Creative
wealth maximization strategies*

THE PREFERRED CLIENT GROUP, LLC
your personal financial concierge

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"Every conversation about money is also about values."
- Ron Lieber, *The Opposite of Spoiled*

The universe has an aggravating sense of irony: After working a lifetime to get it, you can't take it with you. And whatever you leave behind will probably be wasted.

According to the Boston College Center for Retirement Research, two-thirds of American baby boomers will inherit an estimated $7.6 trillion. That's real money. Unfortunately, as *Wall Street Journal* reporter Missy Sullivan put it in a March 8, 2013, article: "They're likely to blow it."

This is not a new problem; ancient philosophers also despaired over the challenges in passing their wealth to future generations. King Solomon lamented:

> I turned about and gave my heart up to despair over all the toil of my labors under the sun, because sometimes a person who has toiled with wisdom and knowledge and skill must leave everything to be enjoyed by someone who did not toil for it. This also is vanity and a great evil.

Today, the phrase "from shirtsleeves to shirtsleeves in three generations" neatly summarizes this reality: The first generation works extremely hard to amass a family fortune. The second generation enjoys many benefits from their parents' efforts, but often lacks discipline, skill or drive to continue on the same track, and ends up spending down the fortune instead of growing it. The third generation, typically having limited awareness of the source of their wealth, squanders what's left.

Sullivan noted that "Research shows family money rarely survives the transfer for long, with 70 percent evaporated by the end of the second generation. By the end of the third? Ninety percent."

Why does this happen?

Several factors conspire to make successful wealth transfers the exception. Perpetuating wealth across generations requires a transfer of productive habits and values as well as assets. If these intangibles are missing from the succession plan, no amount of money can overcome the wasting effects.

For example, the first generation, the one that creates the fortune, may not do as well with family relationships. When the ambition to acquire wealth is an unhealthy obsession, it can damage family dynamics. Children grow distant and resentful of absent parents, or a divorce creates lasting divisions. The first generation may compensate for these imbalances in their personal lives by spoiling their children, lavishing them with material things and discouraging them from developing the habits and skills to create their own wealth. And because their financial success is integral to their self-worth and identity, many first-generation wealth builders have a difficult time letting go; they don't trust anyone else to manage what it took them a lifetime to build. Consequently, the human capital at the heart of their financial success – the skills, values and experiences – never becomes part of the generational transaction.

The failure to transmit these intangibles has a ripple effect, practically and psychologically. When a family fortune is dispersed to several heirs, there is an immediate diffusion; one large fortune becomes several smaller ones. From a management and opportunity standpoint, economies of scale are lost. Instead of one management fee, there are several. And while a large fortune might have the resources to take on a great project, the heirs may not be agreeable to recombining their shares to do the same thing.

In This Issue…

Recipients of inheritances may not comprehend the connection between the money they receive and the work required to obtain and preserve it. Research shows a startling tendency for inherited wealth to be frittered away with ill-informed investment decisions, spendthrift lifestyles, and destructive behaviors. Citing a 2008 study by the World Health Organization, Caren Chesler, in a September 7, 2011, article for *Private Wealth*, wrote that, "While there are a number of reasons wealthy families see their fortunes dwindle, substance abuse is one of the most common."

It Doesn't Have to Be This Way

Even though many generational wealth transfers end badly, there are success stories. And many of these successes have common elements. Among them:

Early involvement in family finances. In his newly released book "The Opposite of Spoiled," author and *New York Times* personal finance columnist Ron Lieber persuasively argues that even at early ages, kids are "intensely curious" about money. This curiosity provides excellent opportunities for parents to connect the value of a dollar to the values they want their children to embrace. Lieber is also a proponent of children working, particularly in a family business, noting that work can be a great catalyst for developing "grit" (defined as "perseverance and passion for long-term goals"). Some parents may consider finances a personal topic, something not to be discussed with children, even when they grow up. But "protecting" children from the realities of family finances – both good and bad – puts heirs at risk when a generational transfer occurs. Early engagement gives both generations time to fashion a mutually beneficial working relationship with the family's fortune.

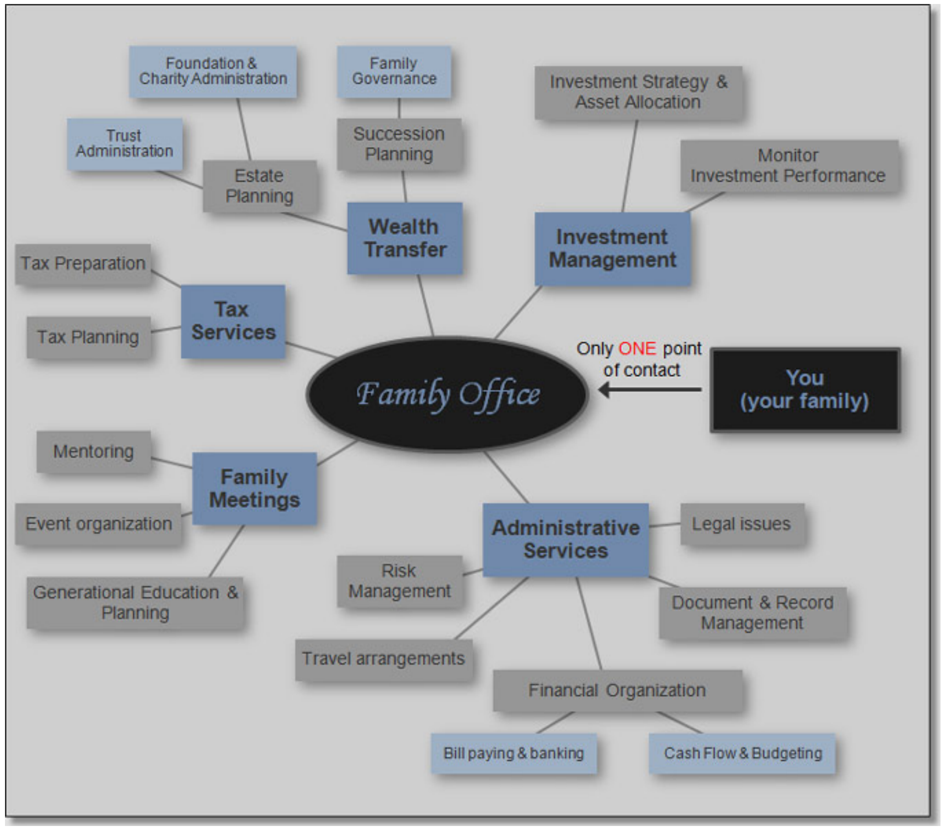
An ethical will to connect values and resources. Also known as a legacy letter, an ethical will has a long history, particularly in Jewish culture. Writer Pat McNees explains that an ethical will "conveys expressions of love, blessings, personal and family stories you treasure; it articulates what you value and want to be remembered for, what you hope your survivors learn from you or want your children and grandchildren never to forget."

An October 31, 2014, *New York Times* article highlighted the resurgence of ethical wills, particularly in video form, adding that these non-binding legal documents "are increasingly seen as important legacy-building ingredients, because they can convey a person's deep inner values and beliefs, even helping soothe ruffled feathers when dispensing family assets." A Financial Planning Association survey found ethical wills to be "ten times more important to most people than their parents' financial legacy."

A transfer structure that encourages stewardship rather than ownership. When heirs receive an inheritance, the assets are theirs to allocate and consume, and their only accountability is the consequences that follow. On the other hand, *Forbes* online contributor Todd Ganos mentions in a February 2014 article this finding from a Pepperdine University study:

"(W)hen mom and dad's assets remain intact and are managed as if they were a company, families will view their wealth differently. As assets pass down the generations, each generation does not view the assets as 'theirs' but rather views themselves as stewards of something bigger."

Typically, this stewardship arrangement involves the establishment of a family trust with heirs serving as trustees. The degree of complexity of this legal structure varies depending on the assets, but the ultimate expression of family stewardship is perhaps embodied in the Single Family Office (SFO).



http://www.switzerland-family-office.com/services.html

The Single Family Office

The SFO concept has a history tracing back to ancient Rome, with the modern version originating in the 19th century among families who amassed great fortunes in the Industrial Age. A Single Family Office is a private company of professionals who are dedicated exclusively to the investment, personal and legacy needs of one family, including:

- Investment-Related Services
- Management of Complex Assets
- Accounting, Tax Planning and Compliance
- Asset Protection and Risk Management

A full-blown SFO is a comprehensive, integrated enterprise that **provides a single point of interface for the family** (see illustration). Its duties can include things like household staff management, travel arrangements, day-to-day accounting and payroll activities, tax planning and reporting, family governance, financial and investment education, philanthropy coordination, and succession planning. While this approach can't ensure heirs will emulate the habits and productivity of the first generation, the format provides safeguards and incentives to encourage a multi-generational perpetuation of wealth.

This assistance is expensive; most advisors believe family wealth must be between $50 million and $100 million in total assets for the SFO format to be economically feasible. But even if your fortune is much smaller, it is possible to **incorporate key features of the family office in your own plans**.

Many financial professionals offer some of the family office services, and can usually provide referrals for other categories. You could select one financial professional to hold the "Family Office" position, i.e., to be informed of your financial interactions with the various professionals, and to assist you in coordinating with them. In the future, this same individual can also be the principal point of contact for heirs. Combined with the right legal structure, an ethical will, and the ongoing engagement with your children, the result looks quite a bit like a scaled-down single family office.

Leaving assets without guidance is a recipe for waste. If you want your wealth to bless successive generations, you should provide instructions and assistance. This is especially true for instilling the values and habits you see as crucial, and also applies to the legal structures and trusted professionals you want to assist your heirs. ❖

ARE YOU PERPETUATING FIRST-GENERATION VALUES TO YOUR HEIRS?

THE TRANSFER PROCESS COULD BEGIN TODAY. DO YOU HAVE A TRUSTED PROFESSIONAL TO FACILITATE A GENERATIONAL TRANSFER?

Millions of Americans with disabilities and their families depend on Social Security, Medicaid and other government-sponsored programs for income, health care, food, and housing assistance. But eligibility for these benefits is means-based: if individuals report more than $2,000 in cash savings, retirement funds and other assets, eligibility is diminished or denied. This presents a financial Catch-22: Expenses may exceed what government programs will pay for, but personal financial assistance jeopardizes existing public benefits.

Recognizing the financial burden of living with or caring for a disability, Congress passed the Achieving a Better Life Experience Act (the "ABLE Act") in December 2014. This legislation amends portions of Section 529 of the Internal Revenue Code to create a new savings vehicle for disabled individuals and their families. But like other good ideas involving tax advantages, the benefits are constrained by several qualifications and limitations.

Similar to regular 529 accounts for higher education, disabled individuals or family and friends can make one-time or ongoing deposits to a 529 ABLE account to pay expenses associated with disability. Any growth or distribution from account values is tax-free, as long as the funds are used for "qualified disability expenses," such as education, transportation, medical care, housing, employment training, financial management, etc. However, ABLE accounts also have some unique restrictions.

- The beneficiary of the funds must have become disabled before age 26, and be entitled to Social Security disability benefits.
- 529 ABLE accounts are state specific; a beneficiary must use a plan offered by the state where he or she resides. Since the bill was passed in December, most states have not yet finalized legislation to authorize ABLE accounts.
- A 529 ABLE account balance cannot exceed $100,000. If it does, the beneficiary's SSI benefits will be suspended. If an ABLE account has assets at a beneficiary's death, the state can seek reimbursement from the account for Medicaid benefits paid to the beneficiary.
- Annual contributions to a 529 ABLE account are limited to the maximum annual gift tax exclusion, currently $14,000. Beneficiaries may have only one ABLE account.
- Contributions to a 529 ABLE account are irrevocable gifts. If ABLE account funds are withdrawn for non-qualified reasons, the amount is subject to income tax and a 10 percent penalty.

Before ABLE Accounts, There Were SNTs and Life Insurance

The 529 ABLE account is "official" governmental recognition of the financial challenges in caring for disabled children and young adults. But it's not the only option. Special Needs Trusts (SNTs) have a long legal history, and were officially authorized by Congress in 1993.

Per the National Special Needs Network (nsnn.com), a Special Needs Trust (sometimes called a Supplemental Needs Trust) is a specialized legal document that…

> …enables a person under a physical or mental disability, or an individual with a chronic or acquired illness, to have held in Trust for his or her benefit, **an unlimited amount of assets** *(emphasis added)*. In a properly-drafted Supplemental Needs Trust, those assets are not considered countable assets for purposes of qualification for certain governmental benefits.

Any earnings and distributions from assets placed in a trust for the benefit of the disabled individual (such as might come from an injury settlement) do not exclude a beneficiary from receiving government benefits. They are, however, still taxable as income, either to the trust or the beneficiary. And determining the tax can be complicated. A February 2010 article in *The Voice*, the monthly newsletter of the Special Needs Alliance, notes that

> The idea of a special needs trust is pretty straightforward, but the income tax rules that apply may be anything but. Whether someone will have to pay income taxes – and who will have to pay them – depends on what the trust says, what comes out of the trust, but most importantly, what goes into the trust.

Compared to 529 ABLE accounts, Special Needs Trusts can be established for beneficiaries of any age, and there are no contribution limits or restrictions on the accumulation amount.

With these broad parameters, life insurance is often used as a funding vehicle in SNTs. Per attorney Ken Shulman in a July 2012 *Voice* article,

> "(A) life insurance policy can provide the family with the comfort of knowing that even if there are financial setbacks in the future, there will be a source of assets for the SNT. Life insurance directed to an SNT can also provide flexibility to a family by providing adequately for the child with special needs while allowing the parents to direct retirement assets or business assets that may be inappropriate for an SNT to their other children. Life insurance is also a useful tool when parents want to leave a larger share for the special needs child and smaller shares for his or her siblings."

Either/or or Both?

The initial reaction from tax experts is that 529 ABLE accounts and Special Needs Trusts address different aspects of disability costs and care. In a February 5, 2015, article for *Investment News*, Darla Mercado concludes "The ABLE account will likely have money going into it and coming out on a regular basis, while the special-needs trust is more of a vehicle for long-term assets."

Establishing a Special Needs Trust is a serious undertaking. SNTs typically require legal and professional assistance to maximize the beneficiary's eligibility for public assistance and efficiently manage taxation. It makes a difference who owns the assets when they are placed in the trust, who is named as beneficiary on life insurance, and how distributions are characterized (the list of "supplemental expenses" for an SNT is different than the "qualified expenses" for 529 ABLE accounts).

Many disabled individuals are dependent on their care-givers for their ongoing well-being. SNTs, life insurance, and 529 ABLE accounts (when they become available in your state) can provide a framework for a lifetime of financial security for those whose ability to care for themselves has been made fragile. ❖

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Does Insurance Determine Your Debt Limit? *(Maybe It Should)*

One of the lingering after-effects of the recent recession is too much debt. As the economy began to slide, consumers couldn't maintain their credit card payments, under-employed graduates sought forbearance for their education loans, homeowners defaulted on their mortgages, and companies failed to meet their pension obligations. The resulting bankruptcies, extended repayment schedules, foreclosures and shuttered businesses have left a mess of bad debt that continues to be a drag on recovery.

Yet, many economists feel a catalyst for a faster economic bounce-back would be an increase in debt. How can the problem be the cure? The key is understanding the right kinds of debt, at the right levels. Here's an excerpt from John Mauldin, in a February 13, 2015, newsletter article "Debt Be Not Proud":

> Debt is a necessary part of any society that has advanced beyond barter or cash and carry. Debt, along with various forms of insurance, has made global finance and trade possible. Debt fuels growth and allows for idle savings accrued by one person to be turned into useful productive activities by another. But too much debt, especially of the wrong kind, can also be a drag upon economic activity and, if it increases too much, can morph into a powerful force of destruction.

So how can we identify "good debt"? One way: evaluate our "various forms of insurance."

Debt and Insurance: Bringing the Future into the Present

Early 20th-century Austrian economist Eugen von Böhm-Bawerk defined debt as "future consumption brought forward." Instead of waiting to accumulate the funds to make a purchase, debt makes it possible to acquire the good or service today, then pay for it (with interest) over time.

Used prudently, debt can purchase the means of its own repayment, and allow individuals and businesses to accelerate their financial growth. A craftsman can borrow to buy tools, giving him the ability to earn a higher income. An entrepreneur can buy a business (or start one) on credit that will produce enough income over time to repay the debt. A worker can finance a vehicle for transportation to a better job. A student can obtain an advanced degree and gain entry to a lucrative career field. This is good debt.

But the risk in a debt-driven economy (even for "good debt") is that loans might not be repaid. To mitigate against this peril, insurance serves a parallel future-into-the-present function: if necessary, it brings future payments into the present. Because of insurance, a damaged vehicle or building is repaired or replaced immediately. Because of insurance, future income that was lost due to disability or death either continues or is replaced with a lump sum. Borrowers can meet their obligations and lenders preserve their assets.

Consider the insurance that typically accompanies a mortgage for the purchase of a home: If it's a conventional loan, a sizable down payment will be required, which ensures the lender can reasonably expect to sell the property – even at a discount – and recover the loan balance if the borrower defaults. Conversely, a lender may agree to a smaller down payment if the borrower agrees to purchase mortgage insurance until the owner's equity in the property reaches a certain level. Title insurance protects both the lender and borrower from a fraudulent sale by the current owner. Until the loan is paid in full, the lender will also require insurance on the property so that in the event of damage, the building can be repaired or replaced. If there's a claim, the lender will be listed as a lien holder, ensuring that insurance payments will either restore the property or satisfy the outstanding mortgage balance. Although not essential to most real-estate transactions, insurers may offer both

If debt obligations exceed insurance protection, there is a problem.

life and disability insurance for the borrower to ensure the loan obligation can be fulfilled.

That's a lot of insurance. But without it, borrowing would be more costly and risky – for everyone. There are costs to bringing the future into the present. With debt, the cost is interest; with insurance it's the premium.

"Oh, I get it…"

If you grasp the connection between debt and insurance, it may provoke an "aha moment" about how individuals, businesses – and even nations – can determine whether they have too much debt. Quite simply, if debt obligations exceed insurance protection, there is a problem.

The expectation for most debt is that repayment will be made from future revenues. For individuals, this usually means income from labor. For businesses, it's profits. For governments, it's taxes and tariffs. So what happens if revenues are disrupted? Is there insurance to maintain payments and fulfill obligations?

In personal finance, the "various forms of insurance" referenced by Mauldin are:

- **Asset protection**, like home and auto insurance, guaranteed interest rates for cash reserves, and default protection on certain debt investments.
- **Income protection**, such as life, disability and health insurance that protect against an interruption or cessation of earnings and/or significant unexpected expenses in the event of accidents, illness or death. Unemployment benefits can cushion a loss of income due to termination or layoff.
- **Cash reserves** in safe, liquid accounts are a hedge against unknown events that might disrupt incomes, and ensure that debt payments can continue without interruption, at least for awhile.

In a perfect world, everyone would have enough assets and cash to never borrow. In the real world, debt is almost inevitable for at least a portion of our financial lives. Individuals and households with inadequate insurance are at a financial disadvantage in the real world, because the only way to safely bring consumption from the future into the present is to also bring along the assurance you can pay for it. ❖

DOES YOUR INSURANCE PROGRAM EXCEED YOUR DEBTS?

OR ARE YOU OVER-EXTENDED – EVEN IF YOU'RE STILL MAKING PAYMENTS?

The "New" Retirement:

It's the Same as the Old

(Except with More Management Responsibility)

The heady decades of robust stock market returns and booming real estate values (think the 1980s and 1990s) precipitated a shift in retirement plans, as 401(k)s and other qualified plans supplanted pensions as the primary source of retirement assets. At the time, this was considered a win-win for both employers and workers. Companies were freed from pension funding obligations while employees had the opportunity to realize higher returns and exercise greater flexibility over distributions than the monthly checks promised by a pension.

Retirement decisions in the pension-dominated model were minimal. With monthly Social Security and pension checks for life, the only real decision was whether any supplemental savings would be tapped for one-time expenses or left as an inheritance. Today, participants in the "new" retirement world of 401(k)s begun two decades ago still have Social Security, but they face a slew of decisions about how much of their retirement nest egg will be "spent down" to provide a monthly income, used to maintain adequate emergency reserves, set aside for an inheritance, and by the way, keep from exhausting their funds before they die.

Analyzing these factors, a current rule of thumb often used by financial planners is an initial retirement withdrawal equal to 4% of the nest egg's beginning balance, then annually increasing this amount to match inflation. Given historical rates of return from a blend of asset types, this formula typically projects a spend-down schedule that slightly exceeds life expectancy. But the absence of guarantees (such as those in a lifetime pension) mean two factors can undo this approach: volatile and/or less-than-average returns and longer life spans. Ominously, many retirees have experienced both issues in the past decade: returns are down, while longevity is up. The theory of the 4% withdrawal rate has encountered some daunting realities.

In a March 7, 2015, article for the *Wall Street Journal* titled "How to Pump Up Your Retirement Income," personal finance author Jonathan Clements sketches a hypothetical alternative to the 4% withdrawal format for a couple retiring at age 62. The strategies include all of the following:

- Staggering/delaying Social Security payments – one starts now, the other waits until age 70.
- Initiating a reverse mortgage at age 62, then saving a portion of the early distributions.

(continued…)

"Our approach to saving is all wrong: We need to think about monthly income, not net worth."

- Allocating another piece of the nest egg to purchase "longevity insurance" in the form of a deferred income annuity.
- Spending down a portion of the nest egg during the eight years of deferred Social Security payments.

Clements concludes this approach would provide the couple "almost 30 percent more than if they had simply claimed Social Security at 62 and plunked for a 4% portfolio withdrawal rate. Moreover, the strategy is arguably less risky, because they're locking in various streams of income that will keep paying no matter how long they live."

Clements' example personifies several conclusions from a July-August 2014 *Harvard Business Review* article by Robert Merton. The opening paragraph from "The Crisis in Retirement Planning" begins:

"Our approach to saving is all wrong: We need to think about monthly income, not net worth."

Merton says pension plans were designed with guaranteed incomes in mind. And vested recipients thought of their benefits in those terms. "Ask someone what her pension is worth and she will reply with an income figure: 'two-thirds of my final salary' for example."

But defined-contribution (DC) retirement plans, like 401(k)s, have a different language and perception. "Most DC schemes are designed and operated as investment accounts, and communication with savers is framed entirely in terms of assets and returns."

When the focus shifts from account balances and rates of return to income and guarantees, retirement priorities and strategies change. What's interesting is that the re-focus is "retro" – finding ways to reconfigure existing assets to perform more like old-fashioned pensions.

The responsibility for producing an income from existing assets can either be seen as an opportunity or an annoyance (who wants to become a "money manager" in retirement?). Either way, the final decisions will be on the individual, not the employer. If retirement is on your horizon, you'll want to educate yourself about the retirement income basics and retain the assistance of financial professionals who can guide you through your options and the accompanying details. ❖

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