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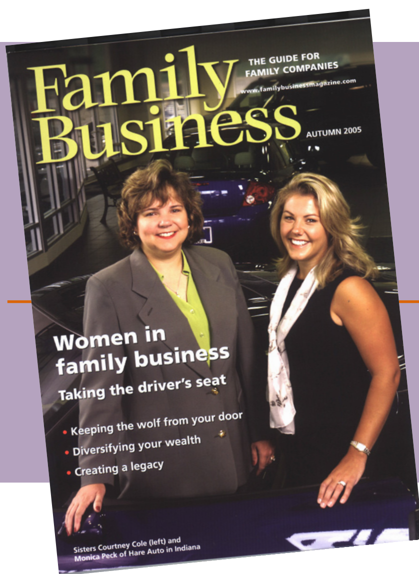

Family Business

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Minimize your personal risk

Financial strategies for diversifying your wealth outside the business

By Stephen Fox and Jerome Simon

Most small to mid-sized family businesses, no matter how successful, make up 80% to 90% of the owner's wealth. The remainder is usually concentrated in the home and a minimal retirement plan. These business owners are vulnerable to economic and personal risks that can often be avoided with planning.

The first step is to understand that a business is an investment and a financial asset like any other. Just as advisers recognize there is no single "ideal" mix of assets in investment portfolios, there is no perfect target for how much wealth should be concentrated in a family business. But here are two key principles:

• *The younger the owner, the more wealth may be concentrated in the business.* As the time approaches to retire or hand over the enterprise to new owners, the more of the owner's wealth should be concentrated outside the business. With less time to recover from business or personal reversals, diversification becomes crucial.

• *Start a regular diversification program as early as possible, and stick to it.* As Albert Einstein noted, compound interest is one of the world's great miracles. The sooner you begin, the bigger the miracle. By diversifying in a tax-efficient way, you get even greater leverage.

> **When the bulk of the owner's assets are concentrated in the business, planning for the family's future becomes more difficult.**

Why diversify?

When the business is the only real source of income for the family, stress between generations and among siblings is almost inevitable.

• The business may fail or decline so much that the owner can't count on it for retirement income. When the owner of a computer parts business saw increasing competition shrink his margins, he began to take money out of the business each year on a tax-deductible basis. After five years he had accumulated $3 million in other vehicles, which are safe from any business slumps and business creditors.

• The more wealth is concentrated in the business, the more the owner will have to depend on it for retirement income. If the next generation is less efficient at running the business, their parents' retirement income may be at risk. When business owners have more assets outside the business, they have greater flexibility. In one case, the owners of a distribution business took a substantial portion of their profits and purchased real estate, which now makes up the bulk of family wealth. This is fortunate for the founders because the children aren't skilled business-

people.

When a business is going to be sold, an owner who has failed to diversify cannot be as tough a negotiator as one who holds significant other assets. Diversification keeps you out of the "must sell" scenario.

When the bulk of the owner's assets are concentrated in the business, planning for the family's future becomes more difficult. For example, how can an owner whose business is the only asset equalize the family inheritance if one child is involved in the business while others are not? Such situations commonly result in family quarrels, particularly when the children outside the business question whether those running the business are doing a competent job or believe they may be taking too much money out of the business.

Variations on these themes have caused family business owners grief that could easily have been avoided through advance planning and asset diversification.

How to diversify

Careful planning is important to ensure the owner's future as well as the company's.

1. Start planning as soon as the business shows some success. The more you can invest elsewhere, the better off you'll be later.

2. Create a plan, and then monitor and modify it continually. For example, the second-generation owner of a $45 million contracting business wanted to retire at age 60. When he was 55, he arranged for a group consisting of his son and four others to purchase the business in five years. When his son dropped out of the deal, the plan was easily modified for the remainder of the purchasing group.

3. One caveat: If you're planning to sell the business, be careful not to transfer out so many assets (e.g., equipment in manufacturing firms) that there is a negative impact on its value.

4. Take into account any arrangements with other entities that may limit business value. A distributorship or franchise, for example, may not be transferable without permission, which may lower its value.

5. Obtain periodic valuations of the business over time so you know where you stand.

6. In all planning, involve a CPA for expert tax advice and a lawyer to make documentation legally binding. A bank or other lender may impose restrictions on moving assets out of the business.

An integrated approach

Why don't business owners diversify their assets? Many are simply too busy running their companies to devote time to planning for their personal future. Others procrastinate or don't understand why it's important to diversify, And still others fear tax complications or lack competent help in planning.

The best wealth-building strategies are based on an approach that takes into account personal estate planning and business management perspectives. Each family business situation requires an individual solution. Getting professional help will increase the ROI of any planning effort.

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