

Partner Buyout Plans: Are They Ponzi Schemes?

By Marc Rosenberg

Partner buyout plans have been around for a long time. These plans enable partners to retire and cash in the value of their ownership (defined by a firm's capital and goodwill) in a CPA firm without liquidating the firm, which generates the cash to pay them.

These plans are coming under increasing scrutiny by older and younger partners alike, fueled by the aging and retirement of Baby Boomer partners. Older partners wonder if their younger partners have the "right stuff" to keep the firm together. Younger partners are leery of obligating themselves to make substantial retirement payments, many years into the future, to partners who they think may not "deserve" the money.

The younger partners often feel these plans are nothing more than Ponzi schemes (plans where people are fooled into continually contributing money on the front end in exchange for a nice payday at the back end).

Are these retirement plans nothing more than Ponzi schemes?

The keys to a successful partner buyout plan

Fifty percent of all multi-partner CPA firms over \$5 million in annual fees are making retirement payments to retired partners. Seventy-five percent of all firms over \$5 million have provisions for the buyout of partners. This must be compelling evidence that these plans work. So, what is the problem?

For partner buyout plans to work, younger partners have to feel that these plans are a good deal for *them* and *not* a Ponzi scheme. If the following keys to a successful partner buyout plan are present, then this will be a "good deal" to younger partners:

1. *The firm needs to grow.* For example, for retirement plans to work, a 40-year-old partner in a five-partner, \$5 million firm needs to see the firm grow to perhaps a 10-partner, \$10 to \$15 million firm when the partner retires at age 65. Without this growth, there is no room for younger partners. Without younger partners, there will not be enough people to write retirement checks.

The "Ponzi contingent" worries that the clients of retired partners will either leave or be

very difficult to transition to another partner at their firm. The Ponzi group finds itself asking, "Why should we make huge buyout payments to retiring partners whose clients will not be retained?" The question is valid; yet, it is not likely that they will worry about this if the firm grows five to 10 percent a year and continually brings in new or young talented partners.

2. *The firm needs to be profitable.* "Profitable" can be defined as a firm having income per partner that is at least comparable to the profitability of average firms in their market. As a new partner, signing a partner agreement that has a partner buyout provision is a lot easier to do when the partner can expect a handsome income stream over 20 to 30 years. If the firm's profitability is weak, then the Ponzi contingent is right to question the viability of the plan.
3. *No Lone Rangers.* A Lone Ranger partner is someone who (1) has clients the other partners do not know and (2) has not developed strong relationships between the firm's staff and his or her clients. Lone Ranger partners fail the following test question: "If you should suddenly leave the firm, will your clients stay?"

The Ponzi group should be rightly concerned if the firm has Lone Ranger partners.

4. *Coasting by partners is not allowed.* Earlier, we cited the importance of firm growth. Obviously, if the firm has one or more coasting partners, this can hold back firm growth. If a partner builds up a million-dollar client responsibility by age 45 or 50 and coasts his or her remaining 15 to 20 years, it is likely that the Ponzi group's worst fear will be realized—a retiring partner's clients were brought in a long time ago and are unlikely to be retained.
5. *Partner accountability.* This goes hand-in-hand with #4 above. If there is partner accountability in a firm, then it is less likely that coasting will occur, let alone be allowed.
6. *Acid test is "passed."* When a partner retires, the remaining partners' income *increases* because they

Features of a Properly Written Partnership Buyout Plan

Properly written partner buyout plans should include the following:

1. Total payout to retired partners includes their share of the firm's accrual basis capital and goodwill.
2. The most common payout period for capital matches the goodwill payout, usually 10 years. Many firms opt for a shorter payout period for capital, such as five years, than for goodwill.
3. Interest is commonly paid on capital payouts but rarely paid on goodwill.
4. Goodwill value ranges from 70 to 100 percent of fees.
5. Most firms use either the Multiple of Compensation or AAV method for determining an individual partner's share of the goodwill. "Eat what you kill" firms often opt to pay out partners based on each one's ownership percentage or book of business.
6. The plan should have a vesting provision. There are many methods used by firms, but most firms have provisions based both on years as a partner and age at retirement. Firms should avoid situations where a partner rapidly vests a large retirement benefit at an early age.
7. The age at which goodwill benefits should be 100 percent vested should be no earlier than 60; age 65 is very common.
8. Most firms allow retirement at any time, based on vesting provisions.
9. Notice of intent to retire or withdraw should be at least one year; firms are increasingly moving to 18 or 24 months.
10. The plan should have a provision for mandatory partner retirement. The most common age remains at 65, though many firms have opted for the age at which one can receive full social security benefits. Most firms that allow partners to work past the mandatory age move the partner from equity to non-equity status.
11. The plan should have a limitation on the aggregate goodwill payments paid in any year to all retired partners. A common range for this is 5 to 10 percent of annual net fees.
12. Eighty percent of firms do *not* reduce a retiree's goodwill benefits if his or her clients leave the firm after the person retires. Exceptions to this include situations in which there are a few very large clients involved or the retiring partner has a large specialty that will leave the firm when he or she retires.
13. Adopt a very hard rule about client transition requirements: No transition, no goodwill payments. The firm, rather than the retiring partner, should control the transition process.
14. Over 90 percent of all retiring partners work part-time for a period of years after formal retirement. Firms should agree on how a part-time, "retired" partner is compensated.
15. It is common for firms to take retired partners off of the firm's health insurance plan.
16. Payment of goodwill should be taxed as ordinary income to the retiree and as an expense by the firm.
17. Death of a partner should be treated the same as a normal partner withdrawal or retirement, with appropriate vesting.
18. Disability should be defined in the firm's partner agreement. If a partner is disabled for one year, he or she should be declared permanently disabled and retired. There should be a provision that states how the disabled partner will be compensated during the disability period prior to the declaration of full disability.

19. The partnership agreement should stipulate the extent that a partner's vested goodwill and capital benefits are subject to reduction or elimination in the event that he or she commits certain prohibited acts such as joining another CPA firm or committing a felony offense.
20. The partnership agreement should have a non-solicitation agreement that is invoked if a partner leaves the firm and takes clients or staff. This agreement should stipulate the amount the withdrawn partner must pay to the firm in these instances.
21. There should be a "clawback agreement." This would cover a situation in which the firm is sold after a partner retires, and the sales proceeds received by the active partners are in excess of the rate at which goodwill is valued for internal retirement purposes. In this situation, the payments to the retired partners revert to the sales price. This provision is usually phased out after the first two to five years that a partner retires.

"save" paying compensation to the retiree, and this savings exceeds the retirement payments. The Ponzi group should be worried if the firm fails this test.

Evidence that partner retirement plans are not Ponzi schemes abounds

According to the following, there is evidence that partner retirement plans are not corrupt:

1. *Firms are bought, sold, and merged every day.* The goodwill is consistently valued in the range of 80 to 130 percent of fees.
2. *Many firms merge into larger firms to solidify their partners' buyouts.* The goodwill in the larger firms is valued consistently at 80 to 100 percent.

If your firm's partner buyout plan is *not* a win-win for both the older and younger partners, the plan is a Ponzi scheme.

Older partners

They should feel positive about the future of the firm because they have developed strong, talented younger partners, the firm is growing and profitable, partner accountability is established, and the firm is well-managed.

Younger partners

When a potential partner weighs the pros and cons of accepting a partnership offer, he or she should feel comfortable signing onto the partner retirement obligation. This good feeling happens because:

1. The firm is profitable and their share of that profitability over 20 to 30 years is very exciting and attractive.
2. The six keys to success (above) are present.
3. The firm's buy-in for new partners is reasonable, which these days means that this figure is in the \$50,000 to \$150,000 range, regardless of firm size.
4. The firm's partner retirement plan is properly written and fair to all parties (see sidebar, above).
5. They have little fear of being the last person, or the *only* person left, to turn the lights out.
6. The firm has a track record of successfully retiring partners and retaining that partner's clients.

If all the above are present, then younger partners should not view the firm's partner buyout plan as a Ponzi scheme.

About the Author: Marc Rosenberg, CPA, is a management consultant to CPA firms nationwide. For the past 7 years, *Accounting Today* magazine has acknowledged Marc Rosenberg as one of the 100 most influential people in the CPA profession. INSIDE PUBLIC ACCOUNTING has recognized Marc as one of the most recommended CPA firm consultants in the country. Rosenberg is a widely published consultant. His articles regularly appear in all the industry's leading journals. He works with firms in partner compensation, retirement and succession planning, mergers, facilitating retreats, strategic planning and practice management reviews. His firm, The Rosenberg Associates, is based in Wilmette, Ill. You can reach him at (847) 251-7100 and at marc@rosenbergassoc.com. ★