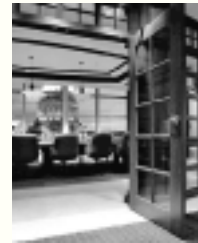
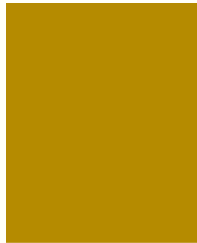


**MICHAEL BEST**

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# Key Elements to A Successful Business Succession Plan

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## Introduction

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- A. Process is Dynamic
- B. Management Succession  
and Ownership Succession
- C. Flow of Events, Not Single Movement
- D. Difficulty of Implementing a Plan

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# OVERVIEW OF FEDERAL AND STATE ESTATE TAX

## Federal Estate And Gift Tax System (as of 2009)

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- At Death, Total Value Of Assets Owned By Decedent Is Subject To Estate Tax
  - Assets receive a full-basis step up (or step down)
  - Marital property law of Wisconsin allows for double step-up at death of first spouse
- 3 Basic Rules:
  - Transfers To Spouse (Who Is A U.S. Citizen) Are Tax-Free
  - Transfers To Charities Are Tax-Free
  - Other Transfers in Excess of the Federal Exemption Equivalent (\$3,500,000 in 2009) Are Taxable

## Federal Estate and Gift Tax Exemption Equivalents

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<u>Year</u>	<u>Estate Tax</u>	<u>Gift Tax</u>	<u>Top Bracket</u>
2009	\$3,500,000	\$1,000,000	45%
2010	REPEAL*	\$1,000,000	35%
2011 >	\$1,000,000	\$1,000,000	55%

- Wisconsin had a separate estate tax for deaths occurring between October 1, 2002 and December 31, 2007
- At present, there is no separate estate or gift tax in Wisconsin

## What Happens in 2010?

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- The estate tax is repealed, as is full step-up (or step-down) of asset value
- Assets passing at death take a carry over basis, with two exceptions
  - \$1,300,000 basis adjustment to assets passing to anyone
  - \$3,000,000 basis adjustment to assets passing to a surviving spouse (or a qualifying trust for a surviving spouse)
    - Standard by-pass trust created in most estate plans does not qualify for the \$3,000,000 basis adjustment
    - Basis adjustment applies to appreciation in the property, not the full value of the property

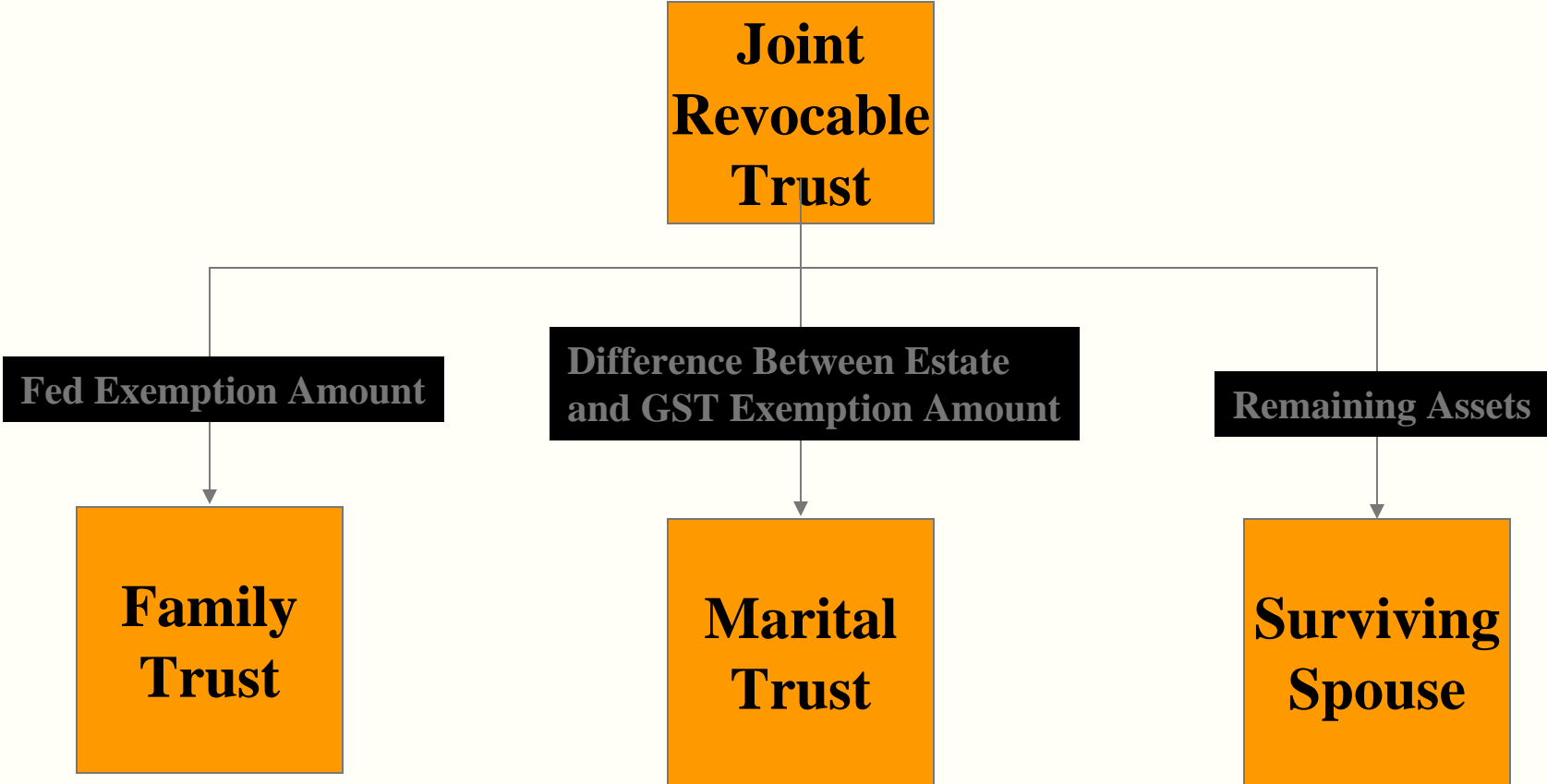
## Use of Bypass Trust to Reduce Estate Taxes

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- Transferring all assets to surviving spouse wastes deceased spouse's unified credit
- Assets up to unified credit can be placed in a bypass trust for benefit of spouse and children (\$3,500,000 in 2009, unlimited in 2010)
- Assets in excess of unified credit pass to surviving spouse and the estate tax is deferred until surviving spouse's death

# Typical Joint Revocable Trust

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## Steps Congress May Take

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- Prior to the end of 2009, the House passed a bill permanently extending the laws in effect for 2009
  - Exemption amount of \$3,500,000; 45% top rate; full step-up
- Senate was embroiled in health care debate and did not address estate tax reform prior to year end
  - Senate has always been more taxpayer friendly
  - Proposals have included an increase in the exemption amount to \$5,000,000; dropping the top rate to 35%; and allowing portability of unused exemption on the first death
- If action is taken in 2010, it could be retroactive to the beginning of the year

# Roth IRA Conversions



## Roth IRA Conversions after January 1, 2010

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- Conversions may now be done by any taxpayer
  - \$100,000 Modified AGI limitation of \$100,000 is gone
- Income taxable on conversion in 2010 may be spread over the following two years
- Tax rate paid on conversion will be the rates in effect in the year the taxes are paid

## Advantages of Roth IRAs

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- Continues to grow income tax free
- No required minimum distributions after the account holder turns 70 ½ (so the account can continue to grow tax free)
- After account holder's death, the Roth IRA is paid out over the life expectancy of the named beneficiary's tax free

## Four Factors to Consider Prior to Conversion

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- Are income tax rates going up in future years after conversion?
- Does the taxpayer have funds outside the IRA to pay the income tax on conversion?
- Does the taxpayer need the monies inside the IRA to live on after reaching age 70 ½?
- What is the current age of the taxpayer?

## Estate tax benefits of conversion

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- Non-IRA funds used to pay the income tax will be out of the taxpayer's taxable estate at death
- Roth IRA is a more favorable asset to fund a credit shelter trust (sometimes called the "Family Trust") at the first death

## Ability to Recharacterize Back to Regular IRA

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- A taxpayer has until the filing date of their tax return for the year of conversion to recharacterize the Roth IRA back to a regular IRA
  - Therefore, taxpayers have until as late as October 15, 2011 to recharacterize an IRA converted in 2010
- Break IRA into multiple IRAs and then convert by asset class



## Wisconsin's Noncompliance with Federal Law

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- Wisconsin is currently the only state to have not adopted federal law regarding Roth IRA conversions
- Bills are presently moving through both chambers to bring Wisconsin into compliance
- What should Wisconsin taxpayers do in the meantime?

## Key Elements of a Succession Plan

1. Start early.
2. Define goals and objectives.
3. Involve family.
4. Seek outside advisors.
5. Identify successors.
6. Create an estate plan.
7. Optimize valuation principles.
8. Adopt shareholder agreement.
9. Communicate plan
10. Implement and monitor plan.

## Start the Planning Early

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- Waiting prevents proper training of successor
- Ideal time – 55-65 years old
- Allows owner to evaluate successor
- Goal is to transition without notice

## Define Goals and Objectives

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- Retirement goals of owner
- Goals of family
- Goals of other interested parties

## Family Involvement in Plan

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- Keeping family in the dark is biggest mistake
- Development of family constitution
- Separate family interests v. business interests
- Anticipate family changes
- Formalize communication

## Advice From Outsiders

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- Objectivity
- Experience
- Team Approach
- Business Colleagues

# Identify Successors

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Management Succession  
v.  
Ownership Succession

## Management Succession Plan

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- Training program for Successor
- Children not selected to succeed
- Keeping non-family employees
- Build support for Successor

## Ownership Succession Plan

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- Coordinate ownership with management
- Business concerns v. family concerns
- Lifetime transfers
- Proper balance of active children with non-active children
- Estate plan is necessity

## Implement an Estate Plan

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- Family/Non-family
- Active/Non-active Children
- Key Non-family Members
- Foundation of House
- Walls and Roof
  - Installment Sales
  - Family Limited Partnership
  - Grantor Retained Annuity Trusts
  - Defective Grantor Trust

## Installment Sales

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- Simplicity
- Estate Freeze
- Valuation Principles
- Cash Flow

# Family Limited Partnerships

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- Split up family business
- Valuation discounts
- Asset protection

## Grantor Retained Annuity Trusts (GRATs)

- Annuity Payment
- Term of GRAT
- §7520 Rate
- Zeroed-out GRAT
- Grantor Trust Rules

## Defective Grantor Trust

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- Installment Sale of Business
- Hurdle Rate = AFR
- Interest Only
- Rev. Rul. 2004-64
- Life Insurance Funding
- Dynasty Trust

## Optimize Valuation Principles

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- Lack of Marketability Discount
- Minority Interest Discount
- Sum of Parts Less Than Whole
- Voting/Non-voting Stock
- Lifetime Gifts
- Give up Control

## Adopt Shareholder Agreement

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- Entity Purchase
- Cross Purchase
- Hybrid Purchase
- “Shotgun” Agreement
- Terms of Agreement

## Communicate the Plan

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- Uncertainty = Indifference
- Last minute choice
- Lose valuable employees
- Career choices of children

## Implement and Monitor Plan

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- Reluctance to implement
- Changing conditions
- Annual family meeting
- Business valuation

## Case Study

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### Assumptions (2009 law applies)

- Dan Jones, 59, and his wife, Martha, 57, own ABC Foods, Inc.
- Dan and Martha have three children:
  - Dan Jr., 32
  - Suzie, 29
  - Sandy, 27
- Dan Jr. is active in the business. Suzie and Sandy, both doctors, live out of state and have no interest in the business.
- ABC has been appraised at \$6 million.
- Dan and Martha own the real estate and building in which ABC operates. This property, with improvements, is valued at \$6 million.
- Dan and Martha have other assets of \$10 million (\$9 million in securities and \$1 million home).

# Option A - Do Nothing

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\$22,000,000	Gross Estate
<u>\$ 7,000,000</u>	Less 2009 Exemptions
\$15,000,000	
<u>x 45%</u>	
<b><u>\$ 6,750,000 in taxes</u></b>	

## Option B – Implement an estate plan that is consistent with Business Succession Plan

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- Recapitalize ABC into a voting/non-voting capital structure
  - 10 shares voting stock (.1%)
  - 9,990 shares of non-voting stock (99.99%)
  
- Sell non-voting stock to DGT #1 for Dan Jr.
  - Purchase price \$3,500,000
  - Give \$400,000 of remaining non-voting stock
  - Promissory note at 2.82% (Feb. AFR)
  - Nine year – interest only
  - ABC has predictability cash flow of \$500,000
  
- Retain voting shares – consistent with Plan

## Option B – (cont.)

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- Put real estate (\$6 million) and \$6 million of marketable securities in FLP
  - Give G.P. Units (10 units) (.1%)  
 $\$12,000,000 \times .1\% = \$12,000$   
( $\frac{1}{2}$  Suzie = \$6,000;  $\frac{1}{2}$  to Sandy = \$6,000)  
No discounts = conservative
- Retain 9,990 Limited Partner Units
  - Cash flow-\$600,000 (rent) + \$180,000 (div. and int.) = \$780,000
- Enter into long-term lease with ABC - \$600,000 per year
- Home and \$3 million of securities remain in Dan's and Martha's name

After implementing Option B, Dan and Martha are in a plane accident.

**Estate Tax Calculation:**

DGT# 1 Promissory Note	\$ 3,500,000
Voting Shares of ABC	\$ 6,000
FLP Interest (99.9%)	\$ 7,800,000*
Marketable Securities	\$ 3,000,000
Home	<u>\$ 1,000,000</u>
	\$15,306,000
Exemption Remaining	<u>\$ 6,600,000</u>
	\$ 8,706,000
	<u>x 45% (tax)</u>
	\$ 3,917,700

[\* \$12,000,000 - (\$12,000,000 x 35%)]

## Recap...

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- Do nothing

Tax: \$6,750,000

- Create FLP/DGT

Tax: \$3,917,700

**SAVINGS - \$2,832,300**

This demonstrates the power  
of using valuation principles

# Ten Years Later...

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## A. Option A – Do nothing

Assume 10% growth on business and real estate; 8% on securities

\$68,854,489  
\$ 7,000,000 Estate exemption  
 \$61,854,489  
 x 45%  
 \$27,834,520 Tax  
 \$41,019,969 / 3 =  
 \$13,673,323  
 (say \$13.6 million to each child)

<sup>1</sup> Business – 10% Growth	\$15,562,454
Real Estate – 10% Growth	\$15,562,454
Securities – 8% Growth	\$19,430,324
Home – 10% Growth	\$ 2,593,742
Cash Flow – Real Estate/ Investment at 3%	\$ 9,973,575
Cash Flow – Business/ Investment at 3%	<u>\$ 5,731,940</u>
	<b>\$68,854,489</b>

## Ten Years Later...

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### B. Option B – w/one addition

Sell Limited Partnership units to DGT  
#2 for benefit of Suzie and Sandy

- \$ 7,000,000 Promissory Note
- \$ 800,000 Gift balance of units
- \$ 7,800,000\*

\*Use 35% discount

# Estate Tax Calculation – Option B

\$ 2,600,000		Home <sup>1</sup>
\$ 7,508,524		Securities <sup>2</sup>
\$ 2,194,224		DGT #1 Net <sup>3</sup>
<u>\$ 5,397,270</u>		DGT #2 Net <sup>4</sup>
<b>\$17,700,018</b>		
<u>\$ 5,800,000</u>		Remaining Exemption
<b>\$11,900,018</b>		
<u>x</u>	<u>45%</u>	
<b>\$ 5,355,008</b>		<b>Tax (say \$5,355,000)</b>

1. Assumes 10% compounding
2. Assumes 8% principal growth and 3% int./div. growth compounding
3. DGT #1 proceeds/cash flow
  - \$3,500,000 Promissory Note
  - \$ 987,000 Interest on Note (2.82%x \$3,500,000 x 10)
  - (2,292,776) Tax paid on DGT (\$500,000 x 40% x 10)
  - \$2,194,224

4. DGT #2 proceeds/cash flow
  - \$7,000,000 Promissory Note
  - \$1,974,000 Interest on Note  
(2.82%x\$7,000,000 x 10)
  - (3,576,730) Tax paid (\$780,000 x 40% x 10)
  - \$5,397,270

# Estate Tax Calculation

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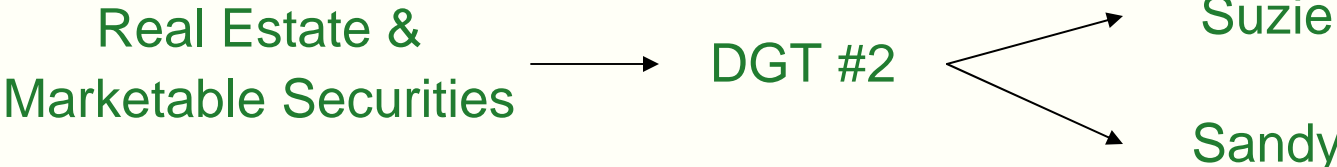
Recap: Do nothing =	\$27,834,520
Option B tax =	<u>\$ 5,355,000</u>
SAVINGS	\$22,479,520

DGT #1 Assets:	\$19,575,455 <sup>1</sup>	
DGT #2 Assets:	\$34,342,005 <sup>2</sup>	
Dan and Martha's Assets After Tax:	<u>\$12,345,010</u>	
Net Assets to Family:	\$66,262,470	
	÷ <u>3</u>	
	<b>\$22,087,490</b>	(say \$22 million to each child)

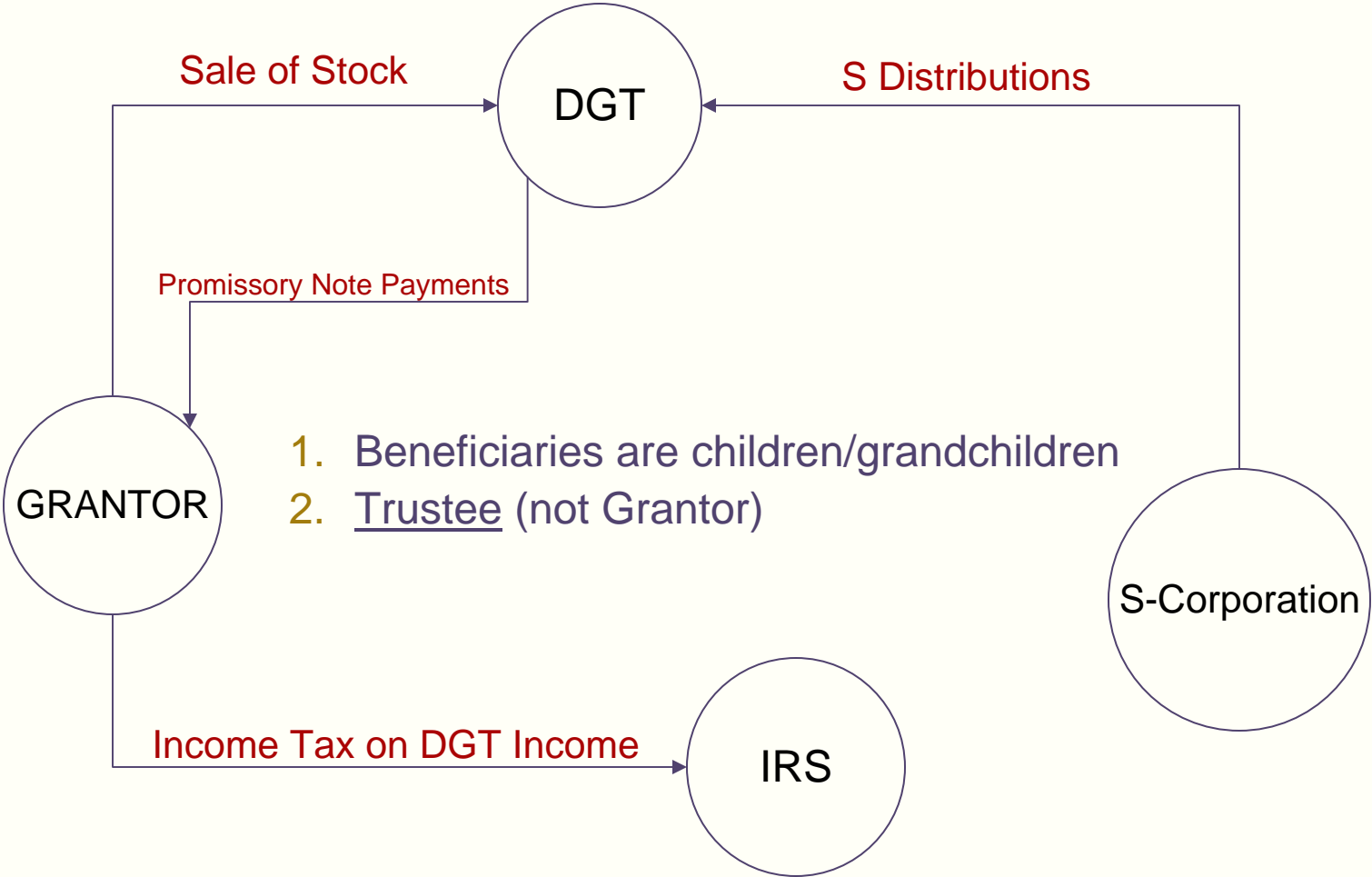
<sup>1</sup> \$6,000,000 business – assumes 10% growth Net cash flow - \$500,000-\$98,700 =\$401,300 for 10 years	\$15,562,455 <u>\$ 4,013,000</u> \$19,575,455
-------------------------------------------------------------------------------------------------------------------------	-----------------------------------------------------

<sup>2</sup> \$6,000,000 real estate – assumes 10% growth \$6,000,000 marketable securities 8% growth Net cash flow \$780,000-\$197,400=\$582,600 for 10 years	\$15,562,455 \$12,953,550 <u>\$ 5,826,000</u> \$34,342,005
----------------------------------------------------------------------------------------------------------------------------------------------------------------------	---------------------------------------------------------------------

Note: To equalize value to each child, parents plan would give more to Suzie and Sandy so that each child would receive approximately \$22 million. Dan Jr. would receive the ABC voting shares. Suzie and Sandy through their FLP interests can expect to receive annual rental payments from ABC of at least \$600,000.

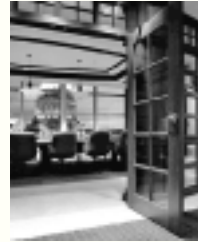
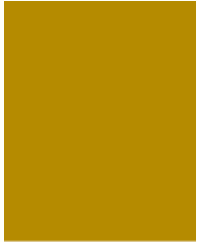


# Operation of a Defective Grantor Trust



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