

A photograph of two hands, one on the left and one on the right, gently holding a small green plant with four leaves and a mound of dark soil. The background is a plain, light-colored surface.

# **Succession Planning A to Z**

**Edward J. Callahan**  
**Director**

**Justin Amico**  
**Director**

**Jeffrey Rogers**  
**Tax Manager**

# What is Continuity Planning?



- Transition
  - Ownership
  - Management
- Current owners
  - Remove equity
  - Change role
- New owners
  - Changed roles
  - Who, when and how
- Company
  - Strategic plan

# Components of Continuity Planning



- Your Personal Financial Plan
- Ownership transfer plan
- Management succession plan
- **“Hit by a bus”** or contingency plan
- Business Plan

# Why Is Succession Hard?

## Owner's Succession Fantasies



- Live forever or get money cleanly
- Work indefinitely, periodically or absentee
  - Getting paid indefinitely
- Successors will clamor for ownership
  - Employees will develop a plan for me
- Family members will ultimately come into the business

# Key Facts and Assumptions *(1 of 2)*



- Alternatives for getting out
  - Liquidate
  - Sell to a third party
  - Sell internally
- Few outside buyers
- Internal sale can maximize value
- B Y O W Y O \$

# Key Facts and Assumptions *(2 of 2)*

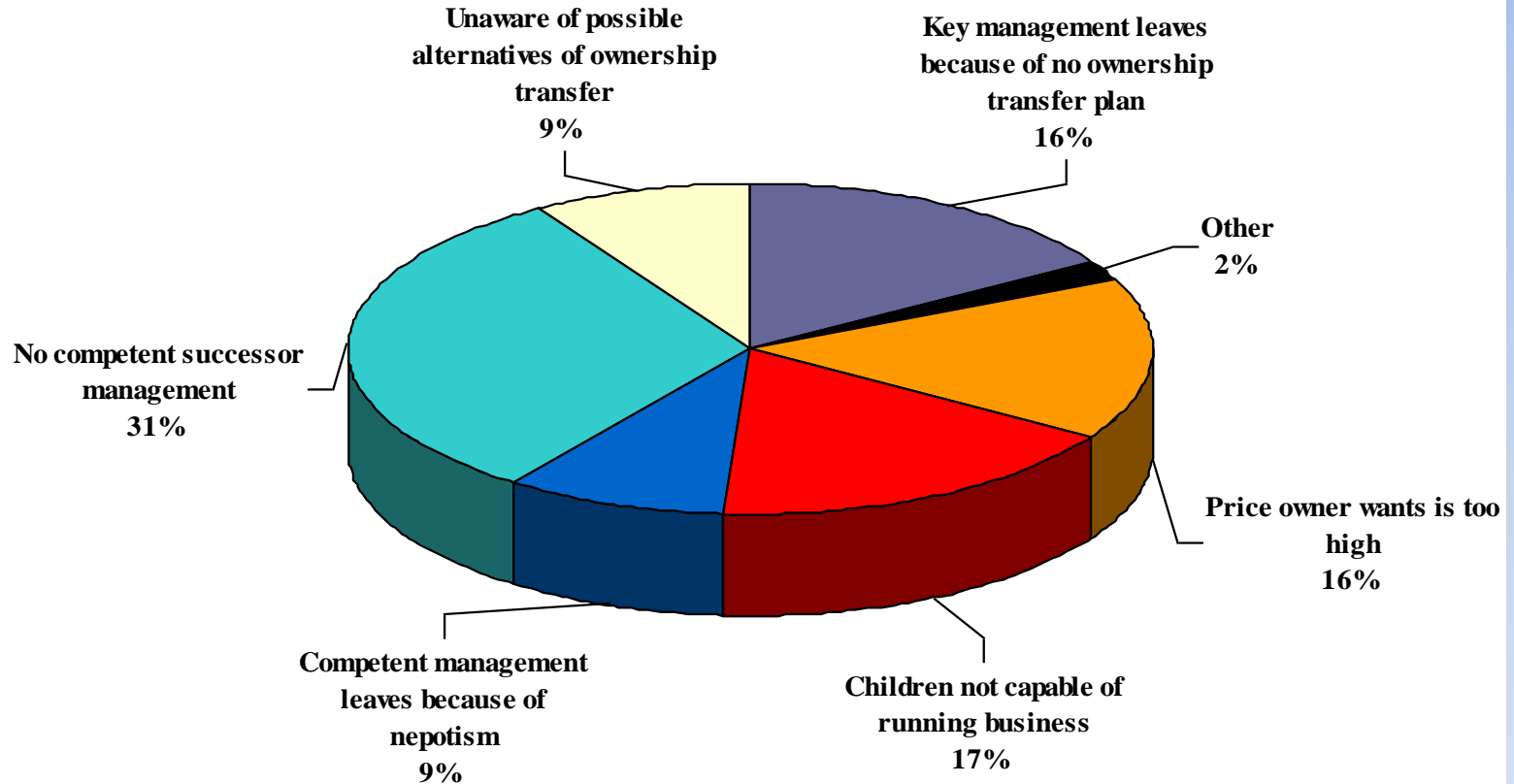


- Time frame of eight to 12 years
- Funding requirements will preclude other strategic alternatives
- People side is the hardest
- Most plans do not work because of
  - Poor communication
  - Inadequate profits
  - Wrong people

# Surety Industry Survey



## Most Common Reasons for Ownership Transfer Plans Not Working



# Why Owners Hesitate to Plan for Management Succession *(1 of 3)*



- Management style not conducive to the development of competent successors
- Fear development of younger successor management
- Believe one person is better than a team or unwilling to share power
- Complete identification with business can result in few outside interests or hobbies

# Why Owners Hesitate to Plan for Management Succession *(2 of 3)*



- Fear a lessening of importance—both in the company and in the community
- Fear retirement will drop income and standard of living
- Reluctant to make decisions regarding family or key employees
- Unwilling to sell for fear of losing firm's individuality

# Why Owners Hesitate to Plan for Management Succession *(3 of 3)*



- Does not want others to learn company's true financial position
- Expectation that the value for a third-party sale should be equal to that in an internal transaction
- Unaware of, or misinformed about, equity transfer techniques

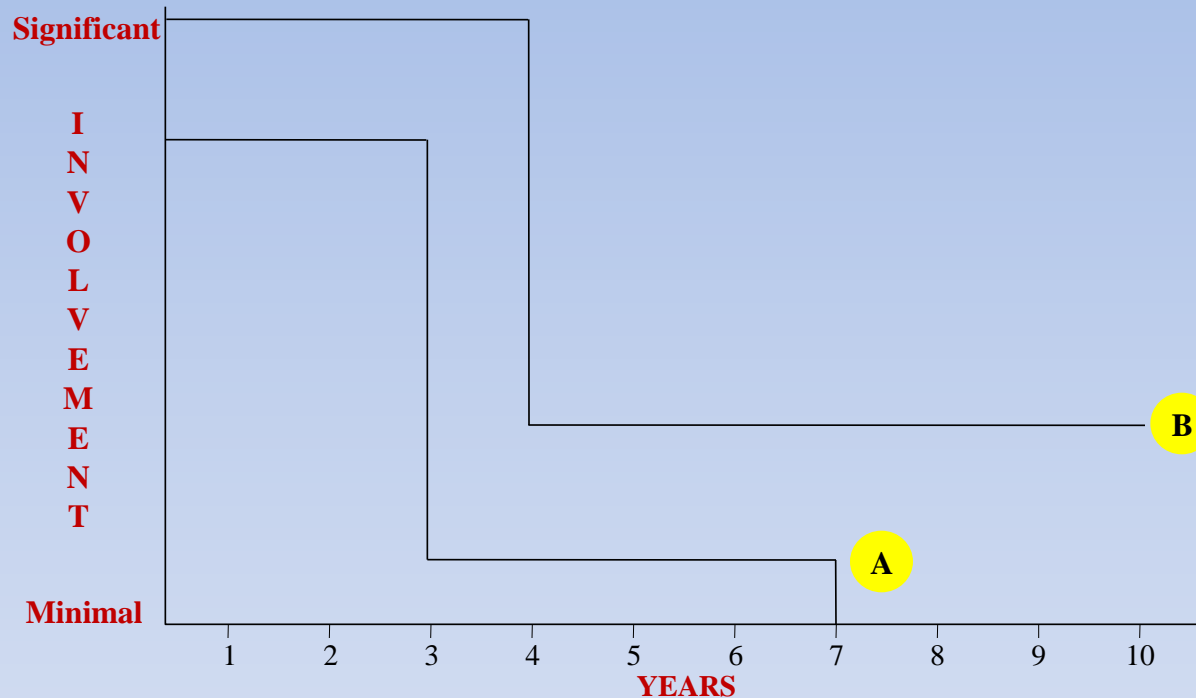
# Current Owner

## Goals, Objectives and Issues



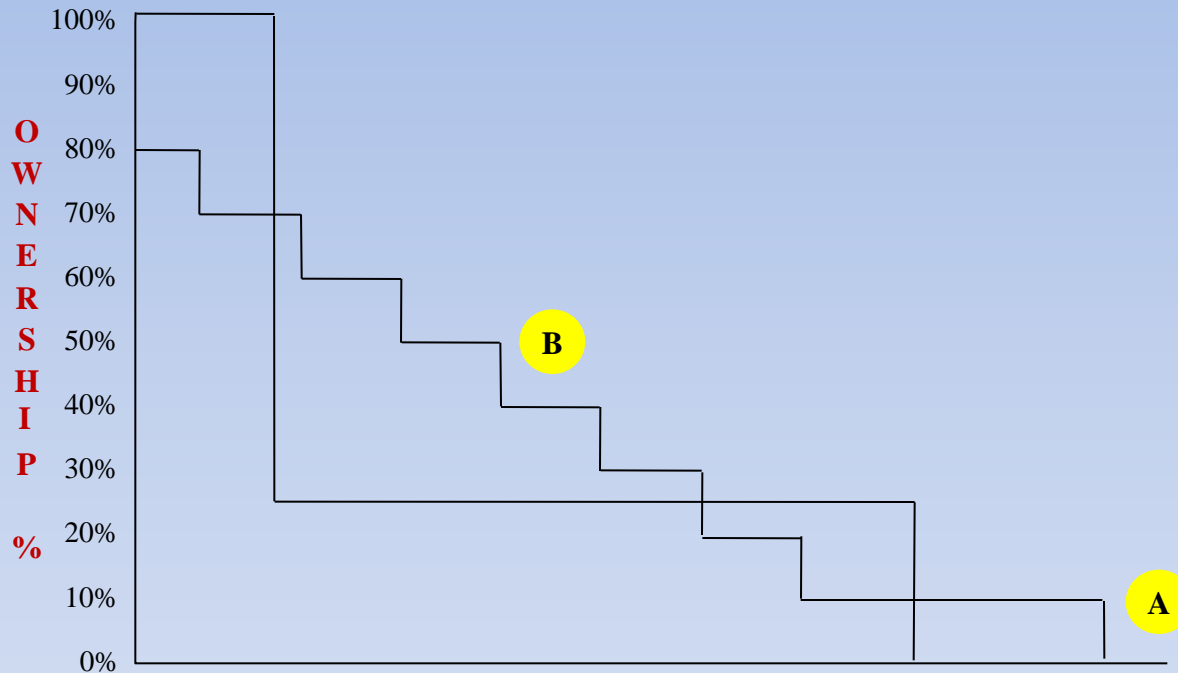
- Continuation of the firm
- Current and future ownership alternatives
- Personal financial objectives and situation
- Estate and life insurance
- Voting control and power
- Indemnification and risk (mitigation)
- Buy/sell agreement terms
- Treatment of children, family and key employees
- Personal role, employment and retirement
- Plan timing and duration
- Management succession and organizational objectives
- Key employee retention
- Compensation/benefits
- Contingency plan and **“Hit by the Bus”** plans
- Overall corporate goals and strategies
- Other personal issues and goals

# Management Succession Profile



- A** Full-time for beginning of plan; minimal role/consulting in latter years
- B** Significantly involved in early years; reduced role in later years

# Ownership Transfer Profile



**A** Own 100% today, sell 75% in year two, and retain 10% - 25% for nine years

**B** Own 80% today; sell 10% per year for eight years

A pair of hands is shown from the front, palms up, holding a small green seedling with four leaves and a small mound of dark soil. The hands are positioned on either side of the seedling, with the fingers slightly curled as if supporting it. The background is a plain, light-colored surface.

# **LEADERSHIP/PEOPLE**

Visit us on the web: [www.fdcpa.com](http://www.fdcpa.com)

Or Call: 888-875-9770

# Filling the “Succession Planning Pipeline”



- Tailor the leadership pipeline model to fit your organization’s succession needs
- Set and communicate Best of Class Performance Standards
- Develop and mentor your strongest candidates
- Evaluate succession

# 3 Options



## *Key Employee as Successor:*

- Known person **“Famous Person Theory”**
- Reward for loyalty
- May lack a broad base of experience
- Usually lacks an entrepreneurial spark
- Must be a consensus choice
- Leadership ability? Management ability?



# Outsider as Successor



- Experienced and proven track record
- Support of current employees
- Unknown commodity
- Culture clash
- Expensive and time-consuming
- Odds are against

# Family Member as Successor



- Plans need to be started early
- Do they have the necessary skills?
- Do they want the position?
- Has it been clearly stated that he/she will be the successor?
- Has the timing of the transition been determined?

# IBM Leadership



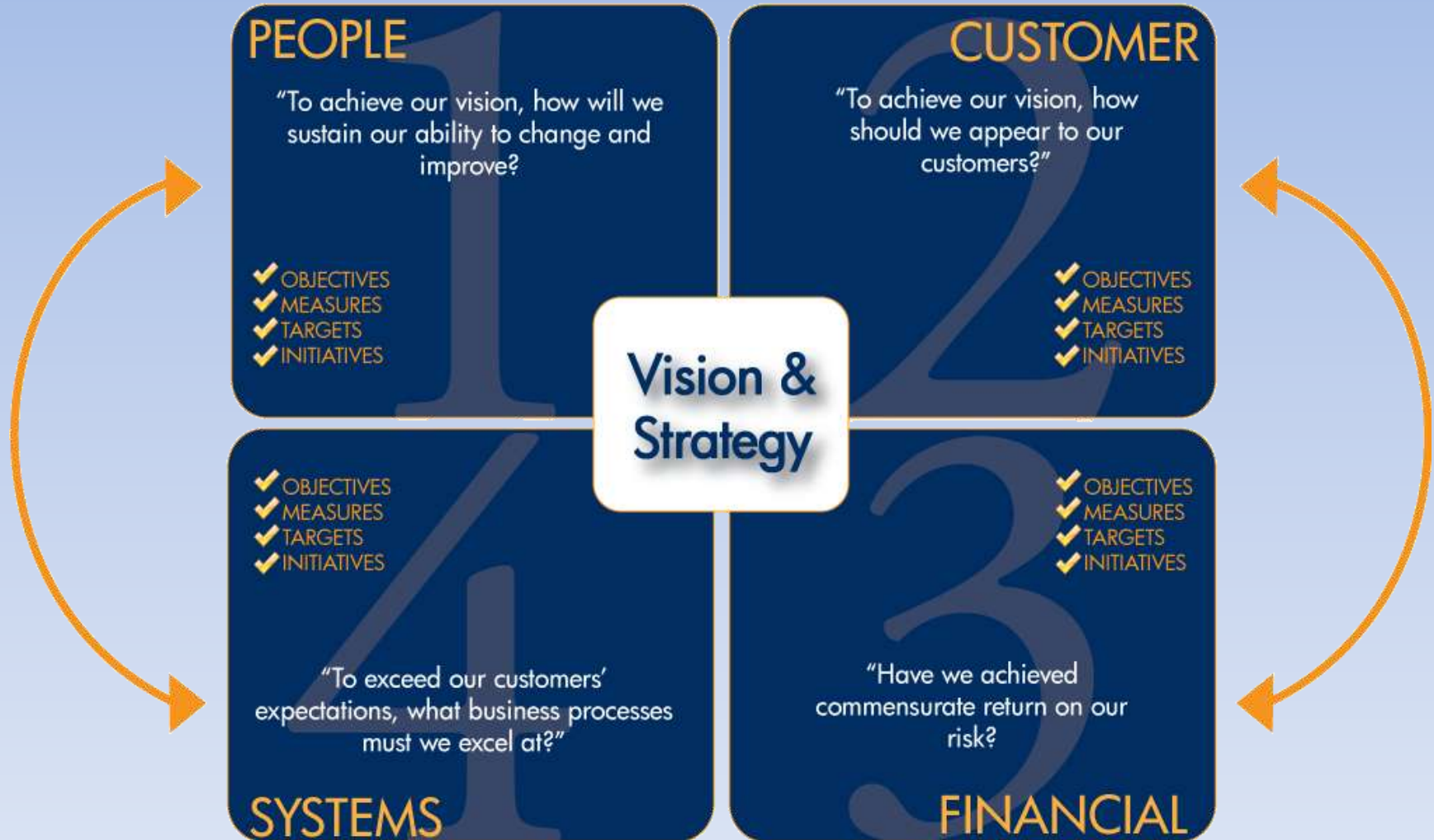
- Leadership
  - New CEO, Lou Gerstner, had the discipline to make difficult decisions
  - Grew a passion for the company
  - **“Fell in love with IBM”**
- People
  - Gerstner’s first top priority: Getting the right people in key seats
    - Built a team of people he knew he could trust
    - Removed executives who did not share the same sense of urgency
    - Replaced those who did not deliver on their responsibilities/promises
    - Turned a culture of bureaucracy into a culture of discipline
    - **“Respect for the individual had evolved into...a culture of entitlement”**

# Measuring Success



- How do you measure success in a growing organization?
  - Financially quantifiable measures
  - Growth on the customer level
- How did you develop your best people?
  - Always document the strategic initiatives you are responsible for executing
  - Document behaviors and strategies that made you successful
- What behaviors lead to positive results?
  - Create a culture that holds people accountable for their actions
  - Create an atmosphere where continuous learning is the norm

# Balanced Scorecard



# How to Create a Growth Environment



- Define the critical metrics of success in your business
- Identify the behaviors of your best performers
- Measure and commit to the behaviors as guiding principles
- Emphasize the principles until they become virtues
- Successfully recover from mistakes

# Best of Class Performance



- Goal Setting
  - Dreams
    - Share with people you trust, who will support you and can help you reach them
  - Stretch goals
    - Necessary to accomplish dreams, accomplish them at a rate of 50%
  - Disciplines
    - Tasks you complete to accomplish your stretch goals – provides structure

# Behaviors of Future Leaders



- Interdependency
- Continuous learning
- No excuses
- Execution
- Measurements
- Accountable
- Want feedback – 360 ◦ Evaluation

# Behaviors of Future Leaders



- Measuring behaviors through a point system
  - **“Measure it and it will improve”**
  - What activities can you measure at monthly / weekly intervals?
    - Customers
    - Marketing
    - People -Recruitment / Development / Mentoring / Training
    - Leadership Initiatives
    - Financial

# Best of Class Performance



- *Measuring progress through key metrics:*
  - Customers
    - Networking event
    - Customer relations meeting
    - Sales meeting
    - # of **“wows”** received this period
  - People
    - Mentoring lunch
    - Training lunch
    - Staff recruited
    - Upward development
  - Process
    - Strategic initiatives executed
  - Financial
    - Gross Profit \$ managed
    - Gross Profit \$ originated
    - Average gross profit margin %
    - Division / Branch profit
    - Number of **“A”** customers developed and maintained

# Continuous Learning

## How's Your Asset?



- Skills Building
  - Asset vs. Revenue (long-term vs. current) – Don't **"Milk the Asset"**
  - Look in the mirror
  - Personal strategic planning – **"Set the Goals"**
  - Stay current
  - Focus – "Depth first, then breadth"
  - Build your network
  - Interpersonal skills – Read personality / react

# Are You Willing to Be Managed?



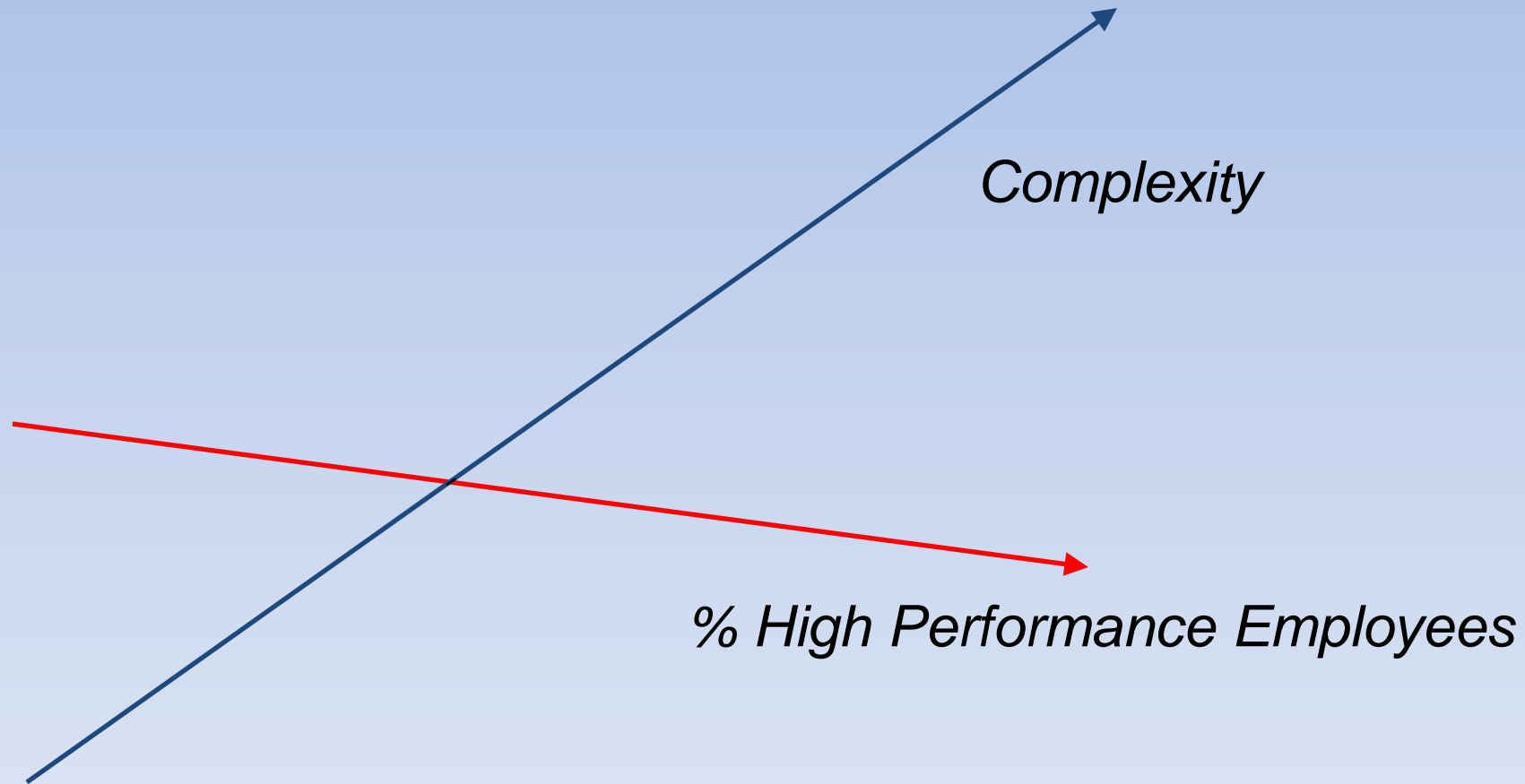
- **“If people are not prepared to be held accountable – it’s unlikely they will achieve much”**
- Want to achieve goals – Need to communicate them and have someone hold you accountable to achieving them – **“Nagging Rights”**

# Does Your Replacement Work For You Now?

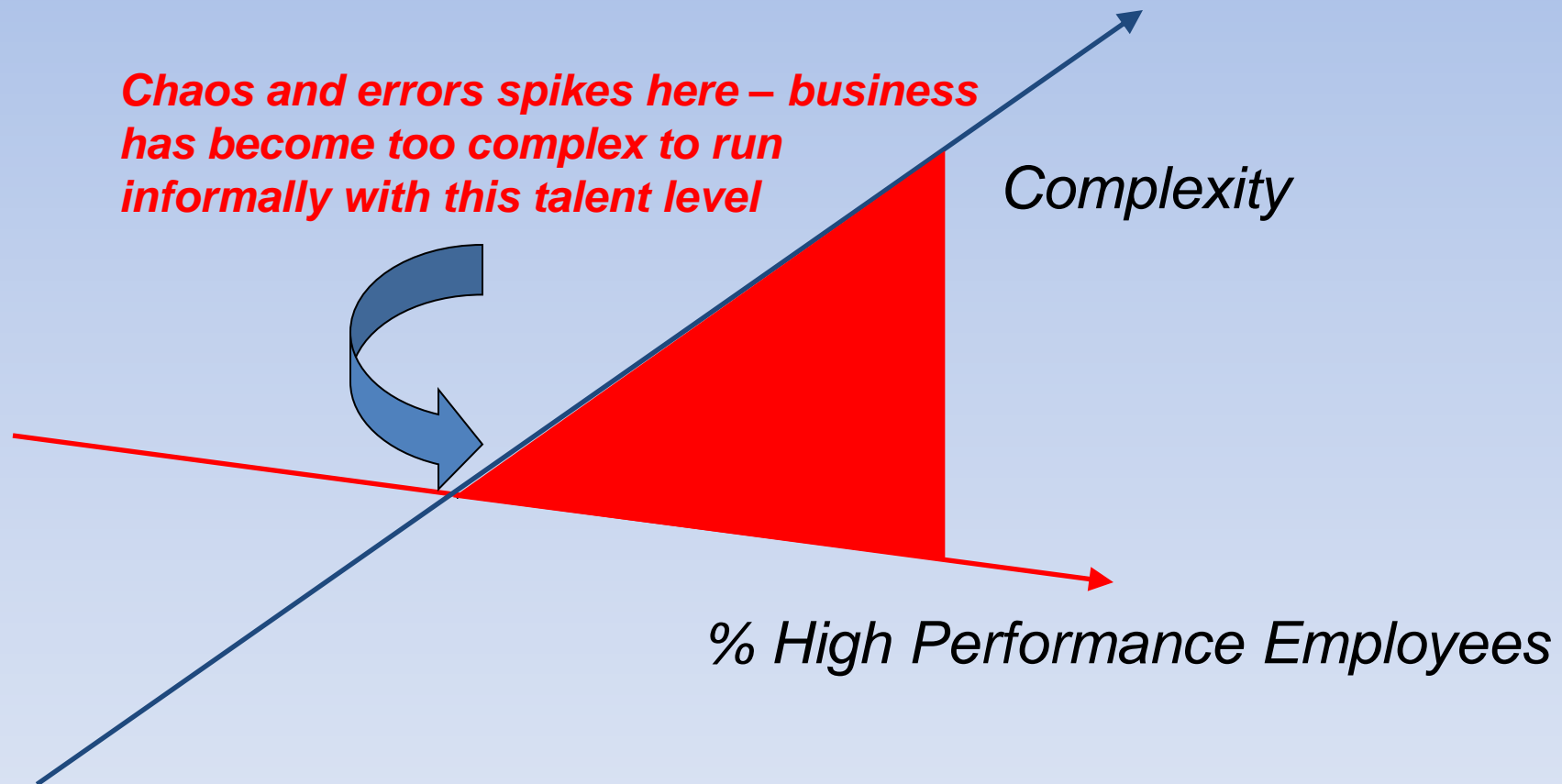


- **Netflix** – High performance employees can not thrive in process oriented companies.

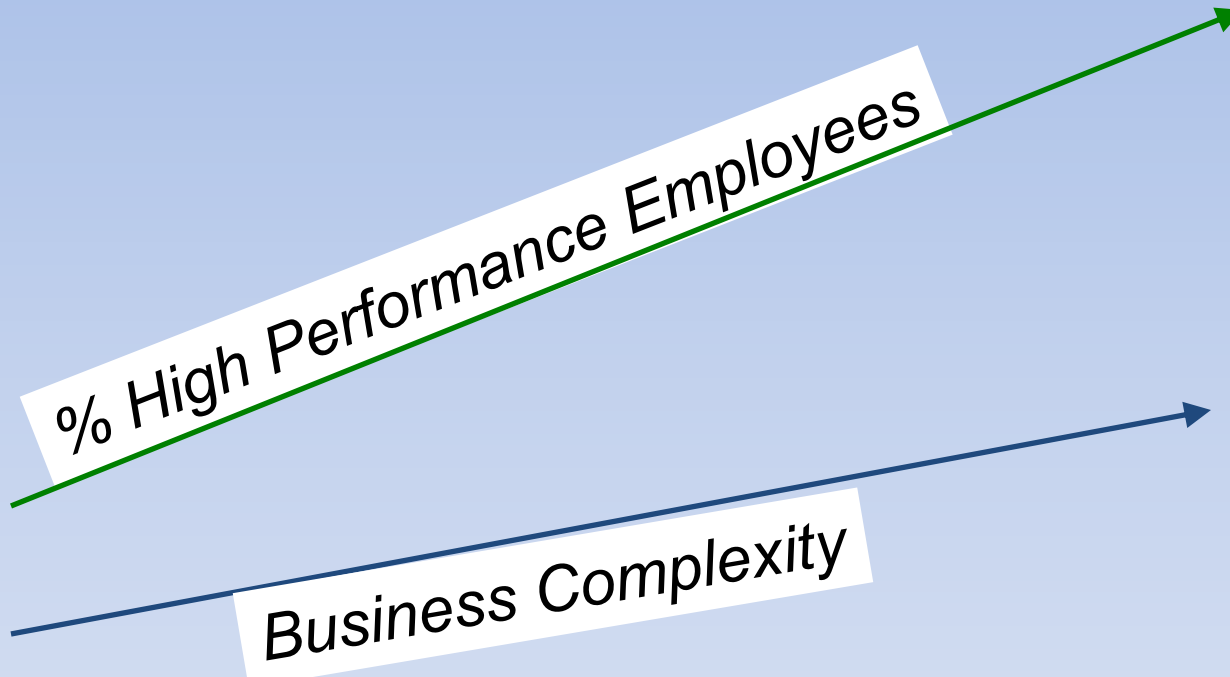
# Growth Shrinks Talent Density in Most Firms



# Chaos Emerges



# The Key: Increase Talent Density faster than Complexity Grows



# Increase Talent Density



% High Performance Employees

- Top of market compensation
- Attract hi-value people through freedom to make impact
- Be demanding about high performance culture
- 1 great employee worth 2.5 X Average employee
- Big salary; no bonus, minimal benefits

# The Rare Responsible Person



- Self motivating
- Self aware
- Self disciplined
- Self improving
- Acts like a leader
- Doesn't wait to be told what to do
- Never feels “that’s not my job”
- Picks up the trash lying on the floor
- Behaves like an owner

# Context, not Control



*Provide the insight and understanding to enable sound decisions*

## Context

- Strategy
- Metrics
- Assumptions
- Objectives
- Clearly-defined roles
- Knowledge of the stakes
- Transparency around decision-making

## Control

- Top-down decision-making
- Management approval
- Committees
- Planning and process valued more than results

A pair of hands is shown from the front, palms up, holding a small green seedling with four leaves and a mound of dark soil. The background is a plain, light-colored surface.

# **BUYOUT STRUCTURES**

Visit us on the web: [www.fdcpa.com](http://www.fdcpa.com)

Or Call: 888-875-9770

# Primary Methods of Internal Transfer



- Traditional Tools
  - 1) Direct sale
  - 2) Sub-S buyout
  - 3) Stock redemption/cross purchased
- Partnership Tools
  - 5) Oldco/Newco LLC
  - 6) Brother/Sister
  - 7) Drop-Down LLC
  - 8) JV Partnership
- Stock-Based Tools
  - 9) Stock Options
  - 10) Restricted stock
  - 11) Stock bonus
- Compensation Tools
  - 12) Deferred comp.
  - 13) Phantom Stock
  - 14) SARs
- ESOP

# Direct Sale



- Sale of stock by owner to employees
- Funding vehicles
  - Employee initial contribution
  - Bonuses/alternative compensation
  - Notes from buying shareholders
- Issues
  - Timing of payments
  - Transfer of control
  - Equity and surety issues
  - Price

# Cross Purchase



- Owners enter into agreement to purchase each other's interest on the occasion of certain events
  - Attractive option for unrelated owners
  - Agreement often provides formula to determine price
  - Often funded with insurance purchased by each owner on the lives of the others

# Installment Sale



- Permit sales proceeds to be collected over time, delaying payment of income taxes
  - Consider private annuity or self-canceling installment note (SCIN)
  - Annuity-purchaser agrees to provide lifetime annuity payment to seller based on life expectancy

# Subchapter-S Buyout Procedure



- Distribute excess capital to owners
- Employees buy as much initial stock as feasible
- Annually distribute all (or most) profits as compensation or Sub-S dividends
- Employee reinvests after-tax dividends and possibly some portion of bonus to purchase stock each year
- Major owner receives cash from sale of stock and relative share of Sub-S distributions

# Employee Purchase of Stock Using Subchapter S-Dividends



## An Example

	Year 1		Year 2		Year 3		Year 4		Year 5	
	\$	%	\$	%	\$	%	\$	%	\$	%
Pretax Corporate Income	500,000		500,000		500,000		500,000		500,000	
Existing Shareholder's Portion	475,000	95.0%	467,000	93.4%	456,440	91.3%	442,501	88.5%	424,101	84.8%
Employee Shareholder's Portion	25,000	5.0%	33,000	6.6%	43,560	8.7%	57,499	11.5%	75,899	15.2%
Income taxes (36%)	9,000		11,880		15,682		20,700		27,324	
Net Dividend Incomed to Employee	16,000		21,120		27,878		36,799		48,575	
Beg. Year Stock Ownership	50,000	5.0%	66,000	6.6%	87,120	8.7%	114,998	11.5%	151,798	15.2%
New Purchase	16,000	1.6%	21,120	2.1%	27,878	2.8%	36,799	3.7%	48,575	4.9%
New Ownership Total	66,000	6.6%	87,120	8.7%	114,998	11.5%	151,798	15.2%	200,373	20.0%

### Notes:

1. Assume equity of \$1,000,000 is held constant throughout the period.
2. Key employee owns 5% of stock in year one.
3. All earnings are distributed annually through dividends or cash bonuses.

# Subchapter-S Buyout Other Considerations



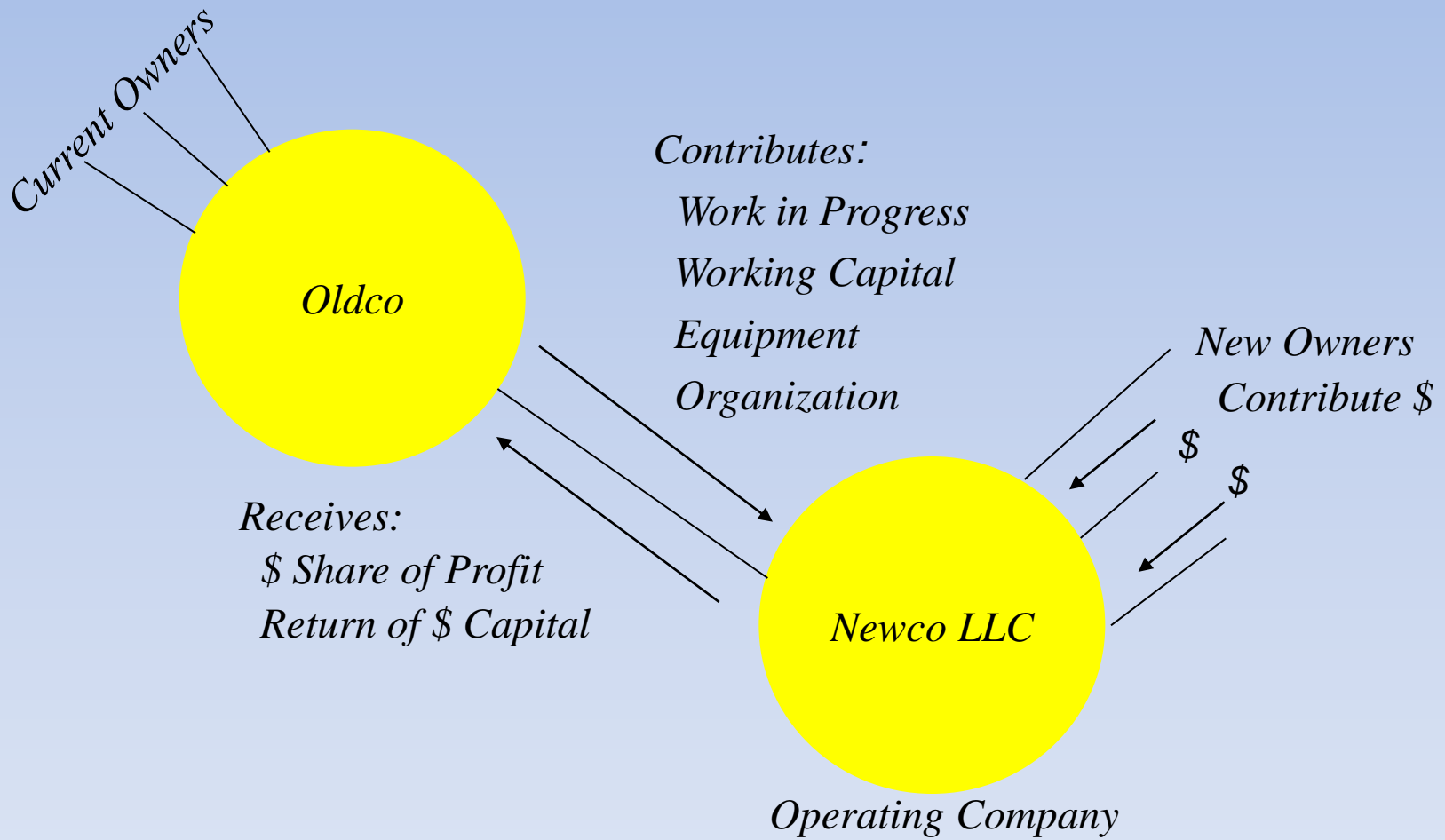
- If control is an issue, nonvoting stock can be used
- Transfer can be debt-free or with minimal debt
- Reducing distributions to fund growth can slow buyout
- The value placed on the stock should be sustainable for future buyouts

# Subchapter-S Buyout Other Considerations

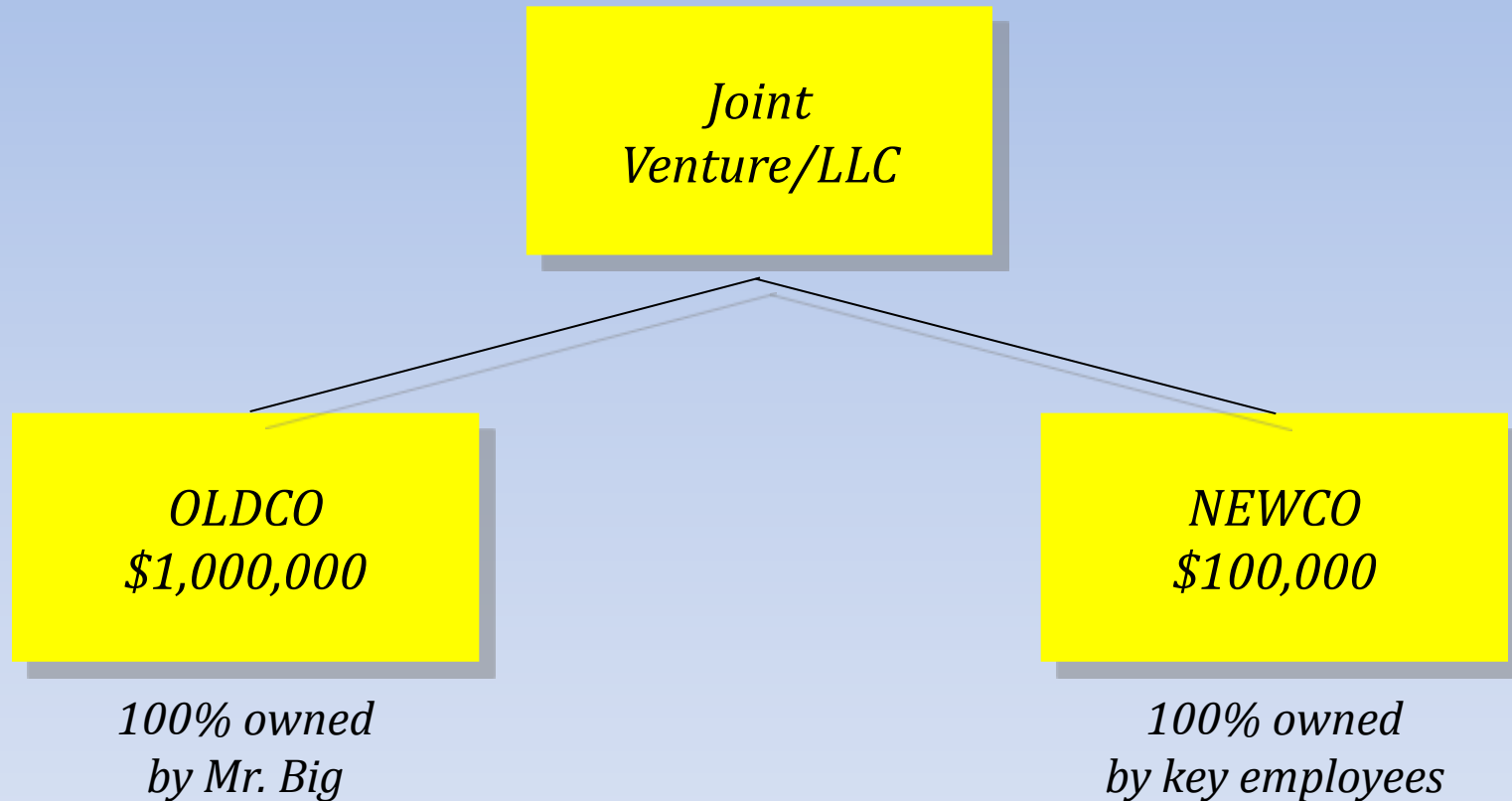


- Selling shareholder proceeds includes:
  - Stock sale
  - Distribution of AAA account prior to sale
  - Sub-S distributions
  - Compensation and benefits
- The more money the company makes
  - The faster the employees complete the buyout
  - The faster the seller gets money
- Very flexible and minimal documentation is required

# Oldco/Newco LLC



# Oldco/Newco LLC



# Oldco/Newco LLC



- Issues
  - Allows for separate and distinct management of:
    - Capital
    - Control
    - Profit and loss
    - Participants
  - Flexible initial capital investment
  - LLC allows additional members with minimal investment
  - Equipment can be contributed as capital, rented or sold

# Oldco/Newco LLC



- Issues (continued)
  - No actual sale of stock
  - No debt or interest
  - Employees do not **“purchase”** anything; they participate in future profits
  - Cannot use an LLC in California

# Oldco/Newco LLC



- Oldco often provides working capital, bonding, work in progress, employees, backlog and equipment
- Newco often provides working capital, bonding and sweat equity
- Newco and Oldco split profits—all of Newco's profits are retained

# Oldco/Newco LLC



- Joint venture is terminated
  - When Newco can stand alone
  - On time
  - By total earnings
- A method to increase the profit participation of the employee group without selling any stock of the existing company and without major investment by the employees



# Oldco/Newco LLC Benefits

- Possible Advantages
  - Seller retains non-operating assets in Oldco
  - Seller can defer taxation on sale or liquidation of Oldco
  - Flexibility as to division of profit between Oldco and Newco
  - Minimize capital required for Newco
  - Valuation and IRS issues concerning stock transfers are minimized
  - Buyer and seller incented to complete transaction as quickly as possible
  - Operating Agreement memorializes both economic and governance issues up front

# Brother/Sister



- Employees capitalize Newco
- Oldco and Newco enter into agreement where, for a charge,
  - Oldco leases fixed assets to Newco  
and/or
  - Oldco loans capital to Newco  
and/or
  - Oldco rents assets to Newco  
and/or

# Brother/Sister



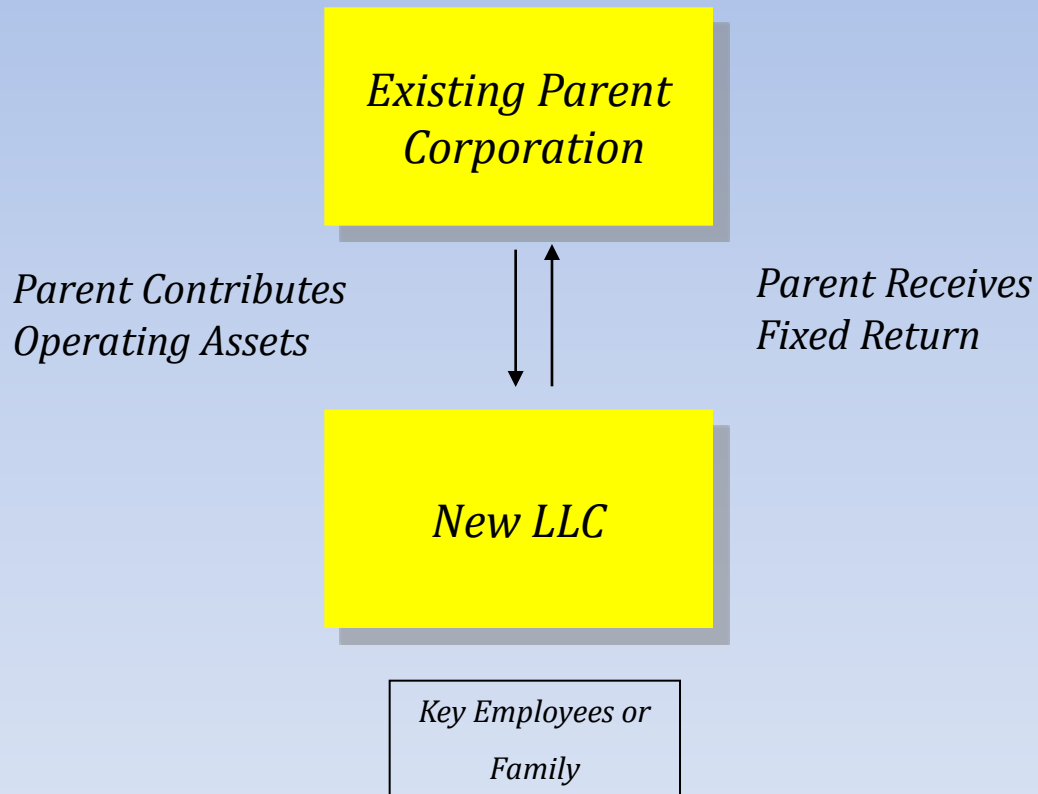
- Oldco provides loan guarantees or bonding and/or
- Oldco and Newco joint venture on select jobs and/or
- Oldco provides services to Newco such as accounting and/or
- Oldco retains some employees

# Brother/Sister and Oldco/Newco LLC Premise



- Buying employees form a new company
- Selling shareholders retain old company
- Operations are transferred to new company
- Oldco supports Newco until it can function independently

# Drop-Down LLC



# Stock Bonus



- Stock bonused in lieu of cash
- Corporate receives noncash tax deduction
- Employee pays tax on noncash income - usually cash and stock are bonused
- Shareholder dilution
- Involuntary shareholders
- Does not remove equity

# Stock Redemption



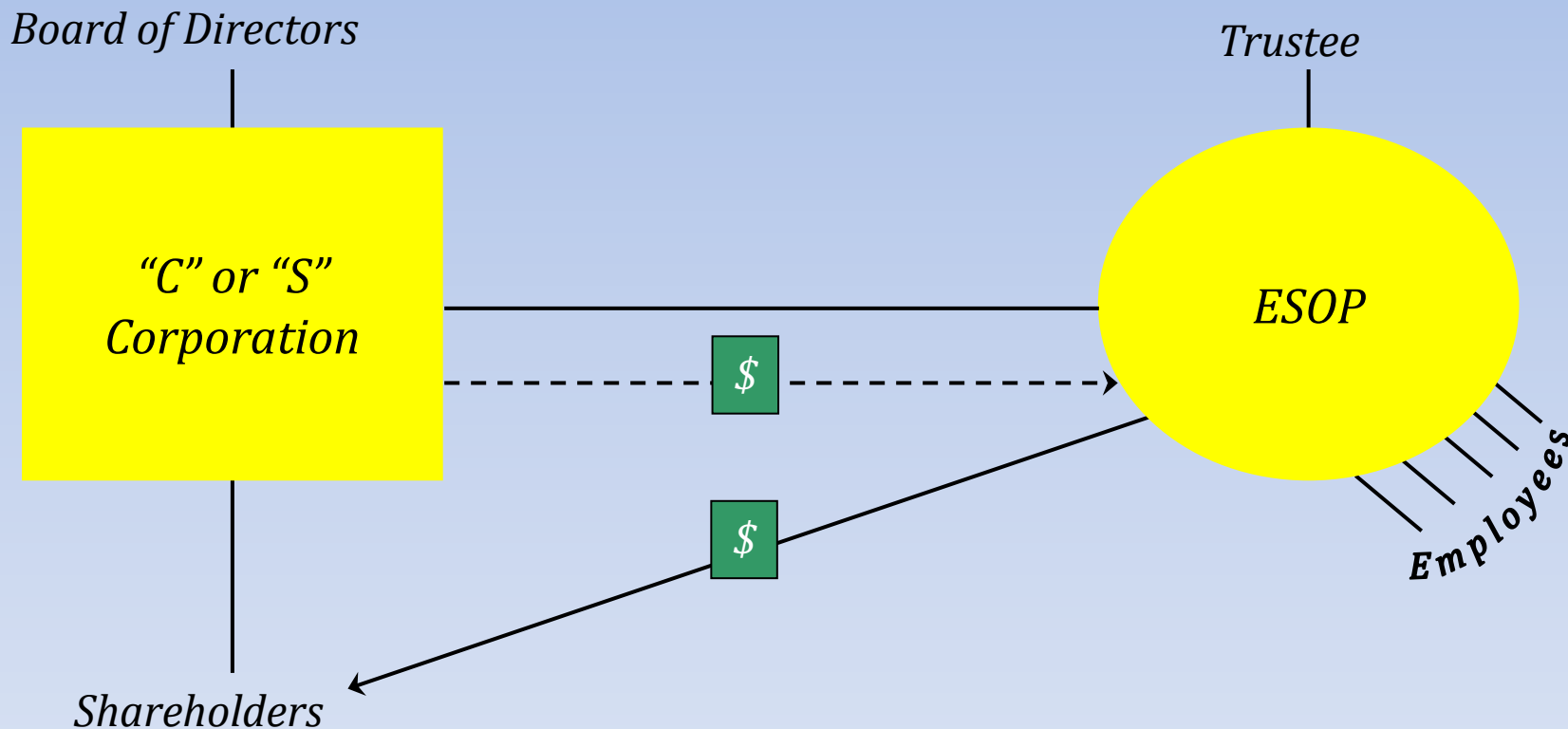
- Corporation reacquiring its own stock
  - Trying to fund transfer of interest with least amount of income tax
  - Important when business is to stay within family
  - Stock can be redeemed from estate to pay for taxes and administrative costs upon death
  - Removal of equity and cash may create surety issues
  - Leveraged redemption/leveraged buyout

# Employee Stock Ownership Plan (ESOP)



- What is an ESOP?
  - An ESOP is a qualified retirement plan
    - Purchases stock of the company
    - For all nonunion employees (in most cases)
  - It is governed by ERISA
    - Company may contribute 25 percent of eligible payroll
    - Cannot discriminate in favor of highly compensated employees
    - Combined employer/employee limit of \$46,000 (2008)
  - Managing trustee appointed by the board

# ESOP Transactions



# ESOP Advantages



- To the selling stockholders:
  - Creates an **“internal market”** to sell stock
  - For a C Corp, Seller may defer capital gains if the ESOP purchases more than 30 percent of outstanding stock
  - For an S Corp, federal income tax is deferred
    - Increases capital available to purchase stock, pay ESOP debt or grow company
  - Non-ESOP shareholders can continue to control the company
  - Stockholders can diversify personal assets

# ESOP Advantages



- To the company:
  - Can be positive incentive for employees
  - Can increase capital available to the company
- To the employee:
  - Can build a retirement asset
  - Provides ownership incentive
  - Defers dividend taxation for stock held by the ESOP until retirement

# ESOP Disadvantages



- Retirement funds are being invested in one construction company
- Repurchase liability for shares owned by ESOP
  - Downsizing can cause repurchases
- For bonding, ESOP repurchase obligations are treated as a liability of the corporation
- Stock must be valued annually by a third party
- ESOP trustees have fiduciary liability
- Many stockholders with minority rights
- DOL and IRS reporting

A pair of hands is shown from the front, gently holding a small green seedling with dark soil. The seedling has several bright green leaves and a thin stem. The hands are positioned on either side of the seedling, with fingers slightly curled as if supporting it. The background is a plain, light-colored surface.

# **ESTATE PLANNING**

Visit us on the web: [www.fdcpa.com](http://www.fdcpa.com)

Or Call: 888-875-9770

# Agenda



- Summary of estate law changes
- Techniques for transferring business stock
- Other estate planning vehicles:
  - Charitable Remainder Trust
  - Charitable Lead Trust
  - Irrevocable Life Insurance Trust
  - Qualified Personal Residence Trust
  - Family Limited Partnership

# Summary of Estate Law Changes



- 2010 Tax Relief Act
- Estate, Gift, and GST exemptions are unified for two years
- Estate, Gift, and GST exemptions at \$5 million per person/\$10 million per couple
- 35% top estate tax rate
- In effect until December 31, 2012, the law will revert to pre-2001 status (\$1 million exemption with 55% top tax rate)

# Portability – In General



- Portability allows for the transfer of any unused amount of exemption from the first spouse to die to the surviving spouse.
- Surviving spouse may use the exemption belonging to his or her last deceased spouse.
- Reduces the need to create credit shelter trusts and transfer assets.
- Does not apply to the GST tax exemption.

# Portability – Planning



- In order to ensure use of the entire \$5 million estate exemption, it may be advantageous to make gifts up to that amount.
- **Caution:** Potential exists for the exemption to be adjusted downward as a result of law change. The possibility exists that additional estate tax may be required on gifts made in excess of the enacted exclusion.
- **Important Takeaway:** Everyone should plan to meet with their estate attorney within the next few months to ensure that your plan is properly updated.

# Techniques for Transferring Business Stock



- Taxable Sale:
  - 1) Straight Sale
  - 2) Installment Sale
  
- Estate Planning Concepts:
  - 1) Gift
  - 2) Grantor Retained Annuity Trust (GRAT)
  - 3) Self-Cancelling Installment Note (SCIN)
  - 4) Irrevocable Life Insurance Trust (ILIT)
  - 5) Charitable Remainder Trust (CRT)
  - 6) Charitable Lead Trust (CLT)
  - 7) Qualified Personal Residence Trust (QPRT)
  - 8) Family Limited Partnership (FLP)

# Taxable Sale of Stock



- Capital Gain Treatment:
  - Currently 15% tax rate
  - 3.8% Medicare tax increase scheduled for 2013
  - Potential for increase to capital gain rate in 2013
- Installment Sale:
  - Elect out of Installment treatment?
  - Self-Cancelling Installment Note (SCIN)
    - Seller forgives annual payment; considered a taxable gift
    - Seller reports interest income as if received;  
Purchaser deducts interest expense

# Gifts



- Lifetime gift exemption increased to \$5,000,000 through 2012
- Annual gift tax exemption = \$13,000 per donee; \$26,000 if gift splitting with spouse

# Grantor Retained Annuity Trust (GRAT)



- Eligible S Corporation shareholder
- Shareholder/Grantor transfers stock to trust in exchange for an annuity stream over an agreed term
- Shorter term preferred as shareholder must survive term to keep out of estate
- IRS stipulated interest rate (IRC 7520 rate) ranged between 2.4% and 3.4% in 2010
- Company must make annual distributions to trust to make annuity payment
- Grantor pays income tax during term on pass-through income
- Goal is to transfer property that will out appreciate the 7520 rate
- Stock transfers to beneficiaries at end of term
- Ideal in a low interest rate environment with depressed business

# Other Estate Planning Vehicles



- Charitable Planning:
  - Charitable Remainder Trusts – Provides an annual stream of payments to non-charitable beneficiaries (including the donor) for a term with an irrevocable remainder interest to be transferred to charity
  - Charitable deduction allowed in year of contribution (subject to limitations) based on actuarial value of remainder interest
  - Tax-exempt at trust level – Ideal for highly appreciated assets
- Charitable Remainder Annuity Trust (**CRAT**):
  - Fixed annual payments
- Charitable Remainder Unitrust (**CRUT**):
  - Annual payments based on a % of the fair market value of the trust's assets

# Charitable Planning



- Who should use a Charitable Retained Trust?
  - A taxpayer who want to retain an income interest
  - A taxpayer with low basis, highly appreciated assets that wants to diversify
  - A taxpayer that wants to reduce estate taxes
  - A taxpayer that wants to retain ultimate control of the assets

# Charitable Planning



- Charitable Lead Trusts – Provides an annual annuity stream to be paid to a qualified charity and the remainder interest to be paid to the donor or beneficiaries
- Charitable deduction allowed in year of contribution (subject to limitations)
- Taxable at entity level
- Charitable Lead Annuity Trust (**CLAT**)
  - Fixed annual payments
- Charitable Lead Unitrust (**CLUT**)
  - Annual payments based on a % of the fair market value of the trust's assets



# Charitable Planning



- Who should use a Charitable Lead Trust?
  - A taxpayer who want to utilize the charitable tax deduction in an unusually high AGI year
- A taxpayer that does not want to give up control of the assets yet:
  - A taxpayer that is willing to forgo current cash flow
  - A taxpayer that wants to take advantage of a low interest rate environment
  - A taxpayer that wants to reduce estate and gift taxes
  - A taxpayer that has a low, discounted value that they expect will appreciate

# Irrevocable Life Insurance Trust (ILIT)



- Illiquid estates often require life insurance to cover estate tax liability
- Proceeds from policy owned by the insured includable in estate
- Proceeds from policy owned by ILIT is not includable (unless death within 3 years)
- Insured possesses no rights to change or cancel the policy
- Purchase of premiums considered a taxable gift

# Qualified Personal Residence Trust (QPRT)



- Grantor transfers personal residence or vacation home into an irrevocable trust for a term of years
- Grantor retains right to live in the property during term
- Property transfers to beneficiaries upon completion of term but reverts into the grantor's estate if he doesn't survive term
- Grantor should pay rent to beneficiaries following term if he/she desires to continuing living in residence
- Transfer to trust is a taxable gift but not at FMV
- Value of gift reduced to reflect grantor's residential right and the risk of not surviving term
- Ideal when property values are depressed but not necessarily in a low interest rate environment

# Family Limited Partnership (FLP)



- Parents transfer assets into a limited partnership in exchange for both general and limited partnership interests.
- Parents gift limited partnership interests to children.
- Limited partnership interests are often allowed up to 50% marketability and minority discounts.
- Because of discounts, more assets can be gifted annually and less tax paid at death.

# Breakout Session Questions



- 1) Has there been any focus on identifying a successor in your organization to date?
- 2) How does the goal setting and measurement process work in your organization today?
- 3) Who does senior management share their goals with and how are they held accountable?