

USING FAMILY EDUCATION AS A TOOL FOR RAISING ETHICAL AND FINANCIALLY RESPONSIBLE CHILDREN

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Introduction

Imagine yourself nearing full retirement age, but being unable to retire because you have undersaved and overspent. Or so you thought. Then your parents, who lived quite frugally, pass away and leave you an inheritance that's significant enough that you can now retire and live the lifestyle you have grown accustomed to. Research suggests this is happening to baby boomers in record numbers. In fact, some economists estimate that baby boomers will complete the biggest wealth transfer of all time by passing on \$59 trillion by the year 2061 (Davies, 2016).

However, not every parent plans to pass their small fortune on to their adult children (nor is every parent able). Although concentration of wealth at the top has been steadily rising, many business tycoons in the top 1% of wealth suggest either cutting children out of inheritance completely or giving a minimal percentage of wealth to children and the rest to charity (Davies, 2016). For instance, Warren Buffett is planning to give away 99% of his wealth to charity and only 1% to his kids. His reasoning: so the heirs have "enough to do anything but not enough to do nothing (Davies, 2016, para 3)." Likewise, Bill and Melinda Gates are not leaving their \$78 Billion fortune to their three children, but to charity (Graff, 2016). The Gates' will pay for their children's college, but then they need to have careers (Graff, 2016). They will have a safety net, but not a trust fund to blow through however they choose (Graff, 2016). "It's not a favor to kids to have them have huge sums of wealth," Gates said. "It distorts anything they might do, creating their own path" (Graff, 2016, para 5). We have all heard stories about spoiled rich kids, trust fund babies, and whatever other phrase you want to coin. We may even know one or two of them personally. A family friend's daughter inherited \$1 million from her very frugal engineer father, after growing up in a middle class home. She had already gone astray in terms of drug use and lifestyle, but her parents were divorced and she was the only child, and really the only person in her father's life. She proceeded to spend down the inheritance by living at the Ritz Carlton, doing more drugs, wrecking a new car and then simply abandoning it by the side of the road and purchasing another new

car. When I heard these stories from my mother, I thought “*Who does that?*” In reality, it may be more common than we think. If the father in this case had set up a trust, the money would have lasted for a longer period of time, and if he had put stipulations or left it in the trustee’s discretion, she may not have received funds at all.

What is family education?

There are two types of intergenerational transfers: *inter vivos* (gifts made during life) and bequests (a plan to leave money to someone upon death). Family education can be helpful for either type of transfer. Family education refers to estate planners sitting down with multiple generations within a family at one time, usually for the parents to discuss their bequest motives with the children and for the professional to educate the children about how to wisely manage the inheritance once it’s received. This is an appropriate time to discuss restrictions on the money – for example, it is being put in a trust with a trustee who can release funds periodically under certain conditions. Stipulations often include drug-free living, completion of a college degree, and attainment of a certain age. This prevents the party animal son or daughter from spending their inheritance on drugs and alcohol. Although the assumption is that most of the family education is focused on future inheritance, which is usually in the form of a bequest, lifetime gifting may also be part of the strategy. There are compelling reasons to do so. For one, \$14,000 per person per recipient per year can be gifted without any gift tax liability under current tax law. In addition, lifetime gifting can help spend down one’s estate, both to avoid estate tax liability later on (although most families are below the estate tax threshold of \$5.45 million for 2016) and to possibly qualify for Medicaid if needed for long term care while avoiding the Medicaid five-year lookback. Finally, a recipient might have immediate needs such as higher education or a down payment on a home that will be moot by the time a healthy donor passes away; sometimes it makes sense to provide help when needed rather than making the person wait.

Inheritance and Productivity

That brings up the million dollar question: how can you leave an inheritance to your children and still encourage them to work hard and be good citizens? Let’s look at what has been done in the past, and whether those things have been effective.

In early farming communities in Japan and Europe, parents gave a bequest only to the youngest child, as an incentive for that youngest child to stick around and look after the parents (Davies, 2016). The

older siblings had already moved away and established a life of their own (Davies, 2016). Nowadays, at least in the United States, children tend to move away and have lives of their own. Sometimes they move back when a parent is in need, but it's not always the youngest child who does this.

In the 1980s, economists at Harvard (including Larry Summers) looked at data for thousands of families and found that the higher the transferable wealth, the more phone calls and visits parents received from their children, especially if the parents were rich and sick and multiple children were competing for an inheritance (Davies, 2016). Although the phone calls and visits are nice, it's preferable that they be heartfelt, and not just in hopes of a later financial reward.

Gary Becker suggested gifting different inheritance amounts for each child as a way to make sure they took the parents' wishes seriously (Davies, 2016). In reality, bequests are usually spread evenly among children, with small amounts going to grandchildren and others (Finch, 2013), although *inter vivos* transfers from parents to adult children or grandchildren tend to be targeted toward the ones considered more needy (Kohli, 2004). In many ways, this makes sense; \$2,000 means a lot more to a child unable to pay rent than to a child who earns that much per hour. This is known in economics as diminishing marginal utility. However, it depends on whether the goal is equity or fairness, as "fair" and "equal" are not one and the same; if equity is a concern, giving more to the needy child may not meet the standard. It can also cause resentment among siblings. What if one child is middle class and the other is fully disabled? Middle class does not equate to "rich" or "has it made," and a substantial inheritance can make a quality of life difference. Good intentions by parents may backfire. Consider the mentally ill son who inherits the family house and a functioning son who inherits \$10,000. If the functioning son resents his brother's inheritance, and won't have anything to do with him, the mentally ill brother may now be on his own to fend for himself without an advocate. If the meds stop working, or he stops taking them, things may not end well. Although community services may be in place for such a situation, someone has to request the services. It might be a more amenable situation if the parents set up a trust for the healthy son and make caring for the mentally ill sibling a condition of receiving a portion of the trust funds.

According to Morgan Stanley, use of incentive trusts has been increasing over the last 20 years (Davies, 2016). Most common in incentive trusts are: payout for completion of an undergraduate

degree, payout matching post-graduation salary or for starting a new business, and payout for good behavior such as attending church or avoiding drugs and/or alcohol (Davies, 2016). If designed properly, these generally work well, although evidence is mixed (Davies, 2016). It's hard to account for every future contingency, and writing such a long contract would be a nightmare – but then what about the child who drops out of college because of a disability, medical condition, or accident (Davies, 2016)? The child needing the most money, through no fault of his/her own, may end up with the least. If the parents have already passed away, then it's up to the siblings to assist, out of the goodness of their hearts. If the disability occurs at a young age, and the person lives long enough, this can be a serious drain on a sibling's finances. It's better for the parents to set up a special needs trust for the disabled child, with instructions to be followed. But see the previous paragraph regarding the resentment that may follow.

Even if the story is not that extreme, unbridled gifts may not be spent the way one envisions. Consider the recent story of a long time University of New Hampshire library employee who left the university \$4M upon his death, unrestricted. The university chose to spend \$1M of the bequest to install a new video scoreboard at the football stadium (Ettinger Law Firm, 2016). How would the decedent feel about this? We will never really know. But, if he had given some guidelines for how the university could spend the money, then we would know. Although this is not a family scenario, the lesson still applies: if you care how your money is spent in the future, provide guidelines.

Inheritance and its impact

Bequest transfers from elderly parents to adult children can accumulate over time and impact the financial position of recipients upon retirement if the money is invested when received and not spent until retirement (Harrington, 2008). Homeownership potentially increases the inheritance because it is one more asset to pass along to heirs (Finch, 2013). Harrington uses PSID data from 1984-2005 and compares the impact of private savings and pensions to that of inherited wealth (Harrington, 2008). She finds that inheritance has only a negligible impact for the most poor and the most wealthy Americans, but is “surprisingly significant” for the middle class (Harrington, 2008, pg. 1). While inheritance only represents 1% of wealth for retired households in the PSID sample, it represents 7.5-8% of retirement wealth for those in the middle class (Harrington, 2008). Larger inheritances may enable some recipients to retire prior to age 65 and live comfortably even if they have

undersaved and overspent up until the point of receiving the inheritance. It was projected that 60% of the baby boom generation will receive an inheritance or *inter vivos* gift that will amount to more than double what their parents and grandparents received (Harrington, 2008). Although these are nominal dollars, real return is still positive. In general, current baby boomers have been purported to have undersaved and overspent while their parents lived frugally (Salsbury, 2006), and an inheritance could narrow or fill what would otherwise be a shortfall between accumulated wealth and retirement spending needs (Harrington, 2008). Lifetime total inheritance, on average, was \$29,500 in 2008 when this article was written (Harrington, 2008). All but the wealthiest Americans are dependent on pensions during retirement (Harrington, 2008), and given the movement away from defined benefit pensions and toward defined contribution plans, these pensions may be a thing of the past. An inheritance can provide a significant supplement for retirement, especially if the money has some years to grow.

This brings up another point: seemingly small amounts, such as \$10,000, can make a big difference. Considering that inheritance makes the most significant difference for those in the middle class, think about what \$10,000 could help someone buy - a year of tuition, part of a down payment for a home, a decent used car, enough to renovate a bathroom or kitchen. Alternatively, it can be used to significantly pay down existing debt, or be invested for future use such as retirement spending, the focus of Harrington's article. Larger amounts can make an even bigger impact - perhaps the recipient is able to start a small business.

Bequests to Grandchildren and Relatives other than Children

If the baby boomer recipients continue overspending, they may not have anything left to pass along to their own kids when they die (Salsbury, 2006). For this reason, as well as others, if a donor wants grandchildren to have some of the money, the donor should specifically leave some money to the grandchildren, even if it's in the form of a trust. If it all goes to the children with instructions to leave the unused amount to the grandchildren, it may all get used.

Much of what has been written is geared toward traditional families. However, it is estimated that 40 - 50% of first marriages end in divorce (Doherty, n.d.), with a median duration of eight years (Ellis, 2011). To add to that, statistics show that 67% of second marriages and 73% of third marriages end in divorce (Banschick, 2012). The end

result may be a marriage later in life between two people with kids from previous marriages. Even if the adult children are on their own and paying their own bills, how things are divided after the death of both spouses can become a bit more complicated. It may be even more crucial to have family education under these circumstances. For instance, if he has two kids from a prior marriage and she has five kids from a prior marriage, does each kid get $1/7$, or does each side of the family get $1/2$? A planner can help the couple decide, and open things up for discussion. This is a good start, but the next step would be to involve the children in the discussion. Meeting with an estate planner with expertise in multiple marriage situations could be beneficial if there is any concern about the surviving spouse changing beneficiary designations and excluding the late spouse's kids. Perhaps a qualified terminable interest property (QTIP) trust is needed rather than a marital trust.

Same sex marriage is now recognized in all 50 states, but some of the legal implications are not yet clear. With any kind of non-traditional relationship – same sex, cohabitation – it's important to involve family members to the extent possible. There may still be a will contest, but a contestant is less likely to prevail if the couple's wishes were clearly known.

These issues also apply to childless adults. An increasing number of adults do not have children. In fact, the percentage of American women who have at least one child has fallen from 64.9% in 1976 to 52.4% (Luckerson, 2015; U.S. Census Bureau, 2014). People without children may still have bequest motives. Perhaps there are siblings, nieces or nephews, or close friends that are like family. If anything, discussion between the childless adult and close friends and relatives is even more important in this instance, because it's harder to guess what that person's wishes are. Even if the decedent had a will listing specific bequests, the gifts may be given outright unless other provisions are made. One could argue that having a niece or nephew blow through an inheritance is not any better for them or society than a son or daughter blowing through an inheritance. Financial education for the future recipient is always important, no matter the relationship between donor and recipient.

Positive Psychology

Positive psychology aims to help already well-functioning clients achieve goals they didn't even know existed (Pavia, 2016). Family education can be one of these hidden goals that financial planners and estate planners can strategize about and add value to their

services. On a broad level, clients can figure out their transfer motives, which can be one of three options: unconditional giving (if they need help, I will provide it), conditional giving (people should do something in exchange for the inheritance), and separation (children need to be self-supporting and not dependent on their parents for support) (Kohli, 2004). Results from the German Aging Survey indicate that more highly educated women are the most likely to give unconditionally (Kohli, 2004). This means the recipients receive an inheritance with no strings attached. Other demographic groups are more likely to give the bequest only under certain conditions. A similar survey in the United States could determine if the effect of being a highly educated woman is the same. Different countries present different needs for inherited money – for example, higher education in the United States is expensive, and housing in Israel is expensive.

Teaching Financial Responsibility

Let's say you read this paper and become convinced that family education is a good idea. You call an estate planner and schedule the meeting with the planner and various multigenerational family members. That's just one meeting. What else can you do to teach your kids to be financially responsible? How do you assess their level of responsibility? Joline Godfrey provides what she calls "Ten Basic Money Skills":

How to save, how to keep track of money, how to get paid what you are worth, how to spend wisely, how to talk about money, how to live a budget, how to invest, how to exercise the entrepreneurial spirit, how to handle credit, and how to use money to change the world (Godfrey, 2003, pg. 44).

Godfrey then goes through suggested age appropriate activities for each of the ten money skills. In addition, she provides a set of values related to money: 1) Money is a tool to help us achieve and maintain independence, 2) It's good to save, it's not good to accumulate for the sake of accumulating, 3) It's best to spend wisely and within one's means, 4) Greed is bad, 5) Part of one's responsibility to humanity is to give generously, 6) Steering wealth can be a respectful act, 7) Money is an energy that can be used for good or evil; it is not a commodity (Godfrey, 2003).

Discussing Financial Responsibility

Carl Richards explains that we often use money as a front in order to avoid discussing deeper issues (Richards, 2012). “We can’t afford that” and “Our money is better spent on higher priority items” are two different states of being, but parents often say the former when they mean the latter (Richards, 2012). Framing the issue in a way that is meaningful to others is important. Money is a sensitive topic that can arouse uncomfortable feelings, and thus conversations about it are often avoided (Richards, 2012). However, more frequent meaningful family conversations about money lead to better decision making. Do not limit the conversation to stock market performance. Discuss the role money plays in the family’s life, what financial goals are being met and which ones are on the table for the future, and what really matters (Richards, 2012). This also involves discussing limitations and past mistakes (Richards, 2012).

Richards then goes on to discuss delayed gratification, and that people who figure out how to live with delayed gratification experience greater success than those who give in to immediate desires (Richards, 2012). He suggests the following ways to save more and spend less: 1) Force yourself into a “holding pattern”. Write down what you want, sit on it for three days, and then reconsider. 2) Go on a “buying fast”. See how long you can go only spending money on necessities. 3) Track your spending. 4) Figure out how much your goals will cost. 5) Consider the effect of taxes. 6) Calculate how much you could earn if you were to invest the money rather than spend it (Richards, 2012). We are wired to avoid pain and pursue pleasure (Richards, 2012). It’s best to come to terms with past financial mistakes and get a fresh start (Richards, 2012).

Conclusion

In this paper I discussed two types of intergenerational transfers: *inter vivos* (gifts made during life) and bequests (a plan to leave money to someone upon death). I then looked at how family education can be helpful for either type of transfer. There may be restrictions on how the money is spent, and there may be compelling reasons to donate more to charity and less to family. Whatever the *inter vivos* and bequest motives are, they should be discussed with family members, especially potential recipients and those who expect to receive. It’s bad enough if an inheritance is blown. What could be even worse is having family members splurge on a few items, expecting to be able to repay the loan in a lump sum when they inherit money someday, only to not receive that inheritance. The person may end up with debt they cannot get out of, and they may end up bitter.

I also speculate on the issue of how to leave children an inheritance while still encouraging them to work hard and be good citizens. This involves looking at what has been done in the past, and exploring how behavioral biases might help or hinder bequest planning. This is considered for traditional and non-traditional families. Finally, I look at ways to financially educate family members on your own as a supplement to the multigenerational meetings between family members and a planner. Although it's beyond the scope of this paper to summarize them all, know that there are dozens of good books to help parents raise financially responsible kids, initiate money discussions, develop budgets, figure out one's money history and its impact on current financial decisions, and numerous other relevant topics.

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