


# The Basics of Business Succession Planning

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## The Basics Of Business Succession Planning



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**PRESENTED BY:**  
**Lawrence G. Staat, J.D., M.S. (Taxation)**

Shaheen, Novoselsky, Staat, Filipowski & Eccleston, P.C.  
Chicago, IL

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### ABOUT YOUR SPEAKER AND HOST

**Larry Staat:**

- SNSFE partner & head of the transactional practice groups
- Develops and implements successful tax-wise plans for transactions involving businesses, real estate, investments, employment, gifts and inheritance
- Counsels business owners in matters affecting their businesses and personal estates
- Named to the Illinois *Leading Lawyer* and *Super Lawyer* lists

**SNSFE:**

- Established in 1960
- Full service business law firm
- Representing closely-held businesses, entrepreneurs and individuals
- From start-up to succession planning
- "A-V" Peer-Review Rated by Martindale-Hubbell

\* Martindale-Hubbell is the facilitator of a peer-review process that rates lawyers. An "A-V" rating is the highest rating for "Legal Ability" and "General Ethical Standards."

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## The Basics of Business Succession Planning

### ORIENTATION

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Cash	\$ 100,000
Marketable Securities	\$ 500,000
Residence	\$1,000,000
Retirement Accounts	\$ 800,000
Business Real Estate	\$1,800,000
Business Interest	<u>\$5,000,000</u>
Total Assets	\$9,200,000
Real Estate Mortgage	<u>\$ 200,000</u>
Net Worth	<u>\$9,000,000</u>

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**2 Questions**

1. How certain is the value?
2. How liquid is the value?

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**What makes the value certain?**

- a. The current leader
- b. What can happen to the current leader?
  - i. Death
  - ii. Disability
  - iii. Distraction
    - ✓ Family or health problems
  - iv. Disinterest
    - ✓ Retirement, new career

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**What makes the value certain?**

- c. The next leader
- d. Because he will continue to do what the current leader does

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**What makes the value liquid?**

- a. The next owner
- b. Because he has the cash

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**A succession plan helps answer these questions.**

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**Succession plan is a 2-part plan**

1. Leadership succession
2. Ownership succession

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**2 succession plans**

- a. The plan
  - i. Covers all 4 "Ds"
  - ii. Expected timeline
    - ✓ Later

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**2 succession plans**

- b. Interim plan
  - i. Unexpected timeline
    - ✓ Sooner than later
  - ii. Accelerate the plan
  - iii. Insurance for business
    - ✓ Disability for buy-out
    - ✓ Life for buy-out

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**Who cares?**

- a. You
- b. Family
- c. Employees
- d. Creditors
  - Bank

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**EXPECTED TIMELINE PLAN**

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**Succession plans vary**

- a. By type of business
- b. By number of owners
- c. By number of leaders

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**2 types of businesses**

1. Personal goodwill
2. Entity goodwill

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**Personal goodwill business**

- a. Personal reputation and relationships
- b. If leader leaves, so do customers
- c. Examples
  - Doctor, lawyer, accountant, architect, consultant, broker, investment advisor, manufacturers representative

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**Entity goodwill business**

- a. Entity reputation and relationships
- b. If leader leaves, customers do not follow
- c. Examples
  - Manufacturer, distributor, retailer, restaurant

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**The idea is that the design of the succession plan is determined by the location of the business' goodwill.**

- That's where the customers are
- Succession plan must protect the business' goodwill

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**2 types of succession plans**

- a. Personal goodwill plan
  - i. Leader and owner are inseparable because leader holds the customers
  - ii. Plans for leadership succession and ownership succession are inseparable
  - iii. One plan
    - ✓ Leader-owner succession plan

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**2 types of succession plans**

- b. Entity goodwill plan
  - i. Leader and owner are separable
  - ii. Plans for leadership succession and ownership succession are separable
  - iii. 2 plans
    - ✓ Leadership succession plan
    - ✓ Ownership succession plan

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**LEADER-OWNER SUCCESSION PLAN**

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*Example:*  
**Small manufacturers representative**

- a. Personal goodwill more than entity goodwill
- b. Revenue stream is rather predictable
- c. One owner
- d. Next leader is employee
- e. Sell 45% ownership interest to next leader
- f. Buy-in by salary allocation
- g. Assume no growth in revenue

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**Income Statement**

	<u>Coming Year</u>
Revenue	\$1,000,000
A's salary (owner)	\$ 175,000
B's salary (employee) \$125,000 last year	\$ 175,000
Other expenses	<u>\$ 400,000</u>
Expenses	\$ 750,000
Profit	<u>\$ 250,000</u>

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**Compensation Without Buy-In**

	Ownership	Salary	Profit	Total Comp
A	100%	\$175,000	\$250,000	\$425,000
B	0%	\$175,000		\$175,000
<b>Total</b>	<b>100%</b>	<b>\$350,000</b>	<b>\$250,000</b>	<b>\$600,000</b>

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**Compensation After Buy-In**

	Ownership	Salary	Profit	Total Comp
A	55%	\$175,000	\$137,500	\$312,500
B	45%	\$175,000	\$112,500	\$287,500
<b>Total</b>	<b>100%</b>	<b>\$350,000</b>	<b>\$250,000</b>	<b>\$600,000</b>

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**Value of Business and Purchase Price**

Profit	\$ 250,000			
Capitalization rate	25%	Ownership Interest	Price	Annual amount over 5 yrs
Value of business	\$1,000,000	45%	\$450,000	\$ 90,000
Balance sheet equity	- \$ 100,000	45%	- \$ 45,000	- \$ 9,000
Goodwill	\$ 900,000	45%	\$405,000	\$ 81,000

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### Compensation During Buy-In

	Before Buy-In	During Buy-in					After Buy-In
		1	2	3	4	5	
A	\$425,000	\$493,000	\$470,000	\$447,000	\$425,000	\$402,000	\$312,500
B	\$125,000	\$107,000	\$130,000	\$153,000	\$175,000	\$198,000	\$287,500
B's Raise	\$ 50,000						
Total	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000

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- ### Years Later...
1. A retires
  2. B buys A's 55% ownership interest
  3. Buy-out by deferred compensation
  4. Business hires C to help B run business
  5. Assume no growth in revenue
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### Value of Business and Purchase Price

Profit	\$ 250,000				Annual amount
Capitalization rate	25%	Ownership Interest	Price		over 3 yrs
Value of business	\$1,000,000	55%	\$550,000		\$183,333
Balance sheet equity	- \$ 100,000	55%	- \$ 55,000		- \$ 18,333
Goodwill	\$ 900,000	55%	\$495,000		\$165,000

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**Compensation During Buy-Out**

	Before Buy-Out	During Buy-Out					After Buy-Out
		1	2	3	4	5	
A	\$312,500	\$183,333	\$183,333	\$183,333			\$ 0
B	\$287,500	\$291,667	\$291,667	\$291,667	\$475,000	\$475,000	\$475,000
C		\$125,000	\$125,000	\$125,000	\$125,000	\$125,000	\$125,000
Total	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000	\$600,000

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- Succession plan documents**
1. Employment agreement
    - a. Salary allocation for buy-in
    - b. Deferred compensation for buy-out
  2. Stock purchase agreement
  3. Shareholders agreement
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**LEADER SUCCESSION PLAN**

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**Who's the next leader?**

- a. The current leader and current owner must choose
- b. When?
  - Before the next leader is needed
  - Now

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**How to locate the next leader?**

- a. Look inside
- b. Look outside
  - i. Someone known
    - Competitor
  - ii. Someone unknown
    - Headhunter

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**How to keep the next leader in place?**

- a. Employment arrangement that keeps the next leader interested in the business
  - i. Employment agreement
    - 1) With attractive financial incentives
      - a) Tied to personal performance
      - b) Tied to business performance
    - 2) With restrictive covenants
      - a) Non-solicitation
      - b) Non-interference

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**How to keep the next leader in place?**

- ii. Deferred compensation
  - 1) Qualified
    - ✓ Profit sharing and 401(k)
  - 2) Non-qualified
    - a) Bonus deferral plan
    - b) Stock appreciation rights (SAR)
    - c) Phantom stock
    - d) Supplemental executive retirement plan (SERP)

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**How to keep the next leader in place?**

- iii. Ownership
  - 1) Minority interest with buy-back
  - 2) Stock option
- b. Continuing education
- c. Good order to business
  - Is your business attractive to an outsider?

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**OWNER SUCCESSION PLAN**

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**Who's the next owner?**

- a. The current owner should choose
- b. When?
  - Before the next owner is needed
  - Now

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**How to locate the next owner?**

- a. Look inside
  - i. Co-owner
  - ii. Next leader
  - iii. Employees - ESOP

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**How to locate the next owner?**

- b. Look outside
  - i. Strategic buyer
    - Competitor, rollup buyer
  - ii. Financial buyer
    - Private equity
  - iii. Business broker

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**How to attract the next owner?**

- a. Business must appear profitable and clean
- b. Do the “due diligence” in advance
  - i. Corporate formalities
    - Good standing, required records
  - ii. Eliminate special arrangements
    - Loans to insiders, employment of relatives

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**How to attract the next owner?**

- iii. Formalize vital relationships
  - Make as permanent and transferable as possible
  - 1) Employees
    - ✓ Restrictive covenants
  - 2) Vendors
    - ✓ Supplier agreement
  - 3) Customers
  - 4) Licensors
    - ✓ Government and private

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**How to attract the next owner?**

- iv. Formalize rights to vital assets
  - Make as permanent and transferable as possible
  - 1) Patents
  - 2) Name registration
  - 3) Copyrights
  - 4) Trade secrets

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**How to attract the next owner?**

- v. Settle pending or potential claims against business
  - 1) Lawsuits
  - 2) ERISA compliance problems
  - 3) Tax compliance problems

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**What should be the deal with the next owner?**

**Goal –**

Sell for the highest price for cash or marketable securities

**Exception for family –**

Arrangement which satisfies income needs and minimizes estate taxes

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**Minimize taxes**

- a. Income taxes
  - i. Tax-treatment goals in sequence: defer, capital gain, ordinary income
  - ii. Defer
    - Tax-free organizations or reorganizations
    - ESOP
  - iii. Capital gain
    - Personal goodwill

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**Minimize taxes**

- b. Estate taxes
  - i. Change ownership to discountable form for family succession plan
    - Minority stock
    - LLC
  - ii. Gift ownership before value is apparent
    - Outright
    - GRAT – Retain income interest

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**CONCLUSION**

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**Questions?**

For more information on the transactional practice groups at SNSFE, or if you have a question about this presentation, please contact:

**Lawrence G. Staat, J.D., M.S., (Taxation)**  
LStaat@snsfe-law.com  
312.621.4400

*Thank you!*

Shaheen, Novoselsky, Staat, Filipowski & Eccleston, P.C.  
20 N. Wacker Drive, Suite 2900  
Chicago, IL 60606-9719  
312.621.4400 (T)  
312.621.0268 (F)  
www.SNSFE-law.com  
www.FinancialCounsel.com

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