White Paper - Nº4

The Wealth Dilemma

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So you are self made. You have done well, even by your own standards. You have built up significant wealth from your own business or farm (or perhaps a combination of the two). You may have sold the business recently, but even if you're still holding it, you are more than comfortable with what you've put aside out of the business over the years. Like all of us, you are getting older. You may have some minor health issues. While there's still plenty of life ahead of you, as the birthday numbers keep going up, your own mortality is starting to weigh upon your mind.

Your children are now in their twenties, thirties, or forties. They are all doing pretty well, but none of them is particularly interested in taking over the business from you. (That will be a topic for another White Paper).

The problem is that you've made all this wealth yourself.

Now what? Do you simply divide what you have equally between your children when you and your spouse both die?

But that raises more questions. Would that be spoiling them? You had to work hard to get where you are, so why shouldn't they?

Of course, you want them to be comfortable. But what does 'comfortable' mean? In today's world, it's going to be a hard slog for the next generation to be able to secure enough for a deposit on a reasonable house in a reasonable suburb, let alone to pay the mortgage off over time. Grandchildren would also be nice, but your children and their spouses are working hard to try to get ahead, and they may be inclined to defer having a family.

The million-dollar question, then, is what are you going to do with your accumulated wealth? There are two parts to what we'll call the 'wealth dilemma':

- **How much should we leave to the children?**
- **What should we do with the rest?**

There is a third issue which is how to educate your children financially, but we have covered that in our White Paper on transferring wealth, available on our website at www.covisory.com.

Let's consider each of these issues in turn. First, how much to leave to the children?

How much is too much?

The first thing to bear in mind is that how much you decide to leave your children is not an irrevocable, once and for all decision. You can always change your mind, whenever you want, just as you would change your Will. Sometimes you can even change your mind after you have given it to them if they upset you or do something that displeases you. You may decide to change your mind in view of what the financial markets are doing, or your perception of your children, changes in their financial position, and a whole host of other reasons.

What you leave to your children can be expressed in absolute terms, which will require on-going review and revision as time passes, or in relative terms. An absolute sum is a fixed amount – $1.5 million, say. A relative term would be something like: 'I want each child to receive sufficient upon the death of my spouse and myself to be able to buy a medium-priced house in Mt Eden.'

So what factors should you take into account in assessing how much to leave to your children? Well, there are no right answers. But here are some of the factors we think you should bear in mind, when you are considering how much to leave your children, and how best to leave it to them.

What are the ages and stages in life of your • children? As they grow up, get married (if they ever do these days!) and have children of their own, they become financially more mature. Ask yourself this: How financially immature are they at the moment?

What is their matrimonial position?• Single, married, in a steady relationship, or recently divorced? The answer may affect not just how much you leave to them, but how you leave it. For instance, you may wish to put it in a specific trust to maintain the status of the 'inheritance or distribution' as separate property for the purposes of the Relationship Property Act.

What have you given them to date? • Was it a distribution or a loan? Have you given the same amount to all your children? If unequal, do you want to even up the distributions between your children or not? If you are going to even it up, will you take into account the time value of money or just stick to nominal terms? If you are thinking about the latter, bear in mind the effect of inflation. A person who received $100,000 ten years ago will have got much more utility and benefit out of the money than their sibling who receives $100,000 today.

Does one of your children have special needs • that should be considered? Is one of you children handicapped, disadvantaged in some way, or simply not as well off in non-financial terms as your other children?

Think about the financial maturity of each • child. This may be a function of their ages, but not necessarily so. Some people are financially mature in their early twenties, while others may still be financially immature at the age of fifty. Your view of your children's financial maturity may not affect how much you decide to leave them, but it may well influence how you propose to leave money to them. Will you make them a loan or distribute it to them directly, or would you prefer to put it into a Protected Trust? That way your children would have access only to the income from the trust, not the capital, because you've selected Trustees who will protect them from spending their capital inheritance.

Finally, consider the amount of wealth you have to pass on. The greater it is (in absolute terms) very likely the more you will want to give them. Imagine how you would think if you had only $1 million to distribute. Now consider $10 million and $100 million. How much would seem the right amount to give your children at each level of wealth?

As you can see, there are no right answers. Determining what you want to do and how best to do it is a process. It takes time to consider all the issues, before you can arrive at what you and your spouse think and feel is right.

A matter of trust

If your accumulated wealth is now largely owned by trusts, there are some significant choices that you may not have thought about – and some distinct advantages. In contrast to a trust, a will by its very nature is a legal document, and therefore precise and rigid. It is difficult to accommodate vague or imprecise concepts or options within the context of a will.

Wealth and trusts are generally covered by a letter of wishes provided by the Settlor to the Trustees. A typical letter of wishes is addressed to the Continuing Trustees after your death (and that of your spouse), and is written in ordinary language, not legalese. While it may not necessarily be binding on the Continuing Trustees, they will usually follow it, even if its intent is unclear and they must apply to the Court for direction.

A letter of wishes may be couched in absolute terms or in relative terms. It may take into account all of the distributions that are being made to date, or take into account only part of them, say 50 per cent. You may wish to put in wording to the effect that the Trustees should be mindful of the relationship property status of any distributions or advances made to your children and their spouses and that, if the trustees are any doubt about the security of the relationship, they should ensure that the trusts and any distributions or advances are protected if the relationship should fail.

It is essential, then, that you carefully select your current independent and other trustees, as well as the trustees that you will appoint on the death of your spouse and yourself.

Choose these people with care, as it is they who will be taking into account your views and wishes later on.

Give some thought too to the age of the trustees you appoint. If you're 60, it is probably not a great idea to appoint your lifelong accountant, currently aged 75, as your trustee. More than likely she or he will die before you do. Better to find a younger lawyer or accountant or some other independent person to be on your Trust now, so that they have time to get to know you and your family. That way they will be familiar with what you would like to have happen after you have gone.

Carefully consider whether you would like to appoint family members as trustees. Would you cause a dispute in the family if you chose one over another? Is there someone in particular who is more financially able and would be considered to be acceptable by the others?

In any event, you need to keep an eye on your Trust and regularly review matters. You will need to keep your letter of wishes up to date and you should also review what you want to distribute to your children.

So what to do with the balance?

This is the multi-million dollar question. We have considered your children already, so they've now got (at least in your mind) more than enough.

Who else could be a beneficiary? Other possibilities are friends, your wider family, former key staff, and charities.

From our experience, it is rare for people to leave large sums of money to friends. Your friends have probably done OK anyway, and they may never have realised how much you had. Sometimes people are left smaller amounts for specific purposes, such as paying for a trip back to their homeland that they have never been able to afford.

Wider family are also worthy of consideration. Generally, as people get older, their connections to their wider family diminish. Your own family ties were probably stronger when your parents were alive and they were head of the family. Now that you have became the top of your tree and the links between effectively the family trees of your siblings became weaker. You may not see as much of your nieces or nephews now that they've got children – or perhaps grandchildren - of their own. But you may wish to make distributions for specific purposes, such as education.

Distributions to key staff are always a possibility, especially if you still own and operate the business or have sold it only recently. Most people tend to take the view that they've paid their staff well enough over the years; apart from setting up employee incentive schemes or paying performance bonuses, they see no need to share the capital wealth with them. In the modern world we are more inclined to see key staff gaining a value of the company in recognition of their efforts, but typically that is done through employee share schemes and other bonus structures.

So that really just leaves charities as the main alternative. Simple!

Now the interesting questions arise.

If you are considering giving money to a charity or charities, you will need to consider the following questions:

1. Which specific causes or charities do you wish 1. to support? Do you want to give money to the Red Cross, provide support for troubled youth, or would you like to provide facilities for the local or regional community? All of these options seem straightforward but you will need to be specific. Be clear about the specific charity that you want to give money to, the specific purpose you would like to support, and perhaps too the specific geographic area. Is it to be limited to New Zealand, the South Pacific, anywhere in the world, or confined to Takapuna? Which specific charities? Is there a specific charity that already operates in the area that you want to support? (An example of this might be Surf Life Saving New Zealand or Auckland Youth Orchestra.)
2. When do you want to give them the money? 2. Should you do it now, or wait until after your death? In our experience, it is better to give income each year to charities and to keep the capital. Better to keep the goose that lays the golden eggs and give the eggs away, than to give away the goose herself. Many people have been caught short as a result of the recent global financial crisis, having seen the value of their investments drop and the income from them shrinking. As a consequence, it has always been our firm's view that you should keep the goose and simply give away her eggs, so that in hard times, you have an adequate asset base. Much later, when you and your spouse have both died, and your kids have got their cut, whatever is left can go to charities.
3. Should you tag the money for some specific 3. purpose? Not only can you give money to a specific charity, but you can give also tell them exactly what you want it to be used for. You might sponsor Surf Life Saving New Zealand and say that you want the money used to buy a fleet of new inflatable rescue boats; or tag the money to Auckland Youth Orchestra to provide scholarships to players from low-income families.

An alternative is to set up your own charitable trust. The advantage of this is that you can transfer both income and capital to a charitable trust.

If the Charities Commission has approved your charitable trust, all its income is generally non-taxable (though there are a few issues to watch out for here).

Your own charitable trust can then receive the income from you together with income from monies it has invested itself and either accumulate all of it or make distributions to the charitable causes that it wants to support. By setting up a charitable trust you have created a fund that can survive in perpetuity and will continue to benefit charities every year in the future.

If you want to set up your own charitable trust, questions 1-3 above need to be answered. There are also a few extras matters to determine; such as who will be your trustees, and how will they determine what are worthy causes? Can you provide them with some guidelines to assist them?

If you don't want to set up your own charitable trust, you could consider supporting one of the 12 community foundations that have already been set up in many parts of the country, such as the Geyser Community Foundation in Rotorua.

A new solution for charitable giving, the Geyser Community Foundation exists for the purpose of ensuring charitable gifts in the Rotorua District are managed as originally intended. You can leave money to the Geyser Community Foundation for the benefit of the Rotorua community generally in which case Geyser will allocate those funds under its own distribution policies. Alternatively, you can set up your own "Named Fund" with Geyser and direct how those funds are to be allocated. It is also possible to make changes to those instructions during your lifetime as long as the end purpose remains charitable.

A "Named Fund" can be named after you or your family and when allocations are made every year both surviving family members and the charity are advised of the annual gift in your name. This is a very special way for loved ones to be remembered and funds set up by parents or grandparents can be added to by other family members creating a growing and perpetual legacy for the family.

Funds gifted to Geyser are invested and the capital retained in perpetuity. Every year the income earned on the capital is made available for charitable distribution. This means that you keep giving forever and the total amount of the gift will, over time, far exceed the original capital donation. This is a very powerful way for individuals, families or organisations to provide long term benefits to their community.

Bear in mind that there is no right answer or preferred method. In our opinion, philanthropy is more of a journey than a process. Often, through smart planning, you can start making distributions to your own or other charitable purposes out of the income of your company, before you've actually sold the business. Since 2009, charitable donations made by a company are tax deductible 'to the extent of its profits'. That means that it is not possible to make a donation that is greater than the profits of a company and obtain a tax deduction. This presents plenty of scope to plan your charitable giving.

Most people's accumulated wealth is held in trusts. Thanks to a couple of old UK judgments, trusts themselves are usually able to make distributions to charities of pre-tax income, either because the charities are specifically beneficiaries by name (such as NZ Red Cross) or by class (any charitable purpose within New Zealand), or through a distribution to or for the benefit of a beneficiary. (The relevant cases are Pilkington's case and re Chlores Settlement.)

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What is your favourite flavour?

We have a favourite saying at Covisory Partners that life is about ice cream: 'Everyone likes ice cream but each of us likes a different flavour'. The key to making good decisions, from our experience, is understanding. To get that, we need to sit down with our clients, have a discussion, and find out what they really want. You choose the flavour and we will work with you to develop the recipe.

People like you don't need to be told what their options are, because there is an infinite number of options. Rather, you need to reflect and decide what you would like to happen. Once your preference has been established, we can work with you to determine how best to give effect to your wishes. (You decide on the flavour, we adjust the ice-cream recipe to suit.) In the future, if you should change your mind, we will come up with a new recipe to suit. Invariably, the arrangements we create are flexible enough to be changed in the future, should you wish.

Through a well-structured discussion process with you and your children (should you wish to involve them in the planning process), an outcome can be found that the whole family is happy with.

In a recent case we worked on, a trust was set up for one of the children, who began using some of the income from the trust's investments to make distributions to charities directly, rather than using the income for their own purposes. In this example, the children had absorbed their parents' values as part of the wider family experience second-generation philanthropy at its best!

Be wary of any adviser who tells you there is a pre-set option and one easy solution. Some of these 'easy solutions' take years to work through. The key thing is to make sure you are happy with the decisions you make, as it is your wishes that need to be respected.

In the future, with all the accumulated wealth in New Zealand that will need to find a home, you can expect to see worthy charities courting people like you to see if you can support them financially.

Nigel Smith

About Covisory

Covisory comprises four specialist businesses providing Financial Advisory services. We specialise in International and Domestic Tax Services, Trust Management, Succession Planning, Strategic and Business Planning, Accounting Services and Business Valuations.

Established in 2007, Covisory 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 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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