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Wealth planning for families with illiquid assets

BY ROY BALLENTINE

Wealthy business owners with mostly illiquid assets have many wealth planning opportunities that are unavailable to other families. They also face significant challenges for the management and preservation of their wealth, particularly if their assets become liabilities.

Business owners often underestimate their family's illiquidity risks. To understand some of the risks, it can be instructive for owners of private businesses to consider the following questions:

- If you had died yesterday, how would your estate raise the cash necessary to pay estate taxes? As a general rule, estate taxes must be paid in cash within nine months of the date of death. This can create a major problem if the assets are mostly illiquid.
- If your death or disability is likely to cause a sharp decline in the value of the business, how will that affect your estate's ability to raise cash quickly?
- If you had died yesterday, what other challenges and concerns would your executors, trustees and family members face as they try to manage the illiquid assets on your balance sheet? Who would assume responsibility for the financial management of these assets?
- If you had become disabled yesterday, how would you cover your family's financial needs and your needs for medical care, if your assets are largely illiquid? How would the value of those assets be affected?
- What portion of your personal balance sheet is liquid and protected from the risks of your business? It is common for many business owners to personally guarantee business debt. If you are the "deep pocket," lenders can come directly after your personal assets if they choose to do so after a default event (unless you managed to negotiate a marshaling agreement with lenders).
- If you have personally guaranteed business debt, how are you going to eventually convince lenders to release your guarantee? If you die with the guarantee in place, what are the implications for your estate? Will the guarantee be used against your estate?
- What is your plan for passing your illiquid assets intact to the next generation? How do you know the plan will perform as intended? Are your estate documents written with this goal in mind? If you created trusts, did you select a state jurisdiction and governing law that are appropriate for your estate goals?
- What is your company's management succession plan? How strong is your successor's ability to lead and manage a business whose assets are mostly illiquid?

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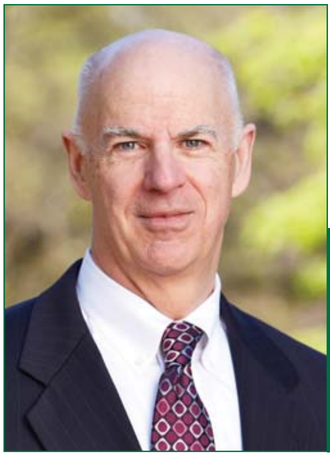
- If your business has outside investors, how would they react to your death or disability if their shares, as well, are largely illiquid?
- If your illiquid assets are subject to a shareholder agreement, LLC agreement, etc., would your executors, trustees and heirs have the same rights as you have with respect to the management of the assets? If their management rights are restricted, how does that affect your heirs?
- In general, your business partners' financial planning (or lack of planning) can be a risk factor for you. If a partner dies, that partner's estate may need immediate access to cash to pay estate taxes. Or imagine that one of your partners becomes insolvent and creditors are able to attach his or her assets, including your partner's share of your business. The illiquidity of these assets complicates a resolution. How would this affect your ability to manage the business?

Wealth planning opportunities

Many business owners mistakenly assume that the illiquidity of their assets limits wealth planning opportunities. As a result, they fail to identify and capitalize on innovative strategies. Here are some planning ideas.

- Asset protection is generally easier and more effective with illiquid assets than with liquid assets. Illiquid assets can be protected through entities such as corporations, LLCs and



Roy Ballentine, CLU, ChFC, CFP, is chairman of the board, chief executive officer and founder of Ballentine Partners, based in Waltham, Mass. Ballentine Partners is a multi-family office and investment advisory firm with clients in the U.S., Canada and Europe.

limited partnerships, and through private agreements containing transfer restrictions.

- The fact that illiquid assets are often difficult to value can be advantageous. It may be possible to transfer a large amount of wealth in a tax-efficient manner through the use of business interests, valuation metrics and trusts.
- Properly designed and fully funded buy-sell agreements can fix the price of an illiquid asset for gift and estate planning purposes, and can also provide cash to cover estate taxes.
- Sale and lease-back arrangements with illiquid assets (especially real estate) can be arranged between the current owner and the next generation of owners. This type of agreement can help keep illiquid assets in the family and pass them on to the next generation in a highly tax-efficient manner.
- Creative agreements to fund the purchase of life insurance can help provide cash to pay estate taxes, and prevent illiquid business assets from being sold during estate settlement.
- The family business interests can create a "family bank" whose function is to make loans to family members for business purposes, or for any purpose that the family decides is worthwhile.
- Business owners may want to consider innovative financing arrangements, such as private annuity contracts and special installment sale promissory notes that are cancelable upon the death of the note maker. When properly used within a family setting, these types of financing arrangements can facilitate the transfer of illiquid assets.
- Business owners can establish customized investment vehicles whose future value and performance will depend upon the performance of the family's illiquid assets. (The customized investments are private agreements between individuals and a family-owned entity, or between family-owned entities.)

Family business liquidity issues almost invariably intersect with family liquidity needs.

Dual liquidity concerns

Wealthy families with illiquid assets are often unaware of the scope of their risks and opportunities. Family business liquidity issues almost invariably intersect with family liquidity needs. It is critical for family business owners to review their liquidity concerns from a dual business and family perspective. Family business owners are encouraged to acquaint themselves with the relatively wide array of wealth planning strategies available to them before they have achieved liquidity. These strategies can provide considerable protection and be an important step toward achieving future legacy goals. FB