NAHB INTERNATIONAL BUILDERS SHOW

PREPARING FOR YOUR FUTURE:

SUCCESSION, TAX & ESTATE PLANNING STRATEGIES FOR TODAY

By

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I. INTRODUCTION

A. Planning and achieving your "Succession Strategy" is a key business consideration for every Business Owner. The purpose of this presentation is to give you an Overview of the kinds of succession strategies that are relevant in today's business and tax world. All of these techniques are "practical" in the sense that real Business Owners in the real world are willing in appropriate circumstances to implement this kind of planning.

B. The succession strategy concerns:

- the Business Owner himself or herself;
- the "active" family members of the Business Owner who may want to continue the business as future owners;
- the "non-active" family members of the Business Owner who want to receive in due time an "equitable" inheritance share; and/or
- the Key Employees of the business who may want to be future owners of the business (in whole or in part), or who at the least want to see the business continued so as to protect their employment.

C. There are Four Broad Options to consider:

1. Liquidate (either before or after the demise of the Business Owner).
2. Outside Sale (sale as a going concern to "outsiders") (people who are not Family Members or existing Key Employees)
3. Family Gratuitous Transfer: Continue the business as a going concern to Family Members by means of a combination gift/bequest and senior compensation program.
4. Continue the business as a going concern by means of an "Internal Sale," either to Family Members, or to Key Employees, or to a combination of Family Members and Key Employees.
5. "Internal Sale" usually involves to a significant extent: "buying yourself out with your own money." An "internal sale" involves an organized systematic

method which is legally enforceable and tax-efficient, and which enables the Business Owner to exit the business by being paid a portion of future business profits, while gradually transferring control to the new owner or owners.

6. A Family Gratuitous Transfer and/or an Internal Sale involving Family Members is easiest when all children are involved in the business. "Equality" between children in the business ("Active"), and children not involved in the business ("Non-active"), can sometimes be a difficult issue to resolve.

7. In an Internal Sale involving Key Employees, the perennial problem in this context is where do the Key Employees get the money with which to buy the business. Future earnings of the business, and life insurance on the life of the business owner, are two of the most commonly used sources in an Internal Sale.

D. Generally speaking, there are (more or less) Eleven Key elements that need to be addressed or considered in any business succession plan:

1. Retirement Planning for the Business Owner.
2. Passing non-voting equity ownership in the business.
3. Passing management control of the business (voting equity).
4. Providing income security for the surviving spouse and dependent children of the Business Owner.
5. Equality issues as between children active in the business and children who are not active in the business.
6. Key Employee compensation.
7. Buy-Sell Agreement.
8. Liquidity planning (to pay the transfer taxes).
9. Minimizing transfer taxes (estate, gift and GST tax) and income taxes.
10. Valuation of the closely-held business.
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E. Four real world succession situations are presented in this overview:

1. The "Red Truck Plan."

2. Template For Family Gratuitous Transfer.

3. Template for Internal Sale Using Oldco-Newco.

4. Relevant Charitable Tax Planning Techniques

II. SETTING TODAY'S STAGE: THE AMERICAN TAXPAYER RELIEF ACT OF 2012.

A. Enactment of ATRA.

- The law is entitled: "American Taxpayer Relief Act of 2012." It is generally referred to as: "ATRA."
- ATRA was approved by the Senate in the early morning hours of New Year's Day, 2013, by a bipartisan vote of 89-8; and then approved by the House at 11 PM on January 1, 2013, by a much less bipartisan vote of 257-167, with twice as many Democrats as Republicans supporting it. It was then signed by the President on January 2, 2013. January 2, 2013 is the "date of enactment."

B. Estate Tax, Gift Tax and GST Tax Provisions in ATRA.

- A $5M unified estate tax, gift tax and GST tax exemption, indexed for inflation. The exemption per person in 2014 will be $5,340,000 (pursuant to COLA).
- If you use the gift tax exemption to shelter gifts from gift tax during lifetime, then you reduce the estate tax exemption available to shelter your estate from federal estate tax on your demise (a "unified system").
- If you use the GST tax exemption to shelter gifts to grandchildren (and great-grandchildren, etc.) from GST tax during lifetime, then you reduce the GST tax exemption available to shelter bequests to grandchildren (etc.) upon your demise (a "unified system").
- Because of amendments to Section 2505, it is clear that if a donor previously made taxable gifts equal to $1,000,000 (the prior gift tax exemption through 12/31/2012), that donor has an ability to make up to $4,340,000 of additional gifts without paying any gift tax.
- Similarly, if a donor previously made taxable gifts in excess of $1,000,000, so that the donor actually paid federal gift tax in a previous year, it is still clear under Section 2505 that such a donor has the ability to make an additional $4,340,000 of taxable gifts without paying any gift tax.
- 40% flat rate of tax above the exemption amount. This is the only change that ATRA made when compared to the immediately prior law (where the rate of tax was 35%).
- If ATRA had not been passed, the "Tax Relief Act of 2010" would have expired on 12/31/2012, and the transfer tax law starting on 1/1/2013 would have reverted to the pre-2001 law, which would have involved a $1.0M estate tax, GST tax, and gift tax exemption, and a top marginal rate of tax equal to 55%.

- The "official" Obama negotiating position on the transfer tax law advocated a \$3.5M estate tax and GST tax exemption, along with a \$1.0M gift tax exemption, and a top marginal rate of 45% (a "non-unified system").

- Thus, it is clear that ATRA represents a substantial victory for Business Owners and other taxpayers: \$5.34M "unified" exemption and top rate of 40%.

- ATRA is "permanent!" Unlike the prior Tax Act of 2001 and Tax Relief Act of 2010, ATRA does not have an expiration date. A future Congress and President can change any law, but at least there is no automatic termination of the ATRA transfer tax provisions.

- Therefore, if the basic estate planning is implemented correctly, a total of \$10.68M can be passed to children and/or grandchildren by Husband and Wife free of all transfer tax liability (\$5.34M per person).

- N.B.: The present interest annual exclusion gift of \$14,000 from the Donor to each Donee (\$28,000 to each Donee if the gift is "split" with the Donor's spouse) is unchanged by ATRA. Use it each year or lose it!

C. Future Changes to Fear

- Practical estate planning and business succession planning today under current law should take into account what future changes have been threatened, and if otherwise appropriate for a particular Business Owner now, we should seek to utilize these techniques before they are legislated out of existence.

- Perpetual Trusts. President Obama's recent Budget Proposals included a 90-year limit on the effectiveness of the GST Inclusion Ratio. The concept is that on the 90th anniversary of the Trust creation, the allocation of GST exemption previously made to the Trust would expire, and the inclusion ratio would therefore become one. This change would apply to Trusts created after enactment of this new law.

- Clients for whom it is otherwise appropriate should be urged to establish one or more Perpetual Trusts.

- Valuation Discount Planning for FLP and Family LLC. Several recent Revenue Proposals of the Obama Administration included a substantial expansion of the anti-valuation discount impact of Section 2704(b). There would be a new category labeled "disregarded restrictions" which would be ignored in the valuation of an interest in a family-controlled entity transferred to a member of the family. Significantly, these "disregarded restrictions" would be disregarded even if they are no more restrictive than the restrictions imposed by applicable state law, which is essentially the current law standard for restrictions which are not allowed to have valuation impact. These proposals would apply to transfers of FLP interests and LLC interests made after the date of enactment.

- Clients for whom it is otherwise appropriate should be urged to establish an FLP and/or Family LLC for the purpose of implementing valuation discount planning, before this technique is legislated out of existence.

- Short Term GRATS. President Obama's 2012 Revenue Proposal included a minimum 10 year term for GRATS. This 10 year minimum period was also part of several pieces of legislation which passed the House of Representatives in 2010, but did not pass or make much progress in the Senate. The President's proposal would also eliminate zero gift GRATS, and decreasing annuity payment GRATS. This proposal would apply to GRATS established after the date of enactment.

- Clients for whom it is otherwise appropriate should be urged to consider a package of shorter term GRATs to be established this year before the law is changed.

- The current "bogey" rate for a GRAT (February, 2014) is 2.4%.

D. Necessary Estate Planning in 2013.

- To make sure that your Will (or Revocable Trust) continues to express your personal value judgments if death occurs in 2014. For example, most Wills use tax concepts to define the amount of the "Credit Bypass Trust/Family Trust" or "Marital Trust". These trusts are almost always defined in terms of, first, "the largest amount that can pass free of federal estate tax," or second, "an amount equal to my federal estate tax exemption," and these defined amounts therefore fund the "Credit Bypass Trust/Family Trust." For a person who dies in 2014, that would mean $5.34M in the "Credit Bypass Trust/Family Trust." Is that what you want? Also, if you use GST planning defined by formula (this is typical), you could end up with $10.68M in the Perpetual Trust, which means less funding in the Residuary Trust for the children during their lifetimes. Is this what you want? The Will or Revocable Trust must be modified now to make clear what you intend if death occurs in 2014 in terms of how "formula" clauses would operate.

- Forget transfer taxes for a moment: there are important non-tax reasons to implement a well-drawn Will.

- You need a good Will even if your net worth is less than $10.68M for husband and wife together, or less than $5.34M for a single person, for any of the following reasons:

- If you have <u>minor children</u>, in order to name a guardian or guardians, and in order to express your value judgments regarding the living arrangements for those minor children (where do they live? In your home? In the home of the guardian?)

- If you have <u>beneficiaries who are not able to manage their inheritance prudently</u> (for example, the child who is 23 years of age, and who would receive $1 million on your demise, or on the demise of you and your spouse, and the issue is whether that sum should be given outright to that child, or whether some form of simple trust until the age of 30 or 35 is more appropriate).

- To make sure that the wealth being left to the surviving spouse ends up in the hands of <u>the children and grandchildren after the death of the surviving spouse</u> (instead of ending up in the hands of any other person, including the new spouse of the surviving spouse). To guarantee this result, you need some form of <u>marital trust planning (typically a QTIP Marital Trust)</u>.

- <u>To set forth the business succession plan</u> for the closely held homebuilder business and to implement that plan (or help to implement that plan).

III. THE "RED TRUCK" BUSINESS SUCCESSION PLAN

A. <u>Context</u>

1. <u>Every</u> closely held business needs a "red truck" business succession plan: what will happen to <u>management control</u> and <u>equity ownership</u> if the Business Owner is hit by the "red truck" and dies suddenly and prematurely?

2. <u>Essential</u> <u>first</u> topic regarding business succession planning. Very frequently the Business Owner has given this topic little or no thought or planning. Often the "plan" is that the fiduciaries under the Will/Revocable Trust will vote the stock (or LLC Membership Interest) and (somehow) manage the company. Most frequently the prior Board of Director (or LLC Management Committee) meetings have been non-existent or at best sporadic, and have served only to fulfill a legal formality and/or "rubberstamp" in a cursory manner whatever the Business Owner has chosen to report in terms of "highlights."

3. <u>Enter the Red Truck Plan</u>. It has two crucial elements: the <u>Control Group</u> structure, which enables the Business Owner to "rule from the grave"; and the <u>Business Plan Memo</u>, which is prepared by the Business Owner, and updated every six months, and which serves as initial business guidance to the Control Group.

B. Basic Elements Of the Control Group

1. The use of a “Control Group” enables the Business Owner to rule from the grave. He or she names the members of the Control Group in his Will or Revocable Trust; he or she can change the members of the Control Group in the future by a simple amendment or codicil.

2. Essentially, the Control Group is a standby Board of Directors, which functions as a real operating board immediately upon death of the Business Owner.

3. Adapt to the specific Family context: Can be viewed as a holding pattern until Junior gets old enough and experienced enough to run the Company. For example, Junior is now 28, and Control Group will function for 7 years. Or there is no “junior” on the immediate horizon, and the Control Group will function for the indefinite future (perhaps until the business is sold or liquidated).

4. Integration With Personal Estate Planning. Will or Revocable Living Trust of the Business Owner establishes Control Group. The Control Group directs the Trustees of the Marital Trust how to vote the stock. The Control Group is instructed by the testator or grantor to vote for themselves as members of the Board of Directors. QTIP Marital Trust (for example) still has legal title to the stock. Control Group members are fiduciaries with regard to beneficiaries of the trust.

5. N.B.: Also, this mechanism must be set forth in “Special Durable Power of Attorney” executed by Business Owner. This functions to establish the standby Board of Directors on incapacity or disability of Business Owner.

6. The Control Group mechanism relies for its legal effectiveness on trust law principles. The grantor of a trust is permitted to instruct the trustees in the text of the trust agreement how to vote the stock owned by the trust, and is allowed to designate one or more persons who will have power to instruct the trustees how to vote the stock. No proxies are involved; no "voting trust" is involved. The trustees continue to vote the stock, but as instructed by the Control Group.

C. Typical Mechanics Of the Control Group

1. Odd Number: 5, or 7, or sometimes 9 or 11.

(a) Typically, non-family members in majority.

- You have a Control Group because you don't have a family member who is already capable of operating the business.

- For example:

- 2 family members: spouse and oldest child active in the business.

- 3 non-family members: one Key Employee; Professional Advisor (usually accountant or financial planner; sometimes the lawyer); Outside Business person.

- <u>Thus, 5 person Control Group electing themselves to Board of Directors</u>.

(b) Or Family in Majority.

- Less typical case.

(c) Key Employees from within the business are <u>never</u> in majority; you do not want the "insiders" operating the business for their own (narrow) goals..

2. <u>Self-Perpetuating</u>: vacancies in Control Group filled by remaining members, but categories are respected. Sometimes specific persons are designated to fill first or second vacancy in a category. (For example, Business Owner designates named CFO as first Key Employee, but if she stops serving for any reason, then named Comptroller will serve instead.)

3. <u>Compensation</u>.

(a) Family Members - usually no compensation (but not always). This can be a way of supplementing financial security for the surviving Spouse, for example.

(b) Key Employee - none or modest bonus; position on Board really understood as just part of her job.

(c) Professional Advisor - Her then prevailing hourly rate multiplied by time actually spent, plus disbursements.

(d) Outside Businessman - Same as Professional Advisor.

(e) Time spent includes reasonable travel time, and preparation time for all meetings of the Board.

(f) <u>Total new compensation likely to be less than Business Owner compensation just before death.</u>

4. Control Group serves for how long?

(a) 5 years? 10 years? 15 years? and/or until business is sold or liquidated?

(b) And/or until Junior gets old enough to run the business.

- at the age of ?

(c) <u>At conclusion of term, Control Group dissolved, and power to vote the stock reverts to the trustees then serving as such of the QTIP Marital Trust (for example)</u>.

(d) If there is a "Junior" in the picture: Junior is co-trustee of QTIP Marital Trust with Spouse, and thereafter (pursuant to terms of QTIP Trust) votes the stock alone, or votes it with Spouse. At all times, however, Junior is a fiduciary in terms of voting the stock.

(e) Spouse <u>always</u> retains the right to require the co-trustees to make the property adequately productive of income, so as to continue to qualify for the marital deduction for federal estate tax purposes.

5. Control Group <u>always</u> retains right <u>to sell or to liquidate the business prior</u> to end of term, if that is their business judgment.

6. <u>Control Group instructed to consider "Business Plan Memo" which Business Owner has prepared (and which is updated periodically)</u>. Stored in "Business Succession" file maintained by Business Owner and located at "x." Business Owner can suggest sale of business interests in Memo, and identify potential buyers, etc. Business Owner explains his version of "business plan" for the closely-held interests.

7. Indemnification of all Control Group members; D and O insurance.

8. Is a child guaranteed employment? Not typically.

9. This <u>general technique</u> must be <u>adapted</u> to the <u>specific</u> realities of that closely held business.

IV. TEMPLATE FOR FAMILY GRATUITOUS TRANSFER

A. General Context: Problem and Opportunity. Family-owned closely held business. Mom and Dad and their Children. The goal of Mom and Dad is to pass the business to the children. This is referred to as a **TEMPLATE** because in almost all pure family business succession situations some version of this solution forms a part of the plan, and in many family situations (particularly in smaller businesses) some version of this solution is an adequate practical solution to the business succession problem. This solution applies where future ownership will be lodged only in children (and perhaps grandchildren), and not at all in Key Employees.

The essence of the template: the business is continued by Gift/Bequest and Compensation to Senior.

B. Summary of the Template:

(1) the Goal of transfer to children;

(2) the Key Elements of:

- Retirement Planning for Dad and Mom
- Eventually passing Voting Control of the Corporation
- Passing Equity Ownership in the Corporation
- Providing Income Security for Mom and dependent non-active children
- Coping with the Equality Issue as between active children and non-active children
- Addressing the Liquidity Need
- Minimizing Taxes
- Obtaining a favorable Valuation

(3) the following Techniques are synergized in the template:

- Recapitalization of the Corporation (or LLC) into Voting and Non-voting stock (or equity classes)
- Systematic gift program of Non-voting equity

- Valuation discounts and appraisals

- Trusts for children/grandchildren

- (possible "parallel") FLP/LLC entity (to help maintain "equality" for Non-active children)

- Buy-Sell Agreement (especially needed if child predeceases Dad)

- Compensation Contracts for Dad (with continuing benefit for Mom)

- "Classic" estate planning involving a Marital Trust for Spouse and Durable Powers of Attorney

- Irrevocable Life Insurance Trust owning joint and survivor life insurance to address liquidity need (if any)

- At the "appropriate" time, transfer of Voting Stock to Active Child/Children

C. <u>Systematic Gift Program During Life</u>.

(1) First, recapitalize ("recap") the corporation (or LLC).

(a) Recap into voting common stock and non-voting common stock. (<u>Not</u> a preferred stock recap pursuant to Section 2701.)

(b) Separates management control (voting common stock) from equity ownership (non-voting common stock).

(c) Section 368(a)(1)(e) provides that this recap is <u>income tax free</u>.

(d) Need special Board of Director and Shareholder Consent. File "Articles of Amendment" with state agency to amend the corporate charter.

(e) <u>Not document intensive; no advance IRS ruling needed</u>.

(f) Five percent of the total equity is allocated to Class A voting common stock; 95% to Class B non-voting common stock.

Example: $4 million stockholder's equity. 2,000 shares (5% of the whole) of $1 par value Class A voting. 38,000 shares (95% of the whole) of $1 par value Class B non-voting.

(g) The two classes are equal in all respects except for the vote.

(h) O.K. for S corporations.

(i) Same technique for LLC operating company: 5% Class A Membership Interest which "votes"; and 95% Class B Membership Interest which does not vote.

(2) Second, Father and Mother keep the Class A voting common, and systematically give away the Class B non-voting common to their children and grandchildren. Use $14,000/$28,000 per year per donee.

Example:
Use it or lose it. 2 children plus 2 spouses plus 4 grandchildren equals 8 X $28,000, or $224,000 per year. After 30% valuation discount, that is $320,000 per year. Over 10 years that is $3,200,000 in initial real value that has been removed from senior generation estate. At 40% marginal rate, that is a savings of $1,280,000 in tax plus future income and growth!

(3) Gifts to children and/or grandchildren can be outright, or in trust. Trust is flexible way of administering and holding legal title to the property. Trusts for children have essentially no restrictions on their terms. Trusts for grandchildren either have to use part of the $5.25M GST exemption, or the trust has to have special features under Section 2642(c) in order to be exempt from generation skipping transfer tax.

(4) Special trust restrictions for S corporation stock: grantor trust; QSST; or ESBT.

(5) Absolute control is maintained in the hands of the owner of the Class A common stock. Ultimately, the Class A is left only to the child or children who will be in control of the business in the next generation.

(6) Valuation discounts of up to 20-40% (depending on risk tolerance) can be claimed in valuing the gift of the non-voting common. Need expert appraisal.

D. Giving Away the "Unified Credit" During Life.

(1) First, recap the corporation (as above).

(2) Father and Mother use some or all of their $5.34M/$10.68M applicable exclusion amount during their lifetime, rather than waiting to use the unified credit upon their demise in their estate.

(3) Gets more future growth out of their taxable estates quicker. Also moves future dividend income out of their estate at no transfer tax cost.

E. Equality Issues in Gift Program.

(1) What if some children are involved in the business and other children are not? Many (but not all) business owners grapple long and hard with issues related to some sense of "equality" when considering the children active in the business versus the children who are not active in the business. This complex problem area has many aspects.

(2) Even if desired, "strict equality" is not really achievable, given differences at least in the timing of gifts to children (gift during lifetime versus gifts at death of estate owner). "Rough equality" tends to be the business owner's goal, but that takes many forms in accordance with specific value judgments.

(3) How much has the child who is active in the business "earned" the right to receive the business, so as to augment what would otherwise be an equal overall share? Resentment and tensions among children have to be considered. Sometimes the business is asked to support, or help support, a child who is not active in the business.

(4) There is a wide spectrum of possible value judgments by the business owner: at one extreme, the active child receives the business and an equal share of the rest and residue; at the other extreme, all children share equally in the rest and residue, and the value of the business received by the active child counts against her equal share.

(5) Possible differences of opinion between Dad ("My son has earned the right to receive the entire business; plus an equal share of whatever else there is."); and Mom ("We love all our children equally, and our daughters will not be penalized because they chose the traditional path of marriage [like their Mother did]; all our children will receive an equal share of all the wealth, including the business.")

(6) Use other assets to achieve "equality." This is the classic and best solution. Give Class B non-voting common stock only to the active children (and grandchildren in their line); at the same time give other assets to the inactive children (and grandchildren in their line). Good candidates for "other assets" are limited partnership interests in family partnership, or LLC membership interests in Family LLC, owning real estate leased to business or owning equipment leased to business. "Other assets" can also be non-Company related assets, of course.

(7) Be careful: Do not give away "other assets" that Father and Mother really need for their own economic security. It doesn't matter, on the other hand, that Father (and Mother) give away Class B non-voting common stock, because control is maintained through the continued ownership of the Class A voting common stock, and that control guarantees favorable compensation arrangements.

(8) Never give even non-voting stock (or equity interest) to Inactive Child or descendants of Inactive Child.

F. Compensation For the Senior Generation.

(1) If Father and Mother give the Company away to family members and do not sell it, how are they "rewarded" for the transfer of the Company?

(2) What is the goal? In the context of a gift program, the goal is not to return the total FMV of the Company to Father and Mother. The "reward" for the parents is seeing the family business continued by the children. The goal, instead, is to make sure that the chosen lifestyle of Father and Mother is secure for the rest of their lives. This goal is achieved by designing the right kind and level of compensation arrangements. The three devices that are typically used are:

(a) Employment Agreement to cover current employment until retirement, with "salary continuation" features in the event of Father's disability;

(b) Deferred Compensation Agreement to delay the payment of a portion of a future salary increase, until the years following the Business Owner's retirement (of course, the portion deferred is a pure "extra", and the Business Owner does not actually give up future salary increase; payment of the deferred amount will be made to the spouse if the Business Owner dies during the term of the payout following retirement) (the payments when received are subject to self-employment tax); and

(c) Consulting Agreement, whereby Business Owner provides consulting advice after retirement.

(3) Tax consequences for all of these devices are (comparatively) favorable: the payments are deductible to the Company, provided that the total payments are within the bounds of "reasonable compensation". As a practical matter, the latter concept does not typically restrict to any substantial extent, although it must always be kept in mind.

G. Gift Program Completed On Death By Bequest.

(1) Class A Stock. There is a very nasty trap if the Business Owner leaves Class A voting common stock outright and not in trust to active children upon Business Owner's demise, while leaving the rest of the Class B non-voting common stock to the QTIP Marital Trust (so as to supposedly defer all federal estate taxes at the senior generation level until the demise of the survivor of the Father and Mother).

Such a disposition causes an artificial extra federal estate tax to be generated because of the gap between the undiscounted value of the Class B in the Business Owner's estate when coupled with the control element of the Class A, versus the discounted value of the Class B when it is used to fund the Marital Trust (in a case where the Class A voting stock goes outright to Child.)

Thus, both the Class A and the Class B must pass initially to the Marital Trust.

The Active Child can be Co-Trustee of the Marital Trust with the sole power to vote the Class A.

After the expiration of the statute of limitations on the Business Owner's estate administration, the Active Child should purchase the Class A stock from the Marital Trust for FMV as then determined by appraisal. This can be an installment payment over (for example) 14 years with AFR interest. Upon the spouse's subsequent demise, any remaining Class B stock left in the Marital Trust will be entitled to claim a valuation discount!

The Business Owner's Will or Revocable Trust should provide that the Class A stock is distributed outright to the Active Child from the Marital Trust upon the subsequent demise of the spouse; this would occur if the Active Child had not yet accomplished the purchase of the stock as mentioned above.

(2) Class B Stock. The QTIP Marital Trust is also written so as to facilitate a continuation during the rest of the Spouse's life of the systematic gift program involving Class B non-voting common stock. Discretionary distributions of corpus are authorized; Class B non-voting stock is distributed to Spouse; Spouse gifts at the rate of $14,000 a year to each active child donee (and to grandchildren in the line of the active child/children, often using Section 2642(c) trusts). Do not "condition" in the text of the QTIP the distribution to the Spouse with the requirement that she in turn re-gift to the active child, etc. This loses the marital deduction.

(3) Upon the Spouse's subsequent demise, the QTIP Marital Trust terminates and distributes the remaining Class B non-voting common stock either only to active children or to all children, depending on the dynamics of the "equality" issue.

(4) Liquidity planning must then be coordinated with the imposition of a federal estate tax (FET) on the subsequent demise of the Spouse, where some of the Spouse's estate for tax purposes (through the QTIP Marital Trust) consists of the remaining Class B non-voting common stock, which was not previously given away.

(a) Liquidity is most often supplied in this context by an Irrevocable Life Insurance Trust (ILIT), which purchases "hard assets" from the QTIP Marital Trust upon the Spouse's demise at then FMV. There is no capital gain to the QTIP Marital Trust because the assets have received a step up in basis for income tax purposes equal to the FMV on the date of the Spouse's demise (or on the date six months after the Spouse's demise, if the Personal Representative of the estate chooses the "alternate valuation date" for federal estate tax purposes).

(b) Joint and survivor life insurance (on the lives of both Father and Mother) is often selected as the life insurance product; the proceeds are received when the FET is due.

(6) Again, note the Essence of the template: the entire business has been continued to family members using gratuitous transfers, being gifts during life and bequests after death, with no sale of the company to any extent involved. Economic security for Father and Mother has been provided entirely by compensation arrangements.

H. Summary of Template Operation..

(1) Recap using Class A voting common and Class B non-voting common.

(2) Business Owner keeps the Class A (at least for the time being and perhaps until demise).

(3) Use systematic gift program for Class B; use unified credit gift to "jump-start" gift program for Class B.

(4) Spend the money for a first class appraisal; have the valuation expert opine specifically on the extent of valuation discount when a minority interest of Class B is hypothetically being sold.

- Negotiate up front for "package" consisting of "full-blown" appraisal now, plus approximate cost of annual updates (consisting of, typically, three page letter report) for (say) next 5 years.

(5) Explicitly address and resolve "equality" problem (if any).

(6) Plan compensation and financial security for senior generation. Prepare Employment Contract (with salary continuation features), Deferred Compensation contract, and Consulting Agreement (just before retirement).

(7) Redraft Will (or RLT) to bequeath Class A and Class B stock to Marital Trust, with Active Child as Co-Trustee to vote Class A (or use the "Control Group" mechanism from the "Red Truck" plan).

(8) Discuss with Active Child and with spouse the fact that Active Child will be purchasing Class A from Marital Trust approximately 3-4 years after demise of Business Owner for then FMV, paying for the same over 15 years with an unsecured promissory note. N.B.: Must

not separate voting Class A from non-voting Class B on demise of Business Owner (by, for example, bequeathing voting stock to Active Child while leaving non-voting stock to Marital Trust), or else IRS makes "Chenowith"-type argument to generate federal estate tax in Business Owner's estate despite the marital deduction.

(9) Discuss with Spouse his or her "moral obligation" to continue systematic gift program of Class B after death of Business Owner, using stock distributed from QTIP Marital Trust.

(10) Prepare Durable Powers of Attorney for Business Owner and Spouse specifically authorizing ongoing gift program.

(11) Project and quantify FET liquidity need on second spouse's death, making reasonable assumptions consistently applied. Draft ILIT. Have trustees buy Joint and Survivor Insurance.

V. TEMPLATE FOR INTERNAL SALE USING OLDCO-NEWCO.

A. The Quintessential Business Succession Problem: Child (or children) who are active in closely held business want to take over; Parent willing to retire but needs to receive some further significant payment from the business. Crucial Key Employee (or employees) want some form of equity ownership, and want the family of the Key Employee to be protected in the event of the demise of the Key Employee. (Existing business may be in "C" corporate form.) Children who are not active in business want to receive ongoing support from family assets. Closely-held home builder business (for example) is major asset of the Family.

Or: No Family Member of Business Owner to be involved. Only Key Employees to be successor owners and managers.

B. Proposed Solution: Semi-permanent joint venture between new business entity ("Newco") and existing business ("Oldco"), with Newco owned in part by Oldco (or Parent), by active child (children) and by Key Employees, and with eventual transition of Oldco's ownership interest in Newco to Active Child (Or: to Key Employees, if Family Members are not involved) after Parent's interim economic goals are met.

C. Techniques Synergized:

[N.B.: the details of the structure differ if the closely-held business is asset intensive like the ownership of one or more commercial office buildings or apartment houses, or a home builder with a significant inventory of investments in land and development cost, versus a real estate related service business like property management or commercial brokerage or engineering service, or a home builder who does not have a significant inventory of investment in land and development cost.]

1. A particular version of "Oldco/Newco" in the form of a semi-permanent joint venture.

2. Conversion of "C" corp to "S" corp (if relevant).

3. Recap of "S" corp (or re-structure of LLC into 5% Class A voting Membership Interest and 95% Class B non-voting Membership Interest).

4. Valuation discount for gift of Class B "S" corp. stock by Parent to inactive children.

5. Valuation discount for capital contribution of Class B non-voting LLC Membership Interest to Newco.

6. A version of Newco in which Parent/Oldco receives distribution of his profit for "X" amount and over "Y" years.

7. "Locking in" the Key Employee with comprehensive protection of his family.

8. Buy-sell agreements within the Newco Operating Agreement.

D. Discussion.

(1) Oldco/Newco is a powerful technique which is also sometimes referred to as Brother-Sister. The most significant recent development in business succession planning is the increasing frequency with which some version of this technique is used. Wide Application: often used in Family situations, or non-Family situations, or where new owners/managers are to be a combination of Family and Non-Family.

(2) Its increasing use is grounded in the recognition that what needs to occur in business succession planning is not that the new ownership/management group needs to purchase the past, but rather that the new ownership/management group needs to share in the future. Let Dad/Mom keep the past; after all, it belongs to them.

(3) If the closely-held business is a "service" business like a home builder without a significant inventory of developed land (or a firm concentrating in property management, or commercial brokerage, or engineering service; etc.), then no sale of stock, or other transfer of equity, of Oldco occurs; instead, the future service business conducted by Oldco is transitioned to Newco. If the closely-held business is, instead, an asset intensive business, like a home builder with a substantial inventory of developed land, or a firm which owns buildings that generate rental income, then Oldco (or Parent) typically contributes a non-voting equity interest in the same to Newco.

(4) If Active Children are involved in Newco, and there are other children not involved in Newco as the new version of the Family's operating business, then Dad and Mom can institute a systematic gift program for Inactive Children (and grandchildren in those family lines) involving Class B non-voting stock in Oldco (following recap of Oldco).

(5) Components of "Simple" Version of Oldco/Newco Technique

[N.B.: this "simple" version is well-suited to non-asset intensive service businesses.]

(a) Sale of operating assets, or lease of operating assets, from Oldco to Newco. Beware trap of recapture income in year of sale, even if sale is on installment basis.

(b) Use of name or related name.

(c) Consulting Agreement to Business Owner from Newco.

(d) If relevant, fee for guaranteeing line of credit. (Ordinary income to Oldco). And/or Oldco loans working capital to Newco on commercially reasonable terms; interest income is taxable to Oldco.

(e) Newco employs the former employees of Oldco.

(f) Old business of Oldco assigned to Newco (if possible), or performed by Newco pursuant to Management Services Agreement.

(g) Newco capitalized initially in minimal manner, but profit (after salaries and tax distribution) must be accumulated until certain target net worth for Newco is achieved.

6. Additional Aspects of "Simple" Version.

(a) If done right, achieves an "estate freeze" for Business Owner's service business. Business Owner will gradually liquefy the entire interest in the business. (The freeze "leaks" to the extent that the Consulting Agreement represents "extra" payment.)

(b) Business Owner's Company (Oldco) will become a "personal holding company" as a result of this transaction, and this problem area needs to be anticipated and planned for. 2003 Tax Act lowered PHC tax to 15%, however.

(c) Ideal Context: An excellent technique to use (in either the simple form or any more complex version) when Oldco has a great deal of "extraneous" assets not related to the service business operating company. Newco buys (or leases) from Oldco only the operating assets used in the service business.

(d) Also can be used by Business Owner's Estate after death of Business Owner in a post-mortem re-structuring. (This is sometimes part of the "Red Truck" plan; Parent's Will or RLT gives this general direction, and leaves all details to be negotiated at that future time between Estate and anticipated owners of Newco.)

(e) See Exhibit 1 for "Simple Version."

7. Another Option: Business Owner Retains Control of Newco

(a) Capitalize Newco as S corporation with Class A voting common and Class B non-voting common; or use LLC structure where Business Owner is in control of Management Committee, with the power both to name one or more successors on Management Committee and to specify their voting power, either during Business Owner's lifetime or in his Will.

(b) Used when dominant Business Owner is not ready to choose among several Key Employees and/or Family Members, as to who will have operational control.

(c) Business Owner bequeaths or sells Class A voting to chosen Key Employee or family member either at time certain in the future (like January 1, 2020, for example), or at Business Owner's discretion.

E. Semi-Permanent Joint Venture Version of Oldco/Newco

(1) A variation of the "Oldco-Newco" approach is the "semi-permanent joint venture." Newco as a new LLC is formed by Oldco (or Parent), plus one or more Family Members, and/or one or more Key Employees. This structure is used especially when an asset intensive closely-held business is involved, like the ownership by Oldco (or Business Owner) of a homebuilding firm with a significant inventory of land and development costs (or the ownership of one or more apartment buildings or commercial office buildings.)

(2) The Newco LLC Operating Agreement then defines the working relationship of Oldco and the other Members in the new joint venture: capital contributions; equipment contributed or used or rented; organization; officers; profit and loss allocation; management, operations and marketing; use of facilities; insurance issues; working capital and/or loans for the same; and use of name.

(3) The Newco Operating Agreement permits one of the other Members of Newco (or Newco itself) to purchase the Membership Interest of Oldco at a certain formula price after the economic goals of Oldco have been satisfied. See Exhibit 3, paragraph 2(d), for an example of this concept: Oldco (or Business Owner) is out; and the other owners (Family Members; or Key Employees; or a combination) remain.

(4) The Membership Interest of the Family Member(s) and the Key Employee(s) in Newco LLC is typically a profits interest only, and starts therefore with a zero capital account.

(5) If Oldco is an asset intensive business (like a homebuilder with a significant inventory of developed land), then Oldco will contribute to Newco a significant portion of the

equity interest in Oldco itself, in order to give Newco access to those necessary business assets. The fair market value of that capital contribution establishes the initial capital account of Oldco in Newco.

(a) If the asset intensive Oldco is itself an LLC owned by the Business Owner, then Business Owner restructures that LLC to create Class A voting and Class B non-voting Membership Interests; and Parent may choose to retain the Class A Membership Interest for the time being (gifting or selling the same in the future to a Family Member, or a Key Employee, or to Newco). Parent then makes a capital contribution of some portion (or all) of the Class B Membership Interest to the Newco LLC.

(b) If the asset intensive Oldco is itself a limited partnership with one or more other owners, then Business Owner transfers some portion or all of his or her limited partnership interest to the Newco LLC.

(c) Perhaps the existing asset intensive business is an S corporation (call the existing business "S#1"). If that is the case, then a more complex maneuver must first occur, since S corporation stock (in Oldco) cannot be owned by an LLC (like Newco). Parent therefore first forms a new S corporation called S-Holdco; transfers his S#1 corp stock to S-Holdco in exchange for the latter's stock; makes a QSUB election for S#1; the QSUB-S#1 now forms a wholly owned LLC; the QSUB-S#1 merges into the wholly owned LLC, which LLC therefore becomes wholly-owned by S-Holdco; and S-Holdco (now functioning as Oldco) contributes some or all of the LLC Membership Interest into the Newco LLC as a capital contribution. The developed land assets (for example) were originally titled in S#1; there is typically no real estate transfer tax when the wholly owned QSUB-S#1 merges into the wholly-owned LLC under the "conversion" statute which exists in most (but not all) states. The said merger is a Section 368(a)(1)(F) reorganization.

(d) Beware #1: If Business Owner owns the assets necessary for Newco operations through an entity with other owners, make sure Business Owner's transfer into Newco is allowed under the governing instrument, or obtain a waiver from the other owners.

(e) Beware #2: Make sure you understand the real estate transfer tax consequences of Business Owner's contribution of his Class B Membership Interest or Limited Partnership Interest into the Newco LLC. Some statutes impose such a tax if the percentage of ownership being contributed exceeds some defined number like 80%.

6. See Exhibit 2 and 3.

VI. RELEVANT AND PRACTICAL CHARITABLE TAX PLANNING TECHNIQUES

A. Support the National Housing Endowment!

(1) The National Housing Endowment ("NHE") is the philanthropic arm of the National Association of Home Builders ("NAHB"). NHE is a charitable tax-exempt corporation organized in accordance with Section 501(c)(3).

(2) Contributions to NHE are tax-deductible for income tax, gift tax, and estate tax purposes.

(3) See the NHE website at www.nationalhousingendowment.org.

(4) Briefly, the NHE provides funds and programs to address NAHB industry concerns, including:

- Supporting scholarship programs that encourage students to select home building and related fields as their life's work
- Assisting colleges and universities in the development of housing-related curricula and activities
- Revitalizing the building industry's labor pool and enhancing its professionalism through training and apprenticeship programs, seminars and continuing education
- Setting the standard for state of the art technology in improving housing construction, performance, safety and affordability

(5) You can integrate charitable support for the NHE into your estate plan in a way that supports or even enhances your estate planning goals.

B. Lifetime Versus Testamentary (Same Basic Concepts)

- Better to make charitable gift during lifetime: Save income tax today, and in effect save estate tax as well (because you do not own the property any more).

- Versus waiting until your demise to make charitable gift, which saves estate taxes only.

- Carryover for "excess" charitable income tax deduction for succeeding five years under Section 170(d) (50% of AGI property) and Section 170(b)(1)(C)(ii) (as to 30% of AGI capital gain property).

C. Outright Donations

- Cash gift during life, or in Will/Revocable Trust on demise.

- Gift of <u>appreciated property</u> during life (saves capital gain tax) (subject to 30% of AGI limit).

- <u>Better than cash to NHE under your Will/Revocable Trust</u>: Leave cash to spouse in Will; no estate tax because of marital deduction; discuss with spouse that purpose is to enable spouse immediately to make charitable gift; <u>spouse then obtains income tax deduction for gift to NHE</u>.

D. <u>Life Insurance Donations</u>

- Gift of existing <u>life insurance policy</u>; amount of donation for income tax purposes is FMV of the policy (essentially CSV); donor then transfers cash in each subsequent year to NHE so that NHE can pay premium and keep policy in force.

- And/or Donor could take out a new life insurance policy and then gift the same to NHE; then cash in each future year for funding of premium.

- <u>Advantages</u> of life insurance donation: simple; certain of result; huge leverage in the amount of the ultimate gift (premiums paid versus death benefit proceeds); self-completing on demise (NHE does not have to wait for the completion of estate administration).

E. <u>IRA Donations</u>

- <u>IRA Beneficiary</u>: Your child will only realize about <u>40 cents</u> on the dollar from your IRA which is subject to <u>both</u> estate tax in your estate <u>and</u> income tax on the withdrawal from the IRA by your child; the IRS receives 60 cents. Instead, name NHE as beneficiary of part or all of that IRA; NHE receives 100 cents on the dollar and the IRS receives zero.

- Common patterns:

  (1) "Very Wealthy": IRA owner will leave IRA directly to NHE, skipping all family members.

  (2) "Wealthy": IRA owner will leave IRA to surviving spouse, to make sure surviving spouse has economic security; and then surviving spouse will bequeath IRA to NHE on subsequent death. No federal estate tax on first demise (marital deduction), and no federal estate tax on second demise (charitable deduction).

F. <u>Marital Deduction Trust/Charitable Remainder</u>

- Very common pattern

- <u>QTIP/Remainder to Non-Profit</u>: Protect surviving spouse by leaving portion of wealth in QTIP trust; spouse receives income for life; discretionary principal for "support in reasonable comfort"; on death of surviving spouse, remainder passes to NHE. <u>Result: no federal estate tax paid at all</u>.

G. <u>Charitable Remainder Unitrust ("CRUT")</u>

□ The most common "lifetime" charitable trust used today (established during <u>lifetime</u> of Donor): the income tax deduction is the primary tax benefit in this context.

□ <u>Irrevocable</u> trust for life of grantor (or joint lives of grantor and spouse), or for term of years not in excess of 20 years.

□ Grantor/Beneficiary receives "<u>unitrust</u>" payment each year: a fixed percentage of the FMV valued each year. Thus, <u>increase</u> each year if FMV of trust increases (also could decrease).

□ At end of term (death of grantor or term of years), NHE receives trust property.

□ <u>Amazing But True</u>: Grantor receives income tax deduction in year one for value of charitable remainder, even though NHE does not receive property for a long time.

□ <u>Key Limit</u>: Income tax deduction for NHE must be at least 10% of FMV of trust.

□ <u>No capital gain tax</u> when trust sells assets; <u>very common</u> for grantor to donate highly appreciated assets to trust, and then trust sells and reinvests with no capital gain tax.

□ Calculation depends on IRS Section 7520 Interest Rate: use the best (highest) of the month of the transaction and the prior 2 months.

□ For February, 2014: best (highest) is 2.4% (From February, 2014)

□ You could (for example) prove to the <u>maximum payout</u> to the Donors, so that the income tax deduction is just over 10% of the value contributed to the CRUT. Or you could prove to a <u>less than maximum payment</u> to the Donors, in which case the income tax deduction to be taken in year one can be a lot higher than 10%.

□ Some of the examples use the lifetime of the Donor or the joint lifetimes of the Donor and spouse. The IRS valuation tables assume a "standard" life expectancy. NHE takes the remainder when the

Donor passes away in fact, whether that be sooner or later than the time allotted in the IRS tables.

□ Example #1: Maximum Payout to Donors (Therefore, Lowest Charitable Deduction of 10%). $1M trust in February, 2014; joint lives of husband and wife ages 60 and 58; assume 6% total return per year. IRS says 28 years of payments ranging from $89,970 in year one to $40,063 in year 28; total payments received equal $1.731M; NHE receives $432,146 at end of year 28. Income tax deduction in year one equal to $100,010 (the minimum 10%). Payout rate is 8.997%.

(1) Variation 1A: 4% annual total return (not 6%)

- What the CRUT produces depends on the annual total return
- Husband and wife receive $1.374M over 28 years
- NHE receives $239,092 at end of 28 years

(2) Variation 1B: 6% annual total return

- Key Difference: Husband and Wife want 5% unitrust payment (not maximum payout)
- Still joint lives: 28 years of payments
- 1st year: $50,000 (5% of $1M)
- Payment grows every year, because annual total return is 6% and annual payout is 5%
    - 10th year: $54,904
    - 20th year: $60,919
    - 28th year: $66,203

- Total payments to H & W: $1.617M
- NHE receives $1.338M after 28th year
- Charitable deduction in year one: $265,870(not the minimum of $100,010)

□ Example #2: Maximum Payout to Donors (Therefore, Lowest Charitable Deduction of 10%). 20 year term; $1M trust in February, 2014; 6% annual total return assumed; $100,020 income tax deduction in year one; donor receives total payments over 20 years equal to $1.418M, ranging from high of $111,360 in year one to low of $41,264 in year 20; NHE receives $351,684 at end of 20 years. Payout rate is 11.136%.

□ Example #3: 8% Payout to Donors. 10 year term; $500,000 trust in February, 2014; 6% annual total return assumed; $221,677 income tax deduction in year one; donor receives total payments over 10 years equal to $366,584, ranging from high of $40,000 in year one to low of $33,488 in year 10; NHE receives $410,418 at end of 10 years.

- □ Example #4: 8% Payout to Donors. 5 year term; $500,000 trust in February, 2014; 6% annual total return assumed; 8% payment assumed; donor receives total payments of $192,332, ranging from high of $40,000 to low of $36,963; NHE receives $453,000 at end of 5 year term; income tax deduction for Donor is $332,923 in year one.

H. Charitable Remainder Annuity Trust ("CRAT"):

- □ Like unitrust except that annual payment to Donor is fixed dollar amount set at inception, and does not increase (or decrease) over time with the value of the trust property.

- □ Dollar value of charitable remainder in CRAT received by NHE at end of term is much higher than with corresponding CRUT because (assumed) growth in value of corpus inures to benefit of NHE (since annuity to Donor is fixed dollar amount and does not grow over time).

- □ Income tax deduction in year one for CRAT is somewhat higher than with corresponding CRUT; this is based on present value today of remainder interest to NHE at end of term.

- □ Donors very seldom use lifetime CRAT: Donors fear loss of purchasing power of the retained fixed dollar amount.

I. Testamentary CRUT and CRAT

- □ Donors will sometimes use a CRUT established in a Will/Revocable Trust to support a Child for life, or a Child and Spouse for joint lives, or for a term of years not to exceed 20 years; or to support a sibling of the Donor who needs supplemental economic support for life.

- □ The capital gain tax avoidance is not relevant in the testamentary context because the Donor/Decedent's assets received a step up on basis on the demise.

J. Charitable Lead Annuity Trust ("CLAT")

- □ Testamentary CLAT frequently used to pass assets at no (or little) estate tax cost to children or to "Discretionary Spray Trust" for children.

- NHE receives fixed dollar amount for term of years (10, 15 and 20 years are common terms selected, depending on age of children).

- Child, or then-living Children in equal shares, or "Discretionary Spray Trust" for Children then receive remainder after term of years.

- CLAT is "zeroed out" or "nearly zeroed out," so that federal estate tax deduction (for present value of stream of annuity payments) equals the initial corpus placed in the trust: no (or very little) federal estate tax.

- In essence, if total return on average over term of CLAT exceeds Section 7520 rate, the Child/Remainder Interest ends up with a positive value.

- Key Concept: Because interest rates are so low now, a CLAT works very well even if "total return" rates are modest.

- Example #1: $1M initial corpus; 20 year term; February, 2014; 2.0% Section 7520 rate (best of 3 last months; now the lowest); $61,160 annual payment to NHE required to zero out; 6.116% payment rate; No Federal Estate Tax on the $1M; if total return on average is 5%, then $630,984 passes to Child at end of 20 years.

    - 6% total return: Child takes $957,329
    - 7% total return: Child takes $1,362,400
    - 8% total return: Child takes $1.862M
    - NHE receives $1,223,200 over 20 years ($61,160 times 20 years)

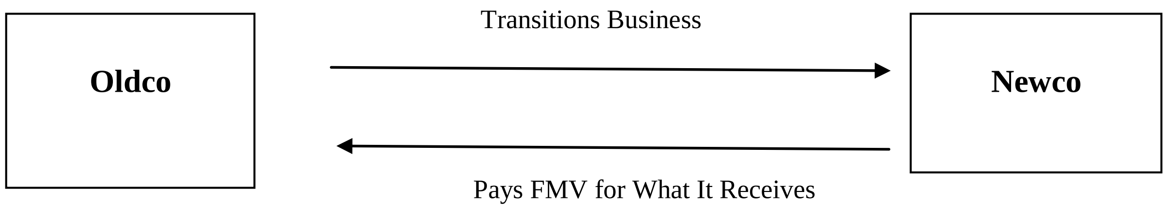
- Example 2: Same as Example #1, except 10 year term: $111,330 annual payment to NHE required to zero out; 11.133% payout rate.

    - 5% total return: Child takes $228,598
    - 6% total return: Child takes $323,430
    - 7% total return: Child takes $428,966
    - 8% total return: Child takes $546,136
    - NHE receives $1.113M over 10 years

- CLATs are not typically used to pass assets to grandchildren or further descendants because of adverse rules in Chapter 13 dealing with GST tax.

EXHIBIT 1

Oldco/Newco: Simple Version
For Closely-Held "Service" Business



(1) A "C" Corp. owned by Dad.

(2) Dad is Consultant to Newco for "X" number of years at "Y" fee.

(3) Oldco loans working capital, or guarantees line of credit, and receives interest payments and/or guarantee fee.

(4) Sells/leases equipment to Newco.

(5) Rents office space to Newco.

(6) Employees go to work for Newco.

(1a) A new LLC formed by group of Key Employees

<u>or</u>

(1b) A new LLC formed by one or more children

<u>or</u>

(1c) A new LLC formed by a combination of Key Employees and children.

(2) Design governance to respond to goals and needs. Dad should have veto power over certain matters until debt to Oldco is paid off.

(3) Compensation of Employees of Newco specified by employment contract. A payment of a "bonus" requires the agreement of Dad while any debt or lease obligation is still owed to Oldco.

(4) Comprehensive Buy-Sell provisions within Operating Agreement, to control buy-back on death, retirement, disability, or termination of employment. Death buy-back funded by life insurance on life of each owner of Newco. (Thus, the family of each owner is protected.).

(5) Finishes existing contracts for Oldco either by contract assignment (if possible) or by Newco executing Management Services Contract with Oldco.

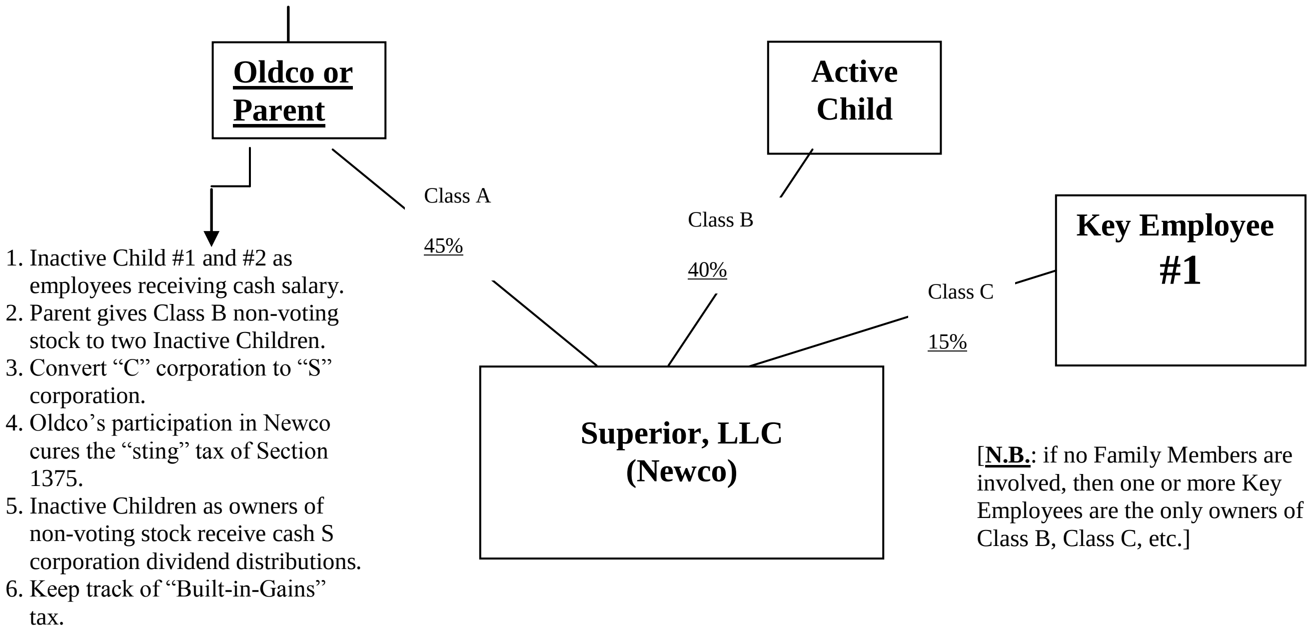
(6) All new work taken in name of Newco.

(7) Operating Agreement specifies that only distribution to owners of Newco is to pay federal and state income taxes as defined, until equity in Newco achieves "X" level, and/or debt to Oldco paid off, and/or "Y" number of years elapse. Goal is to build Newco up as viable "stand-alone" business.

<u>EXHIBIT 2</u>

<u>New Structure: "Semi-Permanent" Joint Venture</u>

Parent: – owns 100% of voting stock of Oldco, a "C" Corp. which now converts to "S" status **or** **Parent owns LLC or S Corp which owns Building or other intensive closely-held business**



(a) This structure can work well when the business being transitioned is a service business without large amounts of tangible assets required for the generation of the business profit.

(b) This structure <u>also</u> can work well when the "business" of Oldco is the ownership of an asset intensive closely held business, like a homebuilder with a significant inventory of land and development costs, or a business which owns one or more commercial office buildings or apartment buildings.

(c) Of course, "Oldco" could be Parent individually rather than an entity. Parent could own all (or some) of the LLC or limited partnership that owns the building, and in these cases Parent could transfer all (or some) of his LLC Membership Interest (typically but not always, his non-voting Membership Interest, retaining the control piece for the time being) or limited partnership interest into the Newco LLC.

(d) If the building is owned in an S corp, then it is necessary to proceed along the lines described in <u>Section V, E, 5, (c)</u> of the outline. (Of course, much more likely that building would be owned in an LLC and not in S. corp.)

(e) In the unlikely event that the building is owned in a C corp, then Dad proceeds by first converting this C corp to S corp, and then proceeds as described in <u>Section V, E, 5, (c)</u> of the outline.

<u>See Exhibit 3 for details of Class A, ClassB, and Class C.</u>

EXHIBIT 3

Class A, Class B, and Class C

Have the following economic attributes (for example):

1. Allocation of Profit and Loss, and distribution of Cash Flow.

    a) Profit is allocated in proportion to the ownership percentages of 45% for Class A, 40% for Class B, and 15% for Class C, until the aggregate amount of profit allocated to the Class A Interest equals $10M.

    b) Profit will continue to be allocated to the respective percentages of the three Classes until the conclusion of the first eight fiscal years of operation of Newco.

    c) Therefore, after the latest to occur of the $10M profit target or the 8 year chronological target, additional profit is thereafter allocated 3% to Class A, 82% to Class B, and 15% to Class C. Thus, after Parent/Business Owner (Oldco) is satisfied in terms of its profit and loss preference, the bulk of the profit and loss thereafter shifts to the Active Child. The Key Employee stays constant at 15% of the profit and loss.

    d) Cash flow is automatically distributed to each of the three Members in the amount measured by the profit allocated to that Member multiplied by the highest combined effective federal, state, and local income tax rate applicable to any of the Members. This is the "income tax distribution" which all Members receive in all years.

    e) Then the cash flow is automatically distributed to the Class A Member equal to the aggregate amount of profit allocated to the Class A Member (that is, 45% of the whole) for such taxable year (after subtracting the income tax distribution already received for that taxable year by the Class A Member), until the $10M profit target and the 8 year chronological target are achieved.

    f) All remaining cash flow is accumulated and added proportionately to the capital accounts of the Class B Member and the Class C Member, until the distribution preferences (both the monetary target and the chronological target) of the Class A Member are fully satisfied.

2. Governance.

    a) Newco is managed by a Board of Directors. The Class A Member has 3 votes; the Class B Member has 1 vote; and the Class C Member has 1 vote.

    b) All decisions of the Board require the approval of a majority vote, consisting of at least 3 votes out of 5 votes total. Thus, Parent/Business Owner as President of Oldco and thus owner of Class A controls Newco.

c) Parent/Business Owner initially is the President of Newco. Active Child is initially the Vice-President. Key Employee is initially the Secretary and the Treasurer. There are employment contracts for each of the three Officers; reasonable compensation is paid for services actually performed for Newco. The employment agreement for the Active Child and the Key Employee contain maximum "non-competition" restrictions.

d) After the satisfaction in full of the distribution preference provided to the Class A Member (as outlined above), then the Operating Agreement gives the Active Child (if she is still at that time individually the owner of the Class B Membership Interest) <u>the right to purchase the Class A Interest from Oldco</u> (controlled either by Parent if then alive or by Parent's Estate if Parent has previously passed away), for its then fair market value. "Fair market value" is defined in the Operating Agreement pursuant to a formula which has been determined by an independent appraiser to represent "fair market value"; remember that at this point in time, <u>the Class A Interest is entitled only to a 3% profit allocation</u> (because the $10M and 8 year preference has been fully satisfied).

e) It is assumed and anticipated that such purchase will be made. Thereafter, the Active Child will have 4 votes out of 5 votes on the Board of Directors, because the Active Child will own both the Class A and Class B Interests.

3. <u>Buy-Sell Aspects and Transitions</u>.

a) If the Active Child as owner of the Class B Interest passes away at a time <u>prior to</u> the satisfaction in full of Parent's Class A distribution preference, then the Child's Estate has the option to compel Newco to <u>redeem the Class B Member Interest for its then fair market value</u> (or, if larger, the face amount of certain life insurance on the Child's life purchased by Newco). If the Child's Estate does not exercise the option to require redemption, then Newco as a Company has a secondary option to compel redemption from the Child's Estate for the same price and terms.

b) If the Child's Interest is redeemed, then from and after the date of closing on the redemption the economic attributes and voting power of the Class B Interest shall pass to and be thereafter enjoyed by the owner of the Class A Interest. <u>Thereafter, Oldco will be entitled to 85%</u> of the profit allocation, etc. This will therefore accelerate the time when Parent's distribution preference is satisfied in full. After Oldco is satisfied in full, it is still in charge of Newco, however, and thereafter will negotiate an appropriate deal with Key Employee (or with Outsider).

c) If the Child passes away <u>after</u> the Class A distribution preference has been satisfied, so that the Child has previously purchased from Oldco the Class A Interest, then upon the subsequent demise of the Active Child, his Estate or Revocable Trust succeeds to his ownership interest, and <u>the Active Child's Estate therefore decides what to do with the business (Newco) on a going forward basis</u>. Presumably, the Child's Estate makes some deal at that point which makes sense with the Key Employee (or with an

Outsider). Parent (who has previously been satisfied in full) has no continuing interest in Newco under the circumstances.

d) Upon the demise of the Key Employee, his Estate has the right to require Newco to redeem the Class C Interest at the greater of its then fair market value or the face amount of the life insurance which has previously been purchased and maintained by Newco. If the Key Employee passes away prior to the satisfaction in full of the distribution preference for Class A, then after the redemption of the Class C interest, its economic attributes pass to the owner of the Class A interest; if the distribution preference of Class A has already been satisfied at the time when the Class C interest is redeemed, then the economic attributes of Class C pass to the owner of the Class B economic interest. The Family of the Key Employee is protected on his demise, therefore.

There will never be a time when the Key Employee is in control of the business, unless (i) the Class A distribution preference has been satisfied in full, the Active Child has purchased Oldco's Class A, but the Active Child subsequently dies, and at that time an appropriate deal is then negotiated between the Estate of the deceased Active Child and the Key Employee who is hypothetically then still alive and active; or (ii) the Active Child predeceases the Parent , the Child's Interest is redeemed, the Class B economic attributes pass to Oldco, Oldco's preference is satisfied in full, and thereafter Oldco negotiates with Key Employee.

If Parent passes away prior to the satisfaction in full of the Class A distribution preference, then his Estate succeeds to his ownership of the controlling interest in Oldco, and thereafter exercises the voting control of having 3 votes out of a total of 5 votes. The distribution preference therefore continues to provide support for the surviving spouse and the Inactive Children. Once the distribution preference is satisfied in full, however, the contract right of the Active Child to purchase the Class A Interest thereafter attaches, and the profit percentage of Class A decreases from 45% to 3% as stated above.

EXHIBIT 3

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Mr. Radowich has comprehensive experience in estate planning and administration. His across-the-board capabilities include preparation of wills and trusts; all estate, gift, generation-skipping transfer and charitable giving tax planning issues; IRS audits; life and disability insurance planning; and related corporate, partnership, individual and fiduciary income tax matters. Mr. Radowich has also concentrated in recent years in business continuity planning for closely held businesses, assisting the family's senior generation to perpetuate the business into succeeding generations and/or key employees, or to sell the business to outsiders, with a minimum of taxes.

Areas of Practice

Wealth Planning

Tax and Wealth Planning

Tax-Exempt Organizations

Tax Policy

Tax Controversies and Litigation

Business Transactions Tax

Bar Admissions

Maryland

Education

J.D., Taxation, Yale Law School, 1971

M.A., Philosophy, Yale University, 1971

B.A., Humanities, Villanova University, 1967

Memberships

American Bar Association

Maryland State Bar Association

Bar Association of Baltimore City

Honors

Listed for more than twenty years in *The Best Lawyers in America*, Trusts and Estates, (Woodward/White, Inc), 1993 to the present

Listed as a *The Best Lawyers in America*, Best Lawyer of the Year, Baltimore Trusts and Estates, 2010.

Selected for inclusion in *Maryland Super Lawyers* (2008 - 2014)

AV® Peer-Review Rated by Martindale-Hubbell

Activities

Fellow, American College of Trust and Estate Counsel (Elected September 11, 1986).

Chairman, Section Council of the Section of Estate and Trust Law, Maryland State Bar Association, 1991-1992 (Chair-elect, 1990-1991; Secretary, 1989-1990; Member, 1987-1989; Ex-Officio Member, 1992-present).

Trustee, Bar Associations Insurance Trust, 1993-present.

Publications

- March 1, 2003, Evolving Rules of Thumb for Marital Planning, *Maryland Bar Journal*

Speaking Engagements

Mr. Radowich has made over 210 presentations on estate planning, estate administration and business continuity planning topics, including presentations sponsored by the American College of Trust and Estate Counsel; National Association of Estate Planning Councils; American Institute of Certified Public Accountants; National Association of Home Builders; CCIM Institute; Associated General Contractors of America; Merrill Lynch; Sun America Securities; Georgetown University Advanced Estate Planning Institute; Christopher Street Financial; Midwest Estate Tax & Business Planning Institute; Maryland State Bar Association; Maryland, Pennsylvania and Kentucky Associations of Certified Public Accountants; St.

Louis and Salt Lake City Estate Planning Councils; Pennsylvania Bar Institute; Baltimore Association of Financial Planners; and Maryland Association of Realtors.

- January 22, 2013, "What is your Exit Strategy? Business, Tax & Estate Planning Strategies for Today" at the International Builders Show
- June 7, 2012, "Before TRA of 2010 Sunsets: Practical Estate Planning for the Next Six Months" at the 39th Annual Midwest Estate, Tax and Business Planning Institute
- March 23, 2012, "Crucial 2012 Estate Planning Issues and the Impact on Foreign Investment" for Agora Financial LLC
- February 9, 2012, "What Works Today Under the TRA of 2010: Practical Estate Planning and Business Succession Techniques (Ten Months To Go!)" at the National Association of Home Builders International Builders Show
- November 11, 2011, "What Works Today: Current Estate Planning and Business Succession Planning Techniques for Real Estate" at the National Real Estate Conference
- June 9, 2011, "Models of Practical Planning Today in Light of the Tax Relief Act of 2010" at the 38th Annual Midwest Estate, Tax & Business Planning Institute
- January 13, 2011, "After the Tax Relief Act of 2010: Estate Planning for the Closely Held Business Owner" at the International Builders Show
- November 3, 2010, "Models of Successful Business Succession Planning: From the Basic to the Complex" at the Advanced Tax Institute
- July 6, 2010, "The Art of the Steal" panel discussion at the Baltimore Museum of Art
- June 3, 2010, "Helping Clients Cope With Today's Estate Planning Chaos: More Episodes from the Current Frontier" at the 37th Annual Midwest Estate, Tax & Business Planning Institute
- May 13, 2010 - May 14, 2010, Ownership Transfer and Management Succession Conference for the Associated General Contractors of America (AGC)
- March 5, 2010, "Strategies for Tax and Estate Planning in the U.S." at the Bonner & Partners Family Office Tax and Estate Planning Symposium
- March 3, 2010, "Recent Significant Developments in Estate Planning" at the Greenberg Wednesday Tax Study Group
- January 19, 2010, Estate Planning for the Closely Held Business Owner
- October 30, 2009, 24th Annual Advanced Personal Financial Planning Conference sponsored by the Maryland Association of CPAs
- June 19, 2009, 36th Annual Midwest Estate, Tax and Business Planning Institute
- May 13, 2009, Generation Skipping Transfer Tax: Practical Estate Planning Techniques
- April 23, 2009 - April 24, 2009, Ownership Transfer and Management Succession for a Construction Firm Conference
- January 22, 2009, 2009 International Builders' Show & Nextbuild
- June 19, 2008 - June 20, 2008, 35th Annual Midwest Estate, Tax and Business Planning Institute
- June 11, 2008 - June 13, 2008, 15th Annual Southern Building Show
- April 24, 2008 - April 25, 2008, Ownership Transfer and Management Succession for a Construction Firm
- March 25, 2008, Generation Skipping Transfer Tax: Practical Estate Planning Techniques
- February 13, 2008, 2008 International Builders' Show
- October 20, 2007, CCIM/IREM National Convention
- June 14, 2007, 34th Annual Midwest Estate, Tax & Business Planning Institute Conference
- June 15, 2006 - June 16, 2006, 33rd Annual Midwest Estate, Tax & Business Planning Institute
- April 27, 2006, National Planning Conference for Ownership Transfer and Management Succession of the Construction Company
- October 19, 2005, 2005 CCIM Institute Conference
- June 5, 2003, 30th Annual Midwest Estate, Tax, and Business Planning Institute
- May 8, 2003 - May 9, 2003, Owner Transfer of Construction Company Conference

- February 21, 2003, Generation Skipping transfer taxes
- February 13, 2003, Generation Skipping transfer taxes