AIA Best Practices:
An ownership transition case study

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Summary

The owners of XYZ Design PC team up with an experienced management consultant to bring in new owners for their architecture firm. After extensive interviews with the owners and the candidates for ownership, the management consultant suggests that the most entrepreneurial candidate receive 10 % ownership in the firm. To make the ownership interest affordable, the management consultant recommends that one of the firm's owners receive deferred compensation from the firm as ordinary income over a five-year period.

Getting a transition plan rolling

XYZ Design PC is a 20-year-old, 20-person firm in a midsized Midwestern city. Founders Frank Young and Frances Zimmer are 55 and 50 years old, respectively. Their regional practice serves health-care and related institutions within a 90-mile radius of the city. The firm gets most of its commissions through repeat work and referrals from satisfied clients, and about 20 % through marketing.

Frank would like to begin phasing out his active participation in the firm and to retire in 10 years. He would like to start selling some of the ownership in the firm to key employees but didn't know how to begin the process. Frank and Frances sought the advice of a management consultant experienced in ownership transition of professional design firms to discuss their intention to bring in new owners for their firm.

Frank and Frances identified Andrew and Barbara as good candidates for ownership and gave them factual information about the firm and its employees, and a financial statement for the past few years. Andrew has been with them since the formation of the firm and is a loyal, hardworking project manager. Three years ago, Frank and Frances hired Barbara, who had been with a larger firm, with the understanding that if things worked out, Barbara would be offered an ownership stake.

The management consultant selected to be part of XYZ Design's ownership transition team interviewed Frank and Frances to learn about their firm's management and operations, their objectives and concerns regarding ownership transfer, and their views about Andrew's and Barbara's strengths and weaknesses. The consultant then interviewed the candidates separately, both to evaluate them independently of the owners' impressions and to gauge their interest in becoming owners of the firm.

After analyzing the results of the meetings, the consultant advised the owners that Andrew is content to remain as a project manager and has no desire for ownership, despite his longevity with the firm. By contrast, Barbara has an entrepreneurial outlook and appears to have the necessary aptitude and desire to become an owner.

Making the deal work

Frank and Frances decide to offer Barbara a 10 % ownership interest in the firm, to be purchased from Frank, who is closer to retirement and wants to begin selling down his ownership interest. Because Frank's goal is to be fully retired in 10 years, and the value of the firm had been established as $600,000, the cost of a 10 % ownership interest in the firm would be $60,000.

Contemplating that the price would be burdensome for Barbara, the consultant recommends establishing a deferred compensation plan for Frank, making the purchase more affordable for Barbara while rewarding Frank, as the founder, with a fair amount for his share of the firm.

The consultant recommends that the firm establish deferred compensation to Frank in the amount of $480,000. The result is that the value of the firm is reduced to $120,000 because the firm's liabilities have increased by the amount of the deferred compensation. With the value of the firm reduced to $120,000 a 10 % ownership will cost Barbara $12,000.

Barbara will pay the seller of the stock (either Frank or the firm) $12,000 in exchange for a 10 % ownership interest in the firm. At the same time, the firm will enter into an agreement with Frank to pay him $480,000 as deferred compensation over an agreed-upon period of years, beginning either now or in the future when he begins to withdraw from daily involvement in the firm.

The deferred compensation will be ordinary income to Frank and therefore taxed at an ordinary income tax rate. Frank and the firm enter into a deferred compensation agreement under which Frank will receive the deferred compensation as ordinary income, paid through the firm's regular payroll over a period of five years. (Because it will be taxed at an ordinary income tax rate, which is greater than the capital gains rate, the firm considers increasing the deferred compensation amount by 20 % to compensate for the tax difference.) Deferred compensation payments will begin five years after Barbara's purchase, when Frank will begin to reduce his time spent on the firm's business.

About the case study

This case study is excerpted and adapted from *Architect's Essentials of Ownership Transition*, which provides highly focused, specific advice on all phases of ownership transition, including candidate selection, valuation, transfer mechanisms, transition plan implementation, and more.

About AIA Best Practices

AIA Best Practices is a collection of relevant, experience-based knowledge and expert advice on firm management, project delivery, contracts and more, aligned with the *Architect's Handbook of Professional Practice, 15th edition*. See the full AIA Best Practices collection at aia.org/aia-best-practices.

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