circumvented (in Illinois a simple revocable trust does the trick). Clients leave assets to or in trust for a surviving spouse to defer the estate tax until the second death, but without an estate tax, how many spouses will be left with too little to maintain their lifestyles?

Fourth, the discussion of succession of the family business-- who should inherit it, who shouldn't, who should control it now or in the future-- often doesn't occur until clients come in to plan their estates. So again, without the estate tax, this planning gets put off, or never occurs in the event of an untimely death. (Aren't they all untimely?) Without an estate plan and succession plan, there will be liquidity issues, a scramble for control and perhaps a loss of business in the process.

II. Passing along the family business: Might not be the best idea

According to *Bloomberg Businessweek*, about 40% of U.S. family-owned businesses survive to be second-generation businesses, but only about 13% are passed down successfully to a third generation. This could be either because of failings of the family running it, or the nature of the business itself.

a. Changing times: What was a good business 10, 20 or even 50 years ago may no longer be. New products or technology quickly "disrupt" markets and make products and services obsolete, or new competitors emerge, taking away business and reducing profit margins. In today's global market, these competitors may come from anywhere in the world. Regulatory changes may impact a business as well. According to a Boston Consulting Group report, one in ten public companies fail each year, which is a fourfold increase since 1965. Historically, the average lifespan of a multinational corporation has been between 40 and 50 years — a figure that has gradually been on the decline. More than one-third of the corporations on the 1970 Fortune 500 list were no longer in existence by 1983.[2]

Look at what the Iphone and Internet have done to these industries: (i) watches, (ii) camera and film (video and still), (iii) maps, (iv) home phone business, (v) U.S. mail, (vi) flashlights, (vii) holiday/birthday cards and invitations, (viii) taxis (Uber), (ix) paper, (x) music, (xi) banking, (xii) news/newspapers, etc. Keep in mind the Iphone is only 8 years old. Wal-Mart stores have nearly replaced the hardware store, corner pharmacy, toy store, beauty supply store, clothing stores, book stores, appliance and electronics stores, pet supply stores and even grocery stores. And Amazon has replaced even more.

Fujifilm, on the other hand, is a successful example of a business that completely reinvented itself to avoid going the way of Kodak (which filed for bankruptcy in 2012). Fujifilm

[2] "Why Are so Many of the World's Oldest Businesses in Japan?" by Zachary Crockett on Priceonomics.com.

used be primarily in the film business, but is now also in the fields of healthcare diagnostic imaging, LCD panels, biopharmaceuticals, microfilters and other areas.

Thus, taking great measures to retain a single business as the primary family asset may not be a wise financial decision simply because times change. The family must be prepared to adapt the business over time, or it may not survive.

b. Heir ability: Just because your client was good at running his business doesn't mean his/her children have any clue what they are doing. The children may not have the same drive and motivation, as they are already wealthy or living fairly comfortably. They weren't raised in the same manner, place or time and haven't had the same life experiences as the founder. They may have been educated at Exeter and Princeton, but that doesn't mean they are good at running the family's particular business, or that they are even interested in doing so. Even if the children are talented business managers, such skill doesn't necessarily apply in all industries in all market conditions.

World-wide, there are 967 businesses founded before the year 1700 (and dating as far back as 578) that are still in operation today. 517 of them, or 53%, are located in Japan. The next closest country, Germany, houses 19% of the world's oldest businesses, most of which are breweries. After that, no other country boasts more than 5%.[3]

So let's look at Japan. Most of Japan's oldest companies boast of being "family run" for dozens of generations. But for some of these companies, this is far from the truth. Where there is no son to inherit a business, or where a Japanese CEO desires a "better quality" son to run the business, an heir is legally adopted. Japanese business owners have engaged in this practice for centuries. Today, 98% of Japan's 81,000 average number of adoptions are of males between the ages of 25 and 30 — many of whom are businessmen who are legally adopted by the owners of companies and put in management positions. This keeps the "family owned and operated" claim technically intact. Moreover, a business owner with no male heirs to his company can legally adopt his daughter's husband as a "second-birth son" through a technique called "Mukoyōshi," If an adoptee fails in his leadership role, he can be disinherited, and another heir can be adopted to take his place. Vikas Mehrotra, a researcher who has traced business-motivated adult adoptions in Japan, surmises that this practice has "rendered Japanese family firms more professionally managed than their peers elsewhere." "If you compare the performance under different kinds of heirs, blood heirs versus adopted heirs," he writes, "the superior performance of second-generation managed firms is entirely attributable to the adopted heir firms."[4]

The point is that the estate plan should not require retention of the family business indefinitely, and allow the family to sell or diversify to preserve the wealth and reduce risk.

c. Fairness: A client may have children working in the business, while other children do not for personal or professional reasons. They may be disinterested in that business, they found

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[3] Id.

[4] Id.

another passion or profession, they are a stay-at-home parent, they have a disability, they live in another geographical area (for personal or professional reasons). If the business is divided equally among the children but one has control, there will be pressure and conflict over whether to reinvest or distribute cash, compensation of the children employed in the business, and whether to sell the business. If the business is not generating cash flow, it is useless to those not working there and they will want to cash in by selling the business. Or they may want to sell in order to reduce their financial risks by diversifying. If the business doesn't succeed, the family wealth and relationships will be destroyed.

If a business in passed down, clients should give those who are not active in the business other assets instead of stock in the business (which could include life insurance), and give them a right to sell or redeem the stock. Perhaps liquidity can be extracted from the business via dividends, distributions or loans, which can be given or left to family members not in the business. Otherwise, their stock will be pieces of paper that have no real value to them.

Given all of these issues, clients must be asked: Is the goal to preserve the business, or preserve the family wealth?

III. Passing along family values: A trust can't fix what you couldn't teach, and whose values anyway?

a. "<u>Good values" change and are subjective</u>: Clients are often tempted-- perhaps by their advisers or by friends at cocktail parties talking about their own fabulous estate plans-- to try to enforce, or perhaps inflict, family values on their children and future heirs. Note that I said "family values" and not "good values," as there may be a big difference.

What constitutes "good values" is subjective. Values vary among family members raised in the same household, let alone among aunts, uncles and cousins. And who says "your" values are "good" values? If I ask everyone in the room for a list of the most important values to impart upon our children, there will be a lot of overlap of values, but there will be differences.

What is a "good" child is just as subjective, and can only be measured based on the person's skills, abilities, interests and circumstances. One's "circumstances" are innumerable. Not everyone is capable of living the ideal life in terms of work, family and home. Mental or physical handicaps, current or future, hereditary or accidental, of themselves or their spouse or children, can drastically change one's path in life and their ability to support and educate their children. Not every person is wired to want to make money; some are better as nurturers and parents. Even if a child is educated, motivated, hardworking, capable and has the best of intentions, he or she could lose a job due to industry changes, new technology, regulatory changes, new competition, economic downturn, mismanagement of their employer, or a bad decision on their part.

Moreover, one's views on money and their children changes significantly over time. A client that writes a trust for his children while in his 30s with young children might write a very different plan in his 40s, 50s, 60s or 80s. Each time he or she will think he is wiser and has a better plan, which may or may not be true. But the family is stuck with the plan in place when

he dies. Maybe they were more clear-headed and optimistic when they were younger, and crotchety, resentful or bitter when they are older. Or maybe they were wide-eyed and naïve in their younger years, and much smarter and wiser from experience in later years. They will be shaped by their life experiences, good or bad, and those experiences in turn shape their estate plan-- for better or worse.

Given that, should these trusts really be perpetuated for hundreds of years? Even if they are "good" values, values from the early 1900s may not be as relevant/applicable today, and that's only 135 years ago. We are designing perpetual trusts to supposedly last hundreds of years. The U.S. Constitution, which is revered to be well crafted by some of the brightest ever in this nation, has required 27 amendments in 228 years, and thousands of lawsuits to interpret ambiguities and to apply the laws to changing times. How well is your trust agreement going to hold up over that time period?

b. Trusts don't create good (or bad) children: How children turn out is based primarily on how they are raised, with or without money. Laziness, lack of ambition, irresponsibility and financial imprudence are not solely the province of the wealthy. The middle class and poor have more than their share that fit that description. In many ways, a poor person raised without proper parental direction may suffer some of the same negative attributes as a "trust fund baby" raised without proper parental direction, except that the poor person's trust fund comes in the form of welfare, Social Security, Medicaid, food stamps and unemployment benefits. Similarly, putting significant sums in trusts for children and grandchildren won't make them bad people, and can enable them to be productive and happy, perhaps with less stress.

I tell my clients that my trust agreements cannot fix what they couldn't accomplish raising your children for the last 25 years. If their threats-- real or veiled-- didn't work, putting a trustee in the middle as a substitute parent is unlikely to make a difference. If the trustee is a family member, it will create a rift that may never be mended.

Take the Rollins family, which owns the $8 billion parent company of Orkin, the pest extermination company. The founder, Wayne Rollins, created trusts for his children and grandchildren. His sons, Gary and Randall were co-trustees along with a close family friend, and they established the "Rollins Family Entity Distribution Program," which required that distributions be received only by those engaged in "serious pursuits that are meaningful, respectable and worthwhile."

Gary's son Glen worked for Orkin and rose to COO, and received more than $12 million from his trust between 1999 and 2009, but Glen's siblings didn't always qualify for each annual payout. Gary and Randall decided that Glen's brother Wayne–who gravitated toward creative work like filmmaking–was ineligible for his distribution in all but three years of the 2000s, adding up to just under $1.2 million, according to court filings. Randall's five children were also found ineligible for annual distributions, with two of them struggling with drug addiction.

In 2010, seeking to offset their own deficiencies in raising their children, Gary and Randall constructed yet another formal mechanism called the "Rollins Perpetual Management Trust." According to court documents, it was intended "to serve as the vehicle through which

the governance of the family and its assets is established in perpetuity." It provided for a monitoring program that would allow Gary and Randall, as trustees, to hire private investigators to follow the beneficiaries, conduct credit checks and drug tests, and review their medical records.

Randall's kids agreed to sign the new trust agreement, and received $9 million in payouts as a reward. Gary's children refused and sued. Finding "meaningful pursuits" was one thing, but signing away their personal privacy in perpetuity was too much. Glen and his siblings then sued the trustees (including his father Gary and uncle Randall) for breach of fiduciary duties. His father and uncle then fired Glen from his positions as president and COO of Orkin, and his mother then filed for divorce from his father after 45 years of marriage.

During this process, it was revealed that Glen (45 with three children), had been having extramarital affairs for years, and that he had been passed over for a leadership position in the family foundation. Glen's wife Danielle filed for divorce. Glen has had no further dealings with the company that bears his family name, and doesn't speak to his father or his uncle.

The Rollins family saga shows how attempts by parents to impose their values by withholding trust distributions and intruding in the lives of other family members can leave a family in shambles. Parents (and uncles) are not going to make up for their parental shortcomings through the use of trusts.

c. <u>Hard and fast rules can have unintended consequences</u>: *Any* hard and fast rules in a trust may backfire, leaving the client with unintended consequences. Examples:

(i) <u>Requiring a college degree to get distributions</u>: How many billionaires dropped out of college (or didn't go) because of a business opportunity that made their fortune and careers? Have you ever heard of Bill Gates, Steve Jobs, Mark Zuckerberg, Lawrence Ellison (Oracle), Michael Dell, Ty Warner, Sheldon Adelson (Sands Hotels), Donald Newhouse (publisher), David Geffen, Ted Turner, Ralph Lauren, Micky Arison (Carnival Cruises), Howard Hughes, or Jack Dorsey (Twitter)? College might have sent them in a safer direction like accounting, law, medicine and the like, and they never would have created such wealth, jobs for others and in some cases, an entire industry. A college degree isn't necessarily the best path for everyone.

Further, some may have a disability or other life situation that prevents them from going to college, or for college to be their best option. A hard and fast rule would potentially cut this person off.

(ii) <u>Requirement for a prenuptial agreement, or to marry someone of a certain culture, ethnicity or religion</u>: Some clients want their children to be required to sign prenuptial agreements or marry persons of certain backgrounds, or else they are cut off. There are a number of problems here. First, the trust would need to specify what the prenuptial agreement must say. Second, what if the child-- or his/her fiancé-- refuses to comply? Does the client *really* want to cut them off? Doing so would not only punish the child, but also his or her future children whose lifestyles will be affected. Many love-struck couples will walk away from

money to be with their true love. King Edward VIII abdicated the throne as King of the UK and Emperor of India in 1936 so that he could marry his American girlfriend. Third, the child could be financially successful in his or her own right and not need the money, or the fiancé could be well-to-do. Finally, the children could simply choose to remain unmarried to get around the prenuptial requirement, and start a family with his or her significant other. So much for perpetuating family values.

Consider the estate of Mauric Laboz who died earlier this year. He left $10 million to each of his daughters, Marlena, 21, and Victoria, 17, which they will receive when they turn 35, but each daughter can earn early bonuses by following their father's wishes. If Marlene marries before age 35, she will get $500,000, but only if her husband signs a sworn statement that he will not touch the money. She will receive another $750,000 if she graduates "from an accredited university" and writes "100 words or less describing what she intends to do with the funds," which essay must be approved by the trustees. Starting in 2020, each daughter will receive an annual payout of three times the income list on her federal income tax return, and could earn the same amount if they act as a caregiver for their mother. If either daughter has children and decides not to work outside the home, she will receive part of her inheritance yearly, as long as the child is born in wedlock. Who knows how this will play out? Will Marlena skip college and instead rush into marriage and have a baby to get the $500,000 and a chunk of her $10 million early?

(iii) Religious requirements: Some clients want their children to be religiously observant, and insert such requirements into their trusts. This is one of the most difficult areas to manage. What does "observant" mean? There are a hundred shades of religious observance, and different interpretations and opinions of what is proper. And who's going to police this? Is the trustee supposed to go to church on Sundays to make sure the beneficiary is there and participating? What about daily behaviors that could fall outside religious tenets?

(iv) Matching income: Trusts that match the earned income of a beneficiary have many shortcomings. First, it provides greater rewards to those that earn more (CEO) than those that earn less (teacher). Those who earn more receive more. One who chooses to do volunteer work or be a stay at home parent would receive nothing. Are these family values to be perpetuated? Second, what if a beneficiary has a disability or illness and is unable to work or unable to earn very much income? Third, can the beneficiaries retire yet continue receiving payments? Are our clients going to dictate their retirement age? Fourth, if a beneficiary is extremely successful, he could end up cleaning out his trust, leaving nothing for his children. Such a beneficiary might prefer to not receive distributions, leaving the assets in the trust where they are protected from creditors and possibly taxes. Finally, if the beneficiary marries a wealthy person or inherits other assets, the trust will not serve to encourage work.

IV. Keeping the family together

Money and trusts do not keep families together. If anything, they are more likely to cause stress or divisiveness. I tell my clients that their children should share their toys with each other, but not their money. Could you imagine having to deal with siblings, let alone 2nd or 3rd

cousins, to determine investment policies and how much money everyone will receive? It can sometimes lead to family disagreements and disdain for one another.

This is especially true in large families. Family members may be separated geographically, and the third generation may not know each other very well. The family branches will have been raised in different households with parents of varying backgrounds, and possibly religions and cultures. We all know that blood relationships don't guarantee family harmony, and forcing family members to be trustees for each other or run a family office, family business or foundation together won't help or fix it. It just gives them one more thing to fight about.

Forcing families to be together, let alone intertwining their financial affairs, doesn't make them like each other and isn't necessarily a good or appropriate objective of wealth planning.

V. My takeaway points

1. <u>Divide assets and trusts, don't force grown children and families to share a bank account.</u>

2. <u>The function of trusts is to manage, protect and ultimately dole out assets.</u> Trustees are not parents, parole officers, teachers, social workers, private investigators, priests or rabbis. Their job is to manage the investments (or oversee the management) and determine the timing and amount of distributions to make to beneficiaries within the purposes of the trust, taking into account the beneficiaries' needs, size of the trust and other beneficiaries' interests.

3. <u>Trusts should have objectives that can be reasonably achieved</u>:

- A safety net for tough economic times or unanticipated emergencies
- Ensuring a certain standard of living
- Enabling a beneficiary to pursue his or her passion, in business or otherwise, without having to worry about a mortgage, paying for college and saving for retirement
- Enhancing a beneficiary's lifestyle

Consider setting forth principles and values in the trust that the trustee should try to encourage or discourage, to the extent he can by making or withholding distributions. They should clearly state they are guidance and not binding rules. My provisions:

> "I request that when determining whether to make a distribution to a descendant of mine from any trust hereunder and the amount of such distribution, the trustee do so in a manner that assists, encourages or rewards such descendant for exhibiting or accomplishing the following "desired behaviors":
>
> a) pursue an education at least through college and/or a vocational/technical school;
>
> b) be gainfully employed with a view toward being financially self-sufficient;

c) be a law-abiding member of society;

d) be a productive member of society by making meaningful and positive contributions to family, community and society;

e) engage in entrepreneurial and/or creative activities;

f) handle money intelligently and avoid wasteful spending;

g) act with empathy, thoughtfulness, kindness and consideration toward others;

h) develop healthy and meaningful relationships;

i) make contributions of time, money or both to charity; and

j) maintain a healthy lifestyle, both physical and mental.

The trustee should consider the societal norms in the geographical area in which a beneficiary resides, as I do not intend for the trustee to impose his own personal beliefs on a beneficiary as to what constitutes "gainful employment," "healthy lifestyle," or other subjective notions referred to above, although the trustee's beliefs are certain to be a part of such determinations.

I recognize that a beneficiary's age, health, abilities and other circumstances will affect his or her ability to accomplish one or more of the desired behaviors, and should be considered in construing and applying the foregoing to any particular beneficiary. I consider full-time parents to be productive members of society and gainfully employed, and do not intend that a beneficiary be discouraged from choosing to raise a family as his or her sole occupation.

I do not expect a beneficiary to necessarily accomplish or exhibit all of the desired behaviors, and recognize that some desired behaviors may even conflict with others. It is my hope and intent that the trust property will be used to reward and enhance the quality of life of those beneficiaries that have exhibited, accomplished or are working toward accomplishing one or more of the desired behaviors, and to encourage and assist the beneficiaries to exhibit and achieve the desired behaviors. On the other hand, I also hope and intend that the trust property will not be distributed to a beneficiary who is engaging in self-destructive, abusive or illegal behavior ("undesired behaviors"), except for the beneficiary's health, education and basic support, which may include expenses for rehabilitation and treatment or care.

If the trustee, in the trustee's discretion, determines (1) that a beneficiary is not capable of handling money or financial affairs prudently, or (2) that a beneficiary has financial problems or marital difficulties that could result in the diversion or dissipation of trust property or property distributed from the trust, then I recommend (but do not direct) that the trustee refrain from distributing property to the beneficiary until such problems have been resolved to the trustee's satisfaction.

The trustee shall have no duty to inquire or monitor whether a beneficiary is exhibiting or accomplishing the desired behaviors or the undesired behaviors, as the guidelines set

forth in this Article are not intended to limit the trustee's discretion to make distributions to the beneficiaries, but the trustee should consider the sentiments expressed herein."

4. At some point/age, give heirs responsibility and control over their own financial affairs.

Beneficiaries of trusts that have no say or control don't feel a sense of ownership, and their monthly distributions become like large welfare checks, breeding idleness and apathy. It doesn't feel like their money, so they may as well get whatever they can from the trust.

Instead, trusts can be designed to empower beneficiaries rather than control them. Giving heirs control will also give them a sense of responsibility, directly benefitting if it grows, or accepting the consequences if it shrinks. They may be more entrepreneurial-- because they can. Control can be given gradually, such as over an increasing percentage as the beneficiary gets older. Of course, there will be exceptions for those with disabilities or serious issues (*e.g.*, drugs, spendthrift).

Along the same lines, give beneficiaries powers of appointment so they can adjust the estate plan for their own children. No one can predict what the future will hold for subsequent generations, in terms of their circumstances, abilities and environment.

5. Rethink "family."

Most trusts are limited to bloodlines: They pass from children to grandchildren to great-grandchildren. In other words, the descendants of the patriarch and matriarch. Note what I just said: the descendants of the parents who created the wealth (or who are passing it down). The husband and wife think of each other and their descendants as "family." You can think of the family tree starting with those parents with branches going down from there.

But who says that's where the tree starts? It's all a matter of personal perspective. The children and grandchildren will think of their spouses and children in the same way as their parents did.

An estate plan should allow a child to take care of his or her surviving spouse. Imagine a client's son who marries his high school sweetheart, they raise three children together (perhaps the wife doing more of the raising), and remain married for 60 years until the child dies. The trust from which that child derived a great deal of his income-- and perhaps owns his home-- now passes to his children, leaving his wife out in the cold? Of course, the son could have assets of his own to leave to his wife, but it could be that a great deal of the family wealth is now going to exclude his wife-- the mother of his children, the grandmother of his grandchildren. Perhaps the wife was the driving force that raised the kids and kept the family intact, despite the son's indiscretions such as drug use, affairs or even abuse. This might be the same wife that quit her job to raise the family, and even signed a prenuptial agreement limiting her legal rights if they divorce or her husband dies.

This can be accomplished by giving children and grandchildren a power of appointment-- a power to redirect trust assets to a trust for their surviving spouse. The trust can ensure the

assets eventually pass to the children. Doing so might also reduce or defer estate taxes until the spouse's subsequent death.

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Every family is different, and each branch of the family may be different from the others. Families change, businesses change, values change, and the future is flat-out unpredictable. Family trusts and other agreements need to be flexible. They can set forth ideals for which to strive, but rigid terms that attempt to dictate investments or lifestyles may backfire.