Article by Frederick Bjørn, Private Client Partner at Payne Hicks Beach, originally published online by ThoughtLeaders4 Private Client Magazine Issue 5 November 2021 and reproduced with kind permission

https://thoughtleaders4.com/images/uploads/news/TL4_Private_Client_Issue_5.pdf

Frederick Bjørn
Partner, Private Client

In Focus: **Next Gen**

Authored by: Frederick Bjørn – Payne Hicks Beach

"Boom to bust in three generations". It is a phrase trotted out in numerous client meetings and a warning, in particular, to those wealth creators who have been so fixated on their business that they have not stopped to think about what comes next.

What is it that causes the dissipation of significant wealth over such a relatively short period? There are numerous answers, some of which are unavoidable and some of which are the reason that succession planning and family governance has become such a significant part of a private client adviser's workload in recent years.

One unavoidable side is the often exponential growth of families. Starting with a wealth creator in generation one (G1), it is typical for this wealth to be spread over 10-15 family members by generation 3 (G3). Even without other barriers, a fortune divided 15 ways takes on a very different complexion. Whilst the allotted sum may still be significant for each individual it will quickly diminish without appropriate planning.

Tax should never be the sole driver of succession planning. However, with the headline rate of Inheritance Tax (IHT) in the UK being 40% (one of the highest in the world) it is hard to ignore.

The moral issue surrounding the mitigation of IHT is beyond the scope of this article, but at an objective level, this is a material barrier to intergenerational wealth transfers and needs to be considered early on in the process. When advising family businesses, for example, the availability of IHT business property relief can be key at this stage.

Tax aside, the dissipation of wealth is often driven by a failure to bring the next generation(s) into the fold. There has to be a balance between on the one hand protecting the next generation (G2) and G3 from the wealth in a bid to maintain their drive and ambition, and on the other hand the risk of failing to educate them about the responsibility of wealth. It is notable how often material wealth becomes overwhelming and this is something which has to be addressed early on to enable a smooth transition.

As well as being overwhelmed by wealth, the next generations can be stymied by the success of G1. The wealth that derives from G1 is often the result of business acumen from one or both parents, and this can lead to feelings of inadequacy by G2 and G3 and motivational paralysis. G1 may simply attribute this to a sense of entitlement or laziness, as opposed to a fear of failure. There is of course the other side to this which is that having a financial safety net means that G2 and G3 are less willing to graft and apply themselves when the going gets tough but this should be explored with the family.

How much protection should there be for future generations – does G1 educate G2/G3 and leave them to make their own successes/failures or does G1 put in place a structure to protect them? The use of trusts in this context is one way of balancing this conundrum.

Whilst trusts have fallen out of favour due to increasingly adverse tax implications, they continue to be important succession planning tools.

Rather than merely distributing large sums to G2/3, or indeed G1 retaining sums and paying an allowance (which can seem overly paternalistic), trusts have the benefit of introducing G2/3 to the family wealth/business in a controlled manner – often with third party oversight. Whilst the funds are initially protected, they enable the next generation to feel involved in the wealth which is crucial to a successful transition. This can of course be achieved in other ways, but it is the involvement of third party advisors that can help G2/3 to immerse themselves in the family's affairs without the exclusive oversight of the generation above.

A further issue which often arises is the reluctance on the part of G1 to relinquish control. They have built up the wealth and they never accept that the next generation are no longer children, so they feel duty bound to control everything throughout their life and indeed from beyond the grave in some circumstances. As well as educating G2/3 in the responsibility of wealth, it is important to work with G1 to understand that they can start to let go as their children become more involved and better able to protect the wealth for their own children. This is a core aspect of family governance work and is often delicate. Not every child wants to take on the family business, and not every child will adhere to the principles laid down by their parents. However, it is important for there to be a forum to discuss this and often dialogue will enable both generations to understand the other's concerns so that these can be factored in to the planning. This can lead to a family constitution in which the agreed philosophies are laid down.

How does one raise the barrier to succession planning? As every lawyer likes to say, it depends. It depends on the particular circumstances of the family in question and the characters involved. It also depends on the assets representing the wealth and how far through a wealth cycle the family is. When the material wealth lies in a family business, questions arise as to how this will be run in the absence of G1 and the extent to which it is beneficial for one or more of G2 to get involved (assuming that is what they want to do). If, in fact, the wealth is more liquid then questions of investment and diversification arise, as well as the benefits and pitfalls of remaining as a family unit or splitting off into branches. In any event, the next generation must be educated in protecting what has built up. Is the existing structure fit for purposes? Are there matrimonial considerations to take into account (ie should pre-nups/post nups be considered)? What is the ultimate aim?

It is never too early to start the discussions about family governance and succession planning but it does require an open minded approach. Not every solution will be workable but exploring a family's options and ensuring an open and regular dialogue is key to success.

Payne Hicks Beach LLP
10 New Square, Lincoln's Inn, London WC2A 3QG
DX 40 London/Chancery Lane
Tel: 020 7465 4300 Fax: 020 7465 4400 www.phb.co.uk