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We'll Always Have Paris—*Casablanca* (Warner Brothers, 1946)
(55 1/2 in. by 78 1/4 in.) by Luigi Martinati, sold for \$478,000 at
Heritage Auctions' Movie Posters Signature Auction in Dallas on
July 29-30, 2017, p. 4.



FEATURE: FAMILY BUSINESSES

By **George Isaac**

Avoiding the Family Business Wealth Evaporation Trap

Follow a roadmap to success

Many privately held family businesses unwittingly destroy shareholder wealth every year! They do so by falling into what I call the “Wealth Evaporation Trap,” which results from three management flaws, all easily reversible but all potentially devastating to the owners if not addressed:

- First, leaders manage their business with a narrow and limited perspective, viewing it only as an “operating entity.” They fail to consider that the company is also a “financial investment,” in fact, often the largest part of the owning family’s overall wealth portfolio.
- Second, leaders fail to recognize the critical difference between company return on equity (ROE) and shareholder-realized ROE.
- Third, leaders fail to understand that their “conservative” financial management results in poor stewardship of the family’s overall wealth, exposing family members to unrecognized risks, lower long-term investment returns and diminished liquidity.

The inevitable consequence, even in very successful companies, is the silent and unseen evaporation of family wealth, often over a single generation. These flaws also create problematic family dynamics when the financial results don’t meet either business or family shareholder needs.

Evaluation and implementation of the proper short

and longer term alternative strategies by the company’s management and board of directors can begin to resolve these problems quickly.

Unfortunately, most boards pay minimal attention to two of their most important functions: maximizing realized shareholder value and protecting shareholders’ investment by managing risk. Thus, they fail to exercise an essential part of their legal and fiduciary responsibilities. My experiences in the family business world¹ affirm that these issues are seldom even on the agenda.

Retaining cash in a business is appropriate at times. However, until cash or other assets are distributed and thus “realized,” shareholder returns are zero! The impact of 0 percent returns in the early years of an investment significantly reduces the magnitude of cumulative shareholder returns over the longer term. Until cash is received, shareholders have nothing more than an unrealized stock gain. Yet, they’ve been exposed over the years to the associated business and financial risks similar to owning any other illiquid investment.

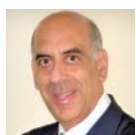
With public company investments, shareholders can realize value any day simply by selling their stock. Private company shareholders don’t have this option. Rather, their investments lie trapped inside the sealed vault of a private business, often family owned, with no meaningful options for sale.

Given this distinction, private companies must act to expand their focus beyond just creation of shareholder value to include realization of shareholder value.

Shareholder Wealth Evaporation
Shareholder wealth evaporates in privately held businesses in many ways:

- 1. Time value of money.** The delay in distributing cash returns to shareholders generates a significant reduction in overall returns due to the time value of

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money and inflation. Waiting for a future liquidity event, such as a sale of the business, is costly from an investment return perspective. Unfortunately, family businesses often treat shareholders as family members rather than investors. However, when a family business recognizes this dynamic and shifts its focus to treating shareholders as investors, the leadership makes different and more salutary decisions. These, in turn, bring improved realized returns and, as a complementary benefit, improved family dynamics.

2. Working capital management. Many conservatively managed businesses shy away from corporate debt. They thus fail to manage working capital properly (that is, accounts receivables, inventories and payables) due to an abundance of retained capital. This misuse of the family business' equity capital results in poor stewardship of a family's wealth. For example, a business can establish a working capital line of credit today for an interest cost of about 3 percent. By self-funding with retained capital, the family is making the unconscious decision to "invest" shareholder equity capital in an investment returning a mere 3 percent. This is a common example of why shareholder wealth evaporates over time. The misappropriation of equity capital also impacts the amount of funds available for business reinvestment, thus hurting future growth.

3. Capital structure. Even conservatively managed businesses should have an appropriate level of debt to support the enterprise. A no debt or low debt policy for all but high risk businesses produces substandard shareholder returns due to the lack of financial leverage on the balance sheet. Unfortunately, I've worked with several companies that proudly report they have no debt and excess cash balances. The result: earn negligible returns and expose family wealth to lawsuits and other unforeseen risks. Tax-efficient transfer of excess cash into special purpose entities (SPEs) provides additional asset protection, greater liquidity to the operating business or individual shareholders and better diversification of the family wealth portfolio.

4. Business management. Too many privately held businesses focus solely on the income statement (that is, revenues, costs and profits). When management isn't disciplined about generating cash and realizing

shareholders returns, it makes decisions that destroy shareholder value. Examples include unjustifiable capital investments, poor working capital management, substandard cost controls, inadequate product or customer margins and a financially sloppy management culture. When both profits and cash are central, management makes better decisions. Cash is said to be king, but shareholder-realized cash is the true king!

5. Unrecognized tail risks. Shareholder value retained in the business is exposed to many tail risks that aren't

A strategy of distributing part of a business' equity appreciation to shareholders on an ongoing basis will maximize shareholder returns, improve shareholder liquidity and investment diversification and reduce exposure to tail risks.

recognized or sufficiently acknowledged by family leadership. Examples include: declining future economic prospects; new competition/products; loss of key customers, suppliers or executives; new governmental regulation; product liability claims; and detrimental press. In addition, uncontrollable economic factors such as interest rates, valuation multiples and tax rates can diminish or decimate shareholder value. The business economic cycle is still a reality; to wit, the Great Recession of 2008 destroyed shareholder value for many privately owned (and publicly owned) businesses—some irretrievably—at no fault of management in many cases.

Realizing Shareholder Returns

Since realizing shareholder value requires cash or other asset distributions, private company CEOs and their



FEATURE: FAMILY BUSINESSES

boards need to implement strategies that generate current and future cash flow for their shareholders. There are three primary strategies to consider:

- Recurring cash distributions—from ongoing operating profits plus depreciation, less current or planned capital expenditures.
- One-time or periodic cash distributions—from improvements in working capital management, restructuring of the business' capital structure and tax-efficient distributions of assets (for example, sale and leaseback of real estate used by the business).
- Cash distribution from sale of the business—made

Estate-planning attorneys' narrow focus on taxes, wealth transfer strategies and asset protection often misses the important issues that impact family business longevity and overall wealth management.

possible or enhanced by steps to increase the company's valuation and maximize its net proceeds after taxes.

The goal is to increase shareholder realized returns while minimizing the exposure to risks—that is, optimizing risk-adjusted returns, a common investment management principle.

My consulting experience has shown conclusively that a strategy of distributing part of a business' equity appreciation to shareholders on an ongoing basis will maximize shareholder returns, improve shareholder liquidity and investment diversification and reduce exposure to tail risks.

There are exceptions, as when high growth companies make an informed decision to retain equity capital in their business to support significant growth opportunities. In those situations, the rewards are often worth the risks but when growth slows, wealth realization becomes an important strategic issue.

Client Case Study

In a recent client case, I developed financial models to evaluate implementing two alternative shareholder distribution strategies to determine the impact of each on the business and management of the family's wealth. My client, a \$100 million manufacturing company, required capital to support a sales growth plan of 10 percent per year. The client forecasted revenues to grow from \$100 million to \$236 million during the 10-year projection period. Our model projected a sale of the business at the end of Year 10. (See "Case Study Results," p. 51.)

In Scenario I, we retained annual operating cash flow in the business to provide capital for growth; we borrowed additional funds when needed. In Year 5, when operating cash flow exceeded capital investment requirements, we paid off the debt and then distributed any remaining cash flow to the shareholders. During Year 6 through Year 10, we distributed all operating cash flows in excess of annual capital investment requirements to the shareholders.

In Scenario II, we distributed 100 percent of operating cash flows annually to the shareholders. Bank debt provided all capital for growth. Debt levels over the 10-year period remained within financing norms, reaching a maximum debt/earnings before interest, tax, depreciation and amortization ratio of 2.5 times.

The main difference between the scenarios was the amount of cash distributions to the shareholders during the 10-year planning horizon based on a strategy of retaining versus distributing annual cash flows.

The different results from the modeling of the two scenarios were significant. Scenario II (annually distributing operating cash flow) was far superior than Scenario I (retaining operating cash flow).

Scenario II was significantly better on all wealth management metrics. It produced a six percentage point increase in shareholder annualized returns on equity—from 13.3 percent to 19.1 percent. It increased the net present value (at a 10 percent discount rate of the cash flow streams) from \$62 million to \$79 million. And, by the ninth year, the shareholders received over 50 percent of their total projected cash for the entire 10-year planning horizon. That generated significant family liquidity to meet various family needs and an ability to begin a wealth diversification program. As a result, the family didn't have to sell their family business to meet current or future liquidity needs and were able to maintain their

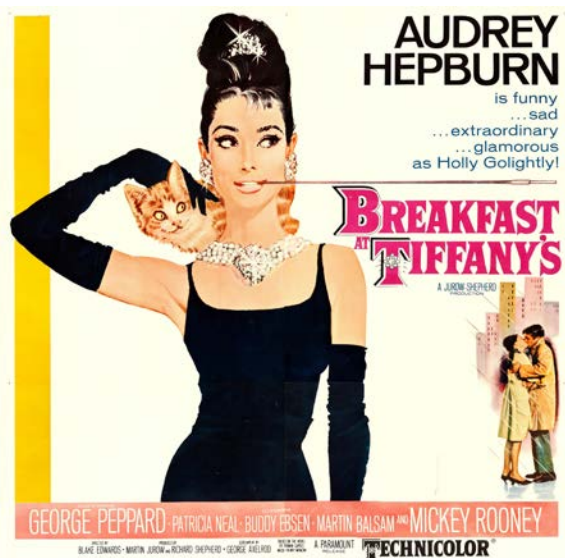


family enterprise for future generations.

Family Wealth Roadmap

The family wealth roadmap provides a work plan to determine how to realize business wealth as it's being created, annually or periodically, based on business and family shareholder needs and objectives. When properly implemented, it will better serve family shareholders by:

- Increasing realized internal rates of return and family member liquidity and decreasing exposures to tail risks;
- Increasing family wealth asset protection and family wealth diversification;
- Improving family stakeholder satisfaction and family dynamics;
- Introducing better financial management disciplines



SPOT LIGHT

Diamonds Are a Girl's Best Friend

Breakfast at Tiffany's (Paramount, 1961) by Robert McGinnis sold for \$5,736 at Heritage Auctions' Movie Posters Signature Auction in Dallas on July 29-30, 2017. Set in New York City, *Breakfast at Tiffany's* starred the iconic Audrey Hepburn. What some may not know is that Truman Capote (whose novella the movie is based on) actually wanted Marilyn Monroe for the lead role. Monroe, however, turned down the role after being advised playing a prostitute would be bad for her image.

Case Study Results

Distribution of annual operating cash flows produced superior shareholder returns

	Scenario I Retain cash	Scenario II Distribute cash
Initial enterprise value—Year 1	\$65 million	\$65 million
Annual revenue—Year 1	\$100 million	\$100 million
Annual revenue—Year 10	\$236 million	\$236 million
Total cash realized after 9 years (prior to selling the company in Year 10)	\$22 million	\$83 million
Total cash realized by owners (after sale of company in Year 10)	\$155 million	\$161 million*
Net present value @ 10% of owners' realized cash	\$62 million	\$79 million
10-year internal rate of return for shareholders	13.3%	19.1%

*Minor difference in total cash realized due to shareholders reinvesting differing cash distributions of \$22 million vs. \$83 million over the 10-year planning period.

— George Isaac

into the business;

- Providing alternative investments to individual family members to meet their individual investment objectives and tolerance for risk more precisely; and
- Facilitating tax-efficient business wealth transfer and estate planning.

I recommend creating a multi-disciplinary team of senior company executives and external professionals experienced in finance, business operational assessment, wealth management and taxes/estate planning to implement the roadmap. The primary steps in the roadmap are:

1. **Business operational and financial review**—evaluating the business' future cash flow generation capability, sustainability, volatility and capital needs. The goal is to determine the amount of free cash flow available for tax-effective distributions over the following three to five years.
2. **Family needs assessment and wealth management**



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review—understanding the individual and overall family’s financial objectives and evaluating the family’s wealth portfolio inclusive of the family business asset. I often uncover family dynamics problems during this phase that need to be addressed so that individual family issues don’t undermine the future survival of the multi-generational business.

3. Capital structure review—rationalizing current working capital, overall business capital structures and existing shareholder distribution strategies. Business needs, always of utmost importance, are evaluated along with shareholder objectives and needs. The goal is to meet the current and future capital requirements of the business while developing strategies to realize increased shareholder value through one-time or recurring shareholder distributions. The team needs to evaluate a variety of options, such as re-capitalizing the business through debt or equity transactions; sale-leaseback transactions (real estate, major equipment); spinning off non-core assets into separate asset-protected companies; selling underused assets and replacing them by outsourcing; and improving working capital management.

4. Shareholder distributions and wealth management planning—preparing a 5-year financial plan for the business and for the family’s wealth portfolio. The project team needs to develop financial models to test various scenarios to determine which plan best supports the business while meeting overall family wealth management investment objectives. I recommend a large cushion of conservatism, with implementation strategies modified annually based on actual business results and an assessment of the economic outlook. In certain instances, I’ve suggested transferring distributions into an SPE with the same ownership group as the business. This standby SPE can lend funds to the main operating business, guarantee loans and provide asset protection strategies by holding assets outside of the operating company. An extra benefit is that shareholders control the assets of the SPE that are now protected from exposure to creditors of the main family business operating entity.

5. Wealth transfer and asset protection planning—projects of this nature can lead to gift and estate planning. Estate-planning attorneys’ narrow focus on taxes, wealth transfer strategies and asset protection often misses the important issues that impact family

business longevity and overall wealth management. A more holistic and goals-driven approach addressing succession plans, governance and family dynamics is required. Plans need to be tailored to meet the needs and objectives of the individual stakeholders, the overall family’s wealth (evaluated from an investment portfolio perspective) and the “golden goose”—the family business. (See “Roadmap,” this page.)

Best of Both Worlds

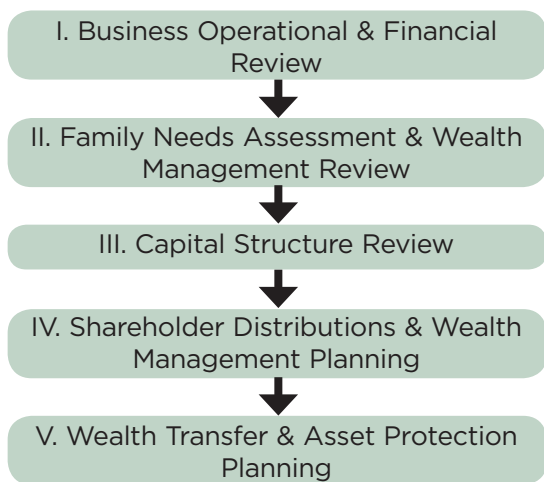
Private companies have the benefit of longer time horizons for performance measurement than public companies. They don’t have the pressures of public companies to produce ever-increasing quarterly earnings, a blessing and a curse. Because public companies focus on delivering shareholder value, they tend to do a better job on this essential measure. Private companies need to up their game on this objective. Once they do so, private companies will have the best of both worlds! 🌐

Endnote

1. I’ve worked as a family business consultant and CEO, as chair of USC’s Family Business Program Advisory Board and as a Deloitte management consulting partner and a member of 14 different business boards.

Roadmap

The primary steps for implementation



— George Isaac