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How to build generational wealth

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The term generational wealth refers to financial assets passed down from one generation to the next. They include property, investments and businesses but also other assets, such as collectibles or royalties from oil and gas holdings.

The process of building generational wealth is intended to provide younger family members — and even those not yet born — with financial opportunities and a head start to long-term stability.

The importance of building generational wealth

Families have different reasons for seeking to build generational wealth.

"Some look to provide the next generation with a level of security, to allow the next generation to take risks, such as starting a business or pursuing their passions, which may not lead to monetary success," said Chris Chorlins, a certified financial planner (CFP) who serves as senior wealth advisor and managing director at MAI Capital Management in St. Louis, Missouri.

Without significant money worries, family members can be more charitably inclined or pursue artistic endeavors, said Chorlins. That's consistent with the goals many wealthy families hope to achieve.

"Several of our client families focus on creating a family legacy with a goal to better the communities where they live," Chorlins said, adding that many of his firm's clients are first-generation wealth creators who started small businesses and grew them into successful enterprises.

The challenges of building generational wealth

Even for wealthy families or couples, building generational wealth isn't always easy. Factors including economic shifts, market volatility and inflation can hinder the best-laid plans. In addition, most Americans are familiar with stories of heirs who squander wealth they've inherited.

Even getting started on the path toward generational wealth is often a steep hurdle.

"For many, obtaining wealth is the greatest challenge due to lack of access to quality schools, exposure to financial institutions and affordable housing, as much of a family's wealth starts with home ownership — social issues that continue today," said Matthew Erskine, an attorney at Erskine & Erskine, a law firm in Worcester, Massachusetts, that specializes in estate planning and related issues pertaining to family-owned businesses.

Families who have wealth to pass to younger generations also face challenges, he added. Those include economic downturns, poor financial management and family conflicts. That means it's not at all uncommon to see families lose their wealth in three generations.

"Subsequent generations may also have different values, priorities and financial goals, making it challenging to align on wealth management strategies," Erskine said.

How to build generational wealth

1. Build a strong financial foundation

Families looking at strategies for how to build generational wealth might consider getting the next generation involved as soon as possible, said Erskine.

"The earlier you begin saving and investing, the more time your assets grow through the power of compound interest," he said.

Erskine cited the rule of 72, which holds that investments that compound at a rate of 10% annually will double approximately every seven years.

"Also, encourage your children to develop good financial habits from a young age. Remember to diversify your investments across various asset classes, such as stocks, bonds, real estate and alternative investments, and seek professional advice to develop a long-term investment strategy aligned with your goals," he said.

2. Invest in education

There are a few ways families can invest in education as part of the generational wealth-building process.

There's formal education, which can enhance career prospects by providing specialized knowledge, developing critical thinking skills and offering networking opportunities. Education also can lead to a greater number of specialized professional qualifications and credentials, which can make a person more competitive in the job market. That attitude toward maximizing one's income is often passed down through families.

"Long-term educational planning across generations can be effectively accomplished through a family dynasty 529 plan," said Michael Unger, vice president of investments and planning at Coral Gables Trust in Coral Gables, Florida.

These plans, he said, which provide tax advantages, offer substantial contribution limits and growth potential, facilitating the accumulation of a sizable cash pile to fund education expenses for multiple generations.

Another form of education involves teaching younger generations about the process of wealth management.

"Getting your children or future beneficiaries involved early is a great way to ensure the time and effort you have put in will continue to show dividends for them in the long term," said Michael Ziminsky, trust officer at Tompkins Financial Advisors in Mt. Kisco, New York.

"Consider having them join a meeting with your financial advising team or asking if that team can assist in some educational meetings to help them understand the ins and outs of the process and, eventually, what to expect when the time comes for the wealth to transfer to them," Ziminsky added.

3. Invest in financial markets

Investing in financial markets is a proven way to build generational wealth, as the stock market has potential for growth that outpaces inflation. In addition, fixed-income investments, such as bonds, can offer a reliable source of income.

"Long-term investing can be incredibly powerful and gives the investor the ability to leverage the power of compound returns," said Unger. "Essentially, compound interest is interest earned on top of interest."

For that reason, he said, putting money to work in the capital markets as soon as possible is a sound strategy for building generational wealth.

4. Invest in real estate

Real estate is a popular asset class among investors seeking to build generational wealth, as it has a low correlation with stocks and bonds.

In addition, real estate has potential for not only steady appreciation over time but also for rental income. Because real estate often increases in value over time, it can offer significant returns on investment for buyers with some patience.

Real estate also offers tax benefits, such as deductions for depreciation and other expenses related to the property, which can add up for those looking to pass along assets to heirs.

5. Create and preserve assets

Assets like real estate, businesses and investment portfolios can provide multi-generational financial stability, growth potential and income streams.

However, those assets need to be safeguarded. It's not always the case that a particular asset, such as a home or a business, has to be passed down to heirs. In fact, in many cases, succeeding generations aren't interested in the assets themselves but would benefit from cash generated in a sale.

That's true for families of all wealth levels, not just billionaires, but portfolio planning is crucial to have assets to pass along at all.

"We often think of generational wealth as belonging to the aristocratic families of the past; however, these same legal structures and strategies to preserve wealth for future generations can be used by you and your family," said Unger.

"Preserving and growing wealth across many generations requires thoughtful planning and portfolio management," he added. "To prevent the erosion of wealth through the passage of time, it is paramount that the portfolio's return surpasses the combination of inflation and distributions."

6. Maximize tax benefits

Taxes are inevitable, but with careful planning, investors can minimize how much taxes eat away at the portfolio they're handing down to heirs.

"Different states have different estate or inheritance tax thresholds, but the best way to plan for these taxes, and possibly reduce them, is to have an estate plan in place," said Ziminsky.

For example, he said, heirs who inherit a traditional individual retirement account (IRA) may need to pay income tax on the money they inherit and withdraw.

On the other hand, a spouse, dependent or other heir who inherits a Roth IRA that was funded for five years or more prior to the account owner's death can take tax-free distributions.

Ziminsky also pointed out that most states will also charge an estate tax, which is nicknamed the "death tax."

"Advance planning can help your beneficiaries prepare for tax responsibilities upon your passing," he said.

7. Avoid debt and financial pitfalls

A key component of generational wealth planning is avoiding debt. Interest payments erode savings and investments, and often impede the ability to build wealth in the first place.

By minimizing debt, families can allocate more resources toward wealth-building activities, such as investing in the markets or growing a business.

Debt, consumerism and living paycheck to paycheck impede Americans' ability to build generational wealth, said Sidney T. Curry, president and CEO of BC Holdings of Tennessee, which specializes in financial wellness education.

Citing data showing that the average American family has at least four credit cards, Curry said, "The best way to avoid debt and financial pitfalls is to have an emergency fund. The emergency fund is literally the glue that holds it all together."

How to pass down generational wealth

Instilling good financial habits, such as staying out of debt and investing as soon as possible, are early steps toward building generational wealth. Getting help from a financial advisor is a way to be sure family members are on the same page when it comes to a wealth transition.

"Building generational wealth is more achievable than commonly perceived," said Unger. "It begins by living within your means so you can save and invest effectively."

Unger also stressed the crucial role of education in the process of generational wealth building.

"It is paramount that children understand key concepts so the pitfalls of poor financial decisions will not consume their lives," he said. "One of the most valuable gifts you can give your children is preparing them to thrive in adulthood."

Frequently asked questions (FAQs)

How can I start building generational wealth if I have limited financial resources?

Avoiding debt, building up an emergency fund and starting to invest in a diversified portfolio are some proven ways for those with limited financial resources to start building generational wealth.

Making sure your heirs are educated about finances and portfolio management are also key components of passing down generational wealth.

What are some tax-efficient strategies for maximizing generational wealth?

Heirs who inherit a Roth IRA can make withdrawals tax-free, as long as the Roth account has been open for at least five years.

Other potential tax-saving measures include setting up a trust, which can offer control over asset distribution.

In addition, the annual gift tax exclusion allows gifting to heirs up to an allowed limit each year, reducing the amount of a taxable estate.

How can I protect my assets and ensure they are passed down to future generations?

In addition to its tax advantages, a trust can help protect assets by legally transferring ownership to a trustee. This ensures that assets are managed according to the grantor's wishes, as a trust provides clear guidelines for how assets are to be distributed.

How does life insurance factor into generational wealth?

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Why is estate planning crucial for generational wealth?

Anyone who wants to build generational wealth and pass along assets to heirs shouldn't play guessing games. Planning for investments, taxes and how to distribute assets is complex and requires a plan. Without a proper estate plan, assets may not be distributed according to a grantor's wishes, possibly erasing any chance of building real generational wealth.