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Commingling personal funds with family business ill-advised

Separating assets wards off IRS and avoids many conflicts of interest

By Charles Paikert
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Wealthy families who own businesses should resist the temptation to mix their personal and business assets, according to a new white paper from the Family Office Exchange, a Chicago-based research organization.

"A common theme in our research was that all the families we spoke to who had broken off their personal business from the operating business were really happy they had done it [and] said they wished they had done it even sooner," said Anna Nichols, director of research for FOX and lead author of the paper, "Boundaries That Matter: Managing Family Assets Separately from the Family Business."

Cost savings, convenience and hopes for achieving economies of scale are the primary reasons wealthy families, especially those with a large amount of illiquid wealth, keep their personal financial and administrative affairs within their businesses, she said.

But such reasoning is shortsighted and counterproductive, the white paper stated, adding that families run significant legal, privacy and operational risks by keeping personal and business assets commingled.

TAX CODE VIOLATION

Anna Nichols: *Families wished they had separated their assets earlier.*

"The [Internal Revenue Code] is very clear that an individual or family cannot take a business deduction for the management of their personal affairs," the white paper stated. It also went on to note that the Securities and Exchange Commission requires that anybody providing investment advice to more than 15 individuals must be a registered investment adviser.

One example of legal risk that Ms. Nichols encountered in her research occurred when a family member insured their car through the family business. After the car was involved in a serious accident, the victim in the other car sued the family business, exposing the company to serious liability.

"The legal issues resulting from mixing family and business assets can be very serious," said Thomas Handler, partner for Handler Thayer & Duggan LLC, a Chicago-based law firm with a family office specialty. "It's a huge subject, and attention is being paid to it only nominally."

Wealthy families are also extremely sensitive to negative publicity, said Brian Hughes, senior vice president and national director for Jenkintown, Pa.-based Pitcairn Financial Group, which has approximately $3 billion in assets under management.

"Families of significant wealth do not want to see stories about themselves on Page 1 of The New York Times or Wall Street Journal — or on Page 6 of the New York Post [the paper's gossip page]," said Mr. Hughes, whose firm is currently working with two families who would like to separate their families' operational businesses.

"They are much less likely to be exposed to something embarrassing by keeping things separated," he said.

In addition, Mr. Hughes said, families may be risking their companies' ability to raise capital in the public markets by not separating their personal finances.

"Those kind of issues will come up in the due diligence process," he said, "and there needs to be a bright line between a family member's role in the business and personal affairs."

The white paper also cited the "operational risks" of mixing family and business.

A business employee who is also a personal wealth adviser is placed in a "conflicted position," according to the paper.

"As an employee, it may be difficult for him or her to carry out family decisions that do not align with the interest of the company," the paper stated, in addition to the fact that the family misses out on the objectivity that an outside adviser brings to the same job.

Even if a family has been using a business employee for personal affairs successfully, Mr. Hughes said, that person may not be best-equipped to handle the family office business as it becomes a "more complex wealth structure."

The biggest benefits for families starting an office, according to Tim Welsh, president of Larkspur, Calif.-based Nexus Strategy LLC, a wealth management industry consultant, are "control, customization, objectivity and discipline."

However, he expects families increasingly to take advantage of technology and platforms to leverage the infrastructure of other family offices through multifamily offices.