

The Basics Of Business Succession Planning



PRESENTED BY:

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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.”

The Basics of Business Succession Planning

ORIENTATION

Balance Sheet of a Business Owner

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><u>\$9,000,000</u></u>

2 Questions

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

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

What makes the value certain?

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

What makes the value liquid?

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

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

Succession plan is a 2-part plan

1. Leadership succession
2. Ownership succession

2 succession plans

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

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

Who cares?

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

EXPECTED TIMELINE PLAN

Succession plans vary

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

2 types of businesses

1. Personal goodwill
2. Entity goodwill

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

Entity goodwill business

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

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

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

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

LEADER-OWNER SUCCESSION PLAN

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

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><u>\$ 250,000</u></u>

Compensation Without Buy-In

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

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
Total	100%	\$350,000	\$250,000	\$600,000

Value of Business and Purchase Price

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

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

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

Value of Business and Purchase Price

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

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

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

LEADER SUCCESSION PLAN

Who's the next leader?

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

How to locate the next leader?

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

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

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)

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?

OWNER SUCCESSION PLAN

Who's the next owner?

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

How to locate the next owner?

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

How to locate the next owner?

b. Look outside

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

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

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

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

How to attract the next owner?

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

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

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

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

CONCLUSION

Questions?

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

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Thank you!

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