31st Annual Tax and Business Planning Seminar

September 18, 2013

DeMark, Kolbe & Brodek, S.C.

Counseling. Planning. Defending.

2013

TAX AND BUSINESS PLANNING SEMINAR

DeMARK, KOLBE & BRODEK, S.C.

SEPTEMBER 18, 2013
ROMA LODGE
RACINE, WISCONSIN

FIRM HISTORY

DeMark, Kolbe & Brodek, S.C. was founded in 1964 as a two-person law firm specializing in areas of practice where tax consequences were dominant considerations, i.e., family business succession planning, estate and tax planning, pension plans, professional practices and probate. Expertise in the areas of employment law, general commercial litigation, real estate and environmental law have been added to the core of the firm's practice to better serve our clients. The firm insists upon high levels of scholarship with all firm members participating in professional education both as students and lecturers.

MISSION STATEMENT

DeMark, Kolbe & Brodek, S.C. represents closely held businesses and their owners, professionals and their practices, corporate executives and the economic interests of individuals. Client relationships are established by understanding each client's objectives and matching services to those objectives. Our goal is to provide counsel to minimize taxes and the impact of government regulations, to avoid legal problems, and to resolve problems cost-effectively when they do occur.

If you wish to utilize our services, we can be
contacted at the following address and phone number:

DeMark, Kolbe & Brodek, S.C.
7418 Washington Avenue
Racine, WI 53406
Phone: 262-886-9720
Fax: 262-886-3074

DISCLAIMER: DeMark, Kolbe & Brodek, S.C. is not offering specific legal advice or legal opinion on any specific client fact situation. This seminar and its printed materials are intended to provide current and accurate information about the subject matter covered and is designed to help accountants, attorneys, CLU's, and other professionals maintain their professional competence. Persons using the conveyed information in dealing with a specific client or other legal matter should research original and fully annotated sources of authority and arrive at their own opinion on how best to proceed for their clients needs.

SCHEDULE

The following is the schedule of the topics to be presented at the seminar:

8:30 – 8:50 A.M.	Registration, Coffee and Distribution of Outlines
8:50 - 8:55	Introduction
8:55 - 9:40	Use of Trusts in Estate Planning for 2013 and Beyond
9:40 - 9:55	Break
9:55 – 11:00	Transferring Equity to Key Employees Using Restricted Stock or Phantom Stock
11:00 – Noon	Happy 20th Birthday to the Wisconsin LLC! What We've Learned
Noon – 1:15	Lunch on your own
1:15 – 2:15	Recent Developments in Employment Law
2:15 – 3:15	BYOD (*Bring Your Own Device to Work*) and Growth in Retaliation Claims: What An Employer Needs to Know
3:15 – 3:30	Break
3:30 – 4:15	What to Expect in Litigation, Mediation and Arbitration
4:15 – 4:45	What Every Landlord Must Know About the Law
4:45	Adjourn Until Next Year

(Seminar topics subject to change)

TABLE OF CONTENTS

2013 TAX AND BUSINESS PLANNING

SECTION 1

USE OF TRUSTS IN ESTATE PLANNING FOR 2013 AND BEYOND

I. INTRODUCTION.

A. Under the American Tax Relief Act of 2012 passed at the end of last year, we now have "permanent" estate tax law including an estate tax exclusion which is $5,250,000 per person for 2013.

B. The new law continues the concept of portability of exclusions between spouses – if one spouse dies, his/her exclusion can be transferred to the surviving spouse <u>but a federal estate tax return must be filed to do so</u>.

C. Using an irrevocable trust at the first spouse's death may still be preferable in many situations to electing portability.

II. GIFT AND ESTATE TAXES.

A. Estate taxes.

1. Estate taxes are imposed at death on the transfer of assets from a decedent to his or her beneficiaries.

2. Exclusions:

Year	Exclusion
2009	3,500,000
2010	Unlimited/$5,000,000
2011	5,000,000
2012	5,120,000
2013 and after	5,250,000 (indexed for inflation)

3. 2012 maximum estate tax rate – 35%.
2013 and after maximum estate tax rate – 40%.

4. Property transferred at death receives a new basis equal to the fair market value as of date of death (or in some cases the alternate valuation date).

5. Wisconsin currently has no estate tax.

6. **A deceased spouse's unused estate tax exclusion may be transferred to the surviving spouse (portability), but a federal estate tax return must be filed to do so.**

B. Gift taxes.

1. A gift tax is imposed on the transfer of assets during a person's life. There are many exemptions from the gift tax, the most common of which are the following:

   a) Gifts to qualifying charities are exempt from gift tax.

   b) Annual exclusion gifts – the taxpayer may generally exclude the first $14,000 of gifts made to each donee during each calendar year from the gift tax (indexed for inflation).

   c) Tuition expenses and medical expenses paid directly to providers are exempt from gift tax.

   d) A taxpayer has a lifetime gift tax exclusion but then the taxpayer's estate tax exclusion is generally reduced accordingly.

2. Exclusions:

Year	Exclusion
2009	1,000,000
2010	1,000,000
2011	5,000,000
2012	5,120,000
2013	5,250,000 (indexed for inflation)

3. Unification of Gift and Estate Taxes.

   a) Historically, at death, the value of the decedent's estate is increased by the value of any "taxable gifts" made during lifetime (excluding annual exclusion gifts or tuition or health care gifts).

b) Example - Sam makes a taxable gift of stock of $1,000,000 in 2008 and dies in 2013 with a gross estate of $4,500,000. Sam is unmarried.

	Gift	No Gift
Gross estate	$4,500,000	$5,500,000
Plus: Taxable gifts	1,000,000	0
Net estate	$5,500,000	$5,500,000
Less: Estate tax exclusion	- 5,250,000	- 5,250,000
Taxable estate	$ 250,000	$ 250,000
Tax rate	40%	40%
Estate taxes	$ 100,000	$ 100,000

c) Advantages and Disadvantages of Lifetime Gifts.

(1) Most significant advantage is that the income and appreciation on the gifted asset escapes estate tax.

Example – same facts as above except that the stock Sam gifted increases in value to $2,000,000 by Sam's death in 2013.

	Gift	No Gift
Gross estate	$4,500,000	$6,500,000
Plus: Taxable gifts	1,000,000	0
Net estate	$5,500,000	$6,500,000
Less: Estate tax exclusion	- 5,250,000	- 5,250,000
Taxable estate	$ 250,000	$1,250,000
Tax rate	40%	40%
Estate taxes	$ 100,000	$ 500,000

Note: If the gifted asset doesn't increase in value, there is no advantage to the gift and, in fact, may be a disadvantage due to carryover basis.

(2) Gifting closely held assets such as S corporation stock or LLC interests often offer the availability of a minority interest discount and/or lack of marketability discount.

4. Carryover basis – Property transferred by gift takes a carryover basis meaning the donee takes the donor's basis.

C. Generation skipping transfer taxes ("GST Taxes").

1. Lifetime gifts and transfers at death to beneficiaries who are more than one generation below the transferor's generation (for example grandchildren) may be subject to the generation skipping transfer tax. The GST tax is designed to insure that, for the most part, all property is taxed at every generation's level and is not avoided by skipping generations.

2. It is important to note that most GST transfers are set up in the form of trusts that benefit the taxpayer's children and grandchildren.

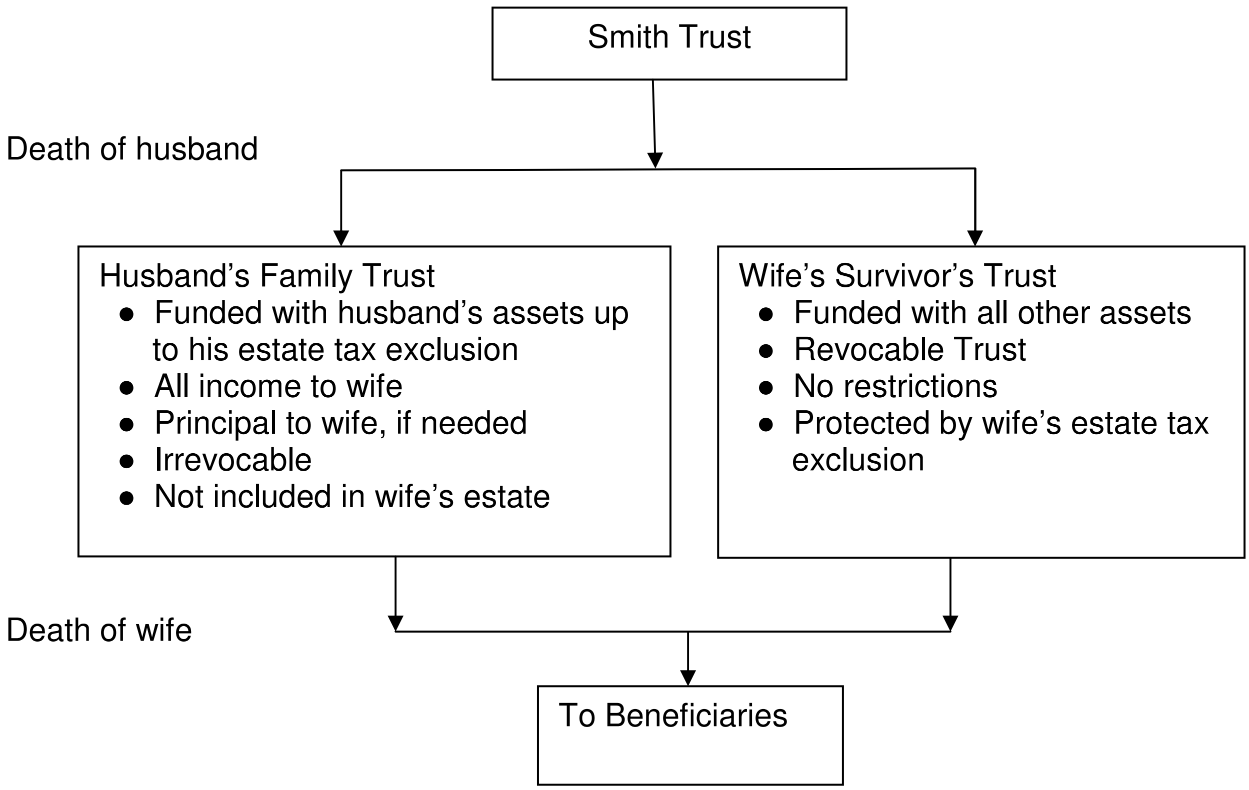
3. Exclusions:

Year	Generation skipping transfer tax exclusion
2009	3,500,000
2010	5,000,000
2011	5,000,000
2012	5,120,000
2013	5,250,000 (indexed for inflation)

4. **There is no portability of a deceased spouse's GST exclusion.**

III. PORTABILITY RULES.

A. For over 30 years, one of the significant goals of estate planning was to make sure that both spouses' estate tax exclusion could be used. This was typically done by dividing the assets into two trusts at the first spouse's death – the Family Trust and the Survivor's Trust. (The Family Trust also is known as the "Credit Shelter Trust" or "A/B" plan).



If the division was not done at the first spouse's death, then the ability to use the deceased spouse's exclusion was lost. There wouldn't be any estate tax at the first spouse's death but at the surviving spouse's death the surviving spouse would only have his/her exclusion.

B. Under the new law, any unused estate tax exclusion at the death of a spouse can be "ported" or transferred to the surviving spouse.

1. The unused exclusion is called the "deceased spousal unused exclusion amount" (DSUEA or DSUE Amount).

Example A: Jane dies in 2013 with an estate of $3,000,000 all of which passes to her husband. Jane has not used any of her exclusion so the DSUEA is $5,250,000. This amount can be transferred to her spouse to use at his death.

Example B: Assume the same facts but Jane leaves $500,000 to her children. The DSUEA is then calculated:

$5,250,000
- 500,000
$4,750,000

2. When the surviving spouse dies, his exclusion is calculated by adding his exclusion together with the DSUEA from his last deceased spouse.

   Example – John dies in 2013 and has not made any taxable gifts during life. His exclusion is $5,250,000 plus the DSUEA from Jane. So using Example A above, John's total exclusion would be $10,500,000.

3. Note that the DSUEA is from John's last deceased spouse. So if John married Susan after Jane's death, and then Susan died before John, John would use Susan's DSUEA and Jane's would be lost. This could be significant because in a second marriage frequently assets are left to the children rather than the second spouse and there may not be as much DSUEA to use.

C. Electing Portability. The surviving spouse can only use the unused exclusion of the deceased spouse if a federal estate tax return was filed for the deceased spouse and a portability election was made. This is true even if no return is required because the estate is below the filing requirement. In 2013, no return is required unless the estate is over $5,250,000.

1. The election must be made by the executor. If there is no executor, a non-appointed executor may file. If there is an executor and the executor does not file, the surviving spouse cannot make the election.

   - This could be important in a second marriage situation where the first spouse will have exclusion that he/she doesn't need but the deceased spouse's executor refuses to file an estate tax return.

   - Example: Second marriage, each spouse has children from a prior marriage. John has $1,000,000 and Mary has $6,000,000. John dies first and leaves his assets to his children. He has DSUE Amount that Mary would like to be able to use at her death. Perhaps this issue could be addressed in a prenuptial agreement and require John's executor to elect portability but require Mary to pay the costs of filing an estate tax return.

2. For estates less than the estate tax return filing requirement ($5,250,000) to make portability election, the return can be based on the estimated total gross estate (within $250,000). It is likely appraisals will not be required.

3. Once made, the election is irrevocable.

4. Note: filing an election extends the statute of limitations indefinitely but solely for the purpose of confirming the amount of the surviving spouse's DSUE Amount.

D. Portability does not apply to the generation skipping tax exclusion.

E. Portability does not automatically apply to state estate tax or inheritance taxes.

IV. PLANNING WITH PORTABILITY.

A. Portability Advantages.

- Simplicity – don't need to fund a Family Trust at first death. If all the assets are in the couple's joint trust, they can just continue as is although the social security number and trustee may need to be updated.

- There is a second step-up in basis at the surviving spouse's death.

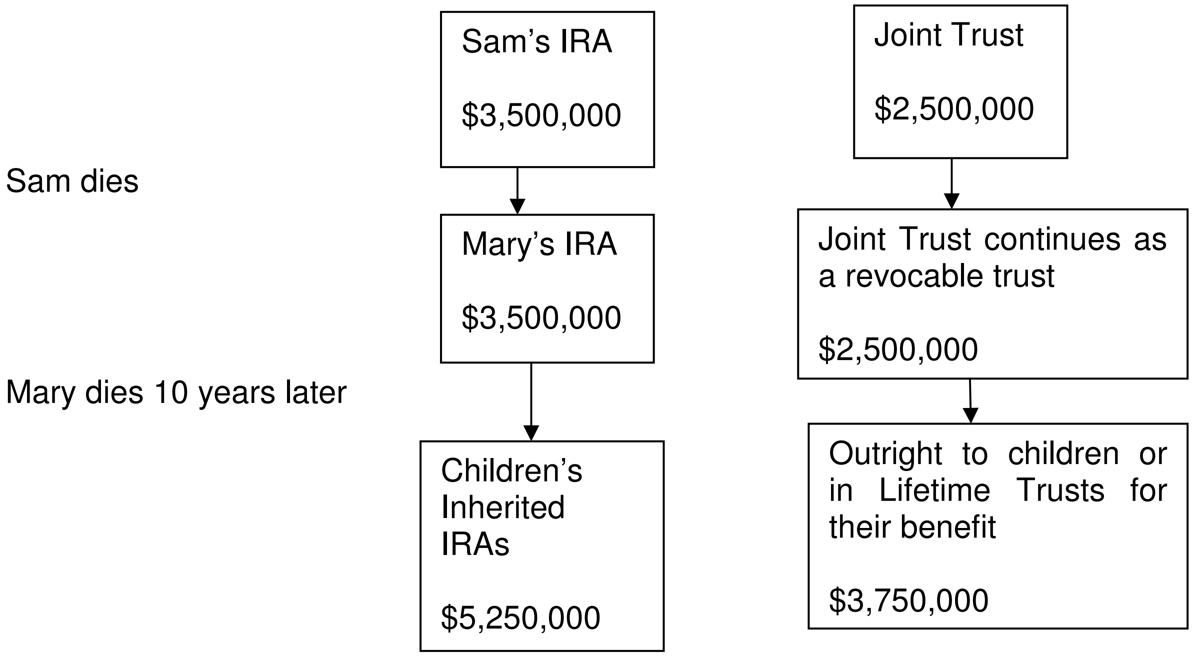
- Where the estate includes significant tax deferred assets with "IRD" (income in respect of decedent such as IRAs and retirement plans), it's often disadvantageous to use these assets to fund a Family Trust.

- Use if the state has an estate tax with a lower exclusion than the federal estate tax exclusion.

Example: Sam and Mary – first marriage

Sam's IRA	$	3,500,000
Home		500,000
Investments		2,000,000

Sam dies, Mary elects portability. Assets increase by 50% over the 10 year span between deaths.



- At Sam's death, his exclusion of $5,250,000 is carried over to Mary.
- At Mary's death, her taxable estate is $9,000,000 but she has an exclusion equal to her basic exclusion of $5,250,000 plus Sam's DSUE amount of $5,250,000 so there is no tax.
- Joint trust assets get a step-up in basis at Sam's death and again at Mary's death.
- Nothing really needs to be done at Sam's death other than to deal with Sam's IRA and update social security number and trustee on trust.
    - Mary will rollover Sam's IRA into an IRA in her name or elect to treat Sam's IRA as her own.
    - She will name the children as the outright beneficiaries so at Mary's death, the children can set up inherited IRAs and base required minimum distributions on their own life expectancies (i.e. defer income tax) although they will have to start taking distributions in the year following the death. For example, a 50 year old child only has to withdraw 1/33.1 in the first year.

- Disadvantages

    - Mary can change the total plan after Sam dies.

    - If the assets appreciate more than expected, Mary could be in a situation where she has to pay estate tax because the appreciation on <u>all</u> assets is in her estate.

    - Further, there is no guarantee on what the estate tax exclusion will be at Sam's death or Mary's death.

B. Use of Family Trust. There will still be many situations where we will want to use a Family Trust (or Credit Shelter Trust) as we have traditionally done. A Family Trust will be appropriate when the first spouse to die wants to make sure his/her share of the assets ultimately pass to his/her children (after the surviving spouse's death).

1. Taking advantage of the first spouse's estate tax exclusion at the first spouse's death locks in the exclusion at that time.

    - If the estate tax exclusion decreases after death, we will have maximized the use of the first spouse's exclusion.

    - Using the exclusion at the first spouse's death provides certainty that the Family Trust assets <u>and</u> all future appreciation on those assets won't be subject to estate tax.

    - Valuing closely held businesses and other assets that are difficult to value at the first death is typically subject to less scrutiny since no tax is usually due.

    - Avoids the possible loss of the first spouse's DSUE Amount if the surviving spouse remarried and the new spouse dies and uses his/her own exclusion.

2. Assets in a Family Trust may have more creditor protection than assets in the surviving spouse's name.

3. Both spouses' generation skipping exclusions can be used.

Example: John and Sue – first marriage, 2 adult children, Charlie and Bob

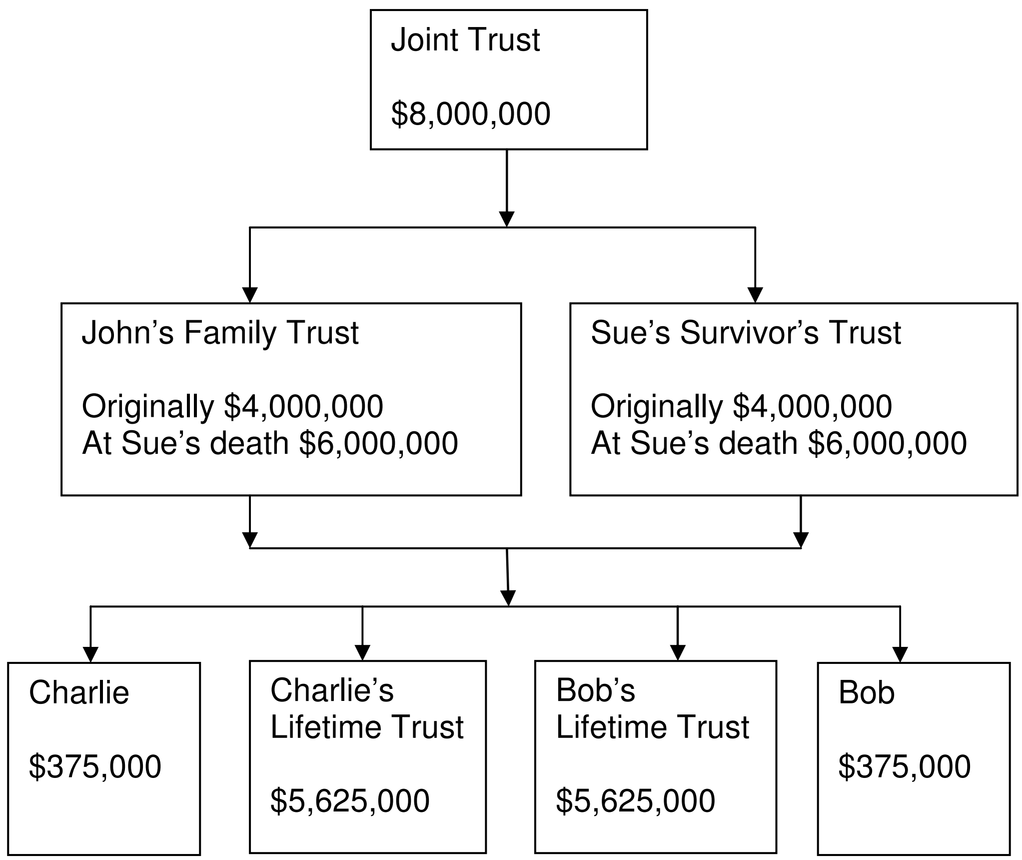
Assets:

Closely held business	$	6,000,000
Home		500,000
Other Investments		1,500,000

10 year span between deaths, assets increase by 50%

John dies first

Sue dies



At John's death, he has DSUE Amount of:

$$\begin{array}{r} \$5,250,000 \\ \underline{-\ 4,000,000} \\ \$1,250,000 \end{array}$$

The $1,250,000 is carried over to Sue.

At Sue's death, she has her own exclusion of:

$5,250,000 (indexed for inflation)
+1,250,000
$6,500,000

- This allows Sue to avoid estate tax at her death.
- John's Family Trust is protected by the use of his exclusion at his death.
- The lifetime trusts for the sons will be exempt from generation skipping tax which means those assets will not be included in Charlie's or Bob's estates for estate tax purposes. In addition, the lifetime trusts will keep the inherited assets separate from marital assets in the event of a divorce for Charlie or Bob.

Note: If all of John's assets had passed to Sue and Sue elected portability of his exclusion, then at Sue death, there could have been estate tax due depending on what the basic exclusion is at Sue's death.

Basic exclusion	$	5,250,000 (indexed)
+John's DSUEA		5,250,000
	$	10,500,000
Sue's estate	$	12,000,000
		-10,500,000
	$	1,500,000
		x .4
Estate tax	$	600,000

V. CONCLUSION. Portability can simplify estate planning but it does not eliminate the need for proper planning and considering whether a federal estate tax return should be filed at a death is critical.

SECTION 2

TRANSFERRING EQUITY TO KEY EMPLOYEES USING RESTRICTED STOCK OR PHANTOM STOCK

I. INTRODUCTION.

A. Popularity of Equity Participation.

B. Objectives of This Year's Seminar Presentation.

1. Develop an Understanding of the Differences. Develop an understanding of the differences between restricted stock and phantom stock plans.

2. Learn How to Structure. Learn how to structure the different types of equity participation plans.

3. Consider Alternative Cash Bonus Plan.

II. UTILIZING RESTRICTED STOCK.

A. Sales of Restricted Stock to Key Employees.

1. Common Transaction. Sales of stock or member interests in an LLC to key employees are fairly common.

2. Piece of the Action. Key employees want a "piece of the action".

3. Golden Handcuff. Employers are willing to consider doing so, but want some form of "golden handcuff".

4. Importance of Restrictions on Stock. Stock restrictions are very common and extremely important from the employer's standpoint.

5. Example of 5 Year CLIFF Vesting Schedule. If the employee leaves employment within 5 years of the date of purchase, the employee is required to sell back the stock to the employer at the original purchase price.

6. Example Of 10 Year Gradual Vesting Schedule. 10% of the stock sold to the employee vests each year. If the employee terminates employment within 10 years of the date of purchase, the unvested shares are sold back at the original purchase price and the vested shares are sold back at a formula price which reflects fair market value.

B. **Application of IRC Section 83**.

1. Tax Treatment of Normal Unrestricted Stock. Normal sales of unrestricted stock by an individual held for more than 1 year are eligible for long term capital gain treatment.

2. When Does IRC Section 83 Apply. IRC Section 83 applies to sales of unvested stock or restricted stock or bargain sales to employees.

3. Example of Restriction. Buy back of stock at original purchase price if employee leaves within 5 years.

4. Impact of IRC Section 83. When the stock is substantially vested, IRC Section 83 will convert long term capital gain transactions into ordinary W-2 wage income for the employee. Employer is eligible for a corresponding income tax deduction.

5. Plain English Version. If an equity interest is sold to an employee, the employee must report ordinary wage income equal to the difference between the fair market value of the equity interest when it becomes substantially vested over the amount paid. Stated differently, the employee must pay tax on the "spread".

6. Use of IRC Section 83(b) Election. If an IRC Section 83(b) election is made within 30 days of the date of the actual transfer, this will accelerate the reporting of the gain on any bargain sale element to the year of the actual transfer, but the employee will be eligible for long term capital gain treatment on any future appreciation if the stock is held for more than one year.

7. Election May be Required Even if Fair Market Value is Paid for Stock.

C. **Legal Rights of Minority Shareholders.**

1. Access to Financial Statements.

2. Can Object to Owner's Compensation.

III. STRUCTURING SALES OF RESTRICTED STOCK TO KEY EMPLOYEES.

A. **Design Firm Restricted Stock Plan**. A design firm wishes to sell 5% of the company's non-voting common stock to each of its 4 key employees.

B. **Objectives of Plan**.

1. Incentivize. Incentivize 4 key employees.

2. Develop Potential Purchasers. Develop potential purchasers of business.

3. Non-Solicitation Agreement. Incorporate non-solicitation agreement.

C. Structure.

1. Stock Sale. Sell 5% of non-voting common stock at "book value" for $75,000 in exchange for a 10 year installment promissory note.

2. Buy Back. Plan will provide for a buy back at original book value if employee terminates employment within 5 years.

3. Repayment of Promissory Note. Repayment will be made from S dividend distributions and cash bonuses.

4. IRC Section 83(b) Election. File IRC Section 83(b) election within 30 days of stock transfer.

5. Avoid Direct Stock Sales. Employees will purchase stock directly from company rather than from existing shareholders.

D. **Safeguards**.

1. Non-Solicitation Agreement. Incorporate non-solicitation agreement.

2. Continuing Option. Plan will provide company with a continuing option to repurchase stock at current fair market value.

3. Stock Subject to Buy Sell Agreement.

E. Sale of Company to Third Party Purchaser.

1. Participation in Sale Proceeds. Key employees participate in sale proceeds.

2. Cooperation in Closing Sale. Key employees cooperate in completing sale.

F. Possible Future Sale of Remaining Stock to Key Employees.

IV. **UTILIZING PHANTOM STOCK PLANS**.

A. **What is a Phantom Stock Plan**?

1. Form of Long Term Non-Qualified Deferred Compensation. It is a form of long term non-qualified deferred compensation paid to a key employee or a select group of key employees.

2. Amount of Non-Qualified Deferred Compensation Directly Related to Business Performance. It is a technique whereby the amount of non-qualified deferred compensation paid to the key employee is measured directly by the future performance of the business, similar to actual stock ownership.

3. Win-Win Situation. It is an opportunity to create a win-win situation where the key employee has a "piece of the action" thereby providing an additional incentive to grow the value of the business.

4. Example. Steve, a key employee, is issued phantom shares in a company which will entitle him to share in 20% of all future increases in the value of the company. At the time of issuance, the company had a book value of $1,000,000. Over the next 15 years, the book value of the company increases to $3,000,000, at which time the plan terminates. 20% or $400,000 is paid to Steve as additional compensation in accordance with the terms of the plan.

B. **Advantages for Key Employee**.

1. No Cash Investment. The key employee has an opportunity to share in increases in the value of the company without a cash investment.

2. No Downside Risk. There is no downside risk to the key employee other than an opportunity lost, if the company fails to increase in value. This is because the key employee is otherwise being fully compensated for services rendered to the company.

3. Avoidance of Personal Guarantees of Corporate Debt. If the company ever has to borrow money, the key employee will not usually have to personally guarantee corporate debt, which often times is required of key shareholder employees, actively participating in the management of the business.

4. Provides Key Employee With Additional Retirement Income. It is a method of providing the key employee additional income at retirement or upon a future sale of the business.

C. **Advantages for Employer**.

1. Facilitates Growth of the Business. It is a methodology to attract and retain successor management, thereby enabling the business to continue to grow.

2. Golden Handcuff for Talented Key Employees. Incorporating a vesting schedule into the plan, can create a golden handcuff for talented key employees to stay with the business.

3. Confidentiality and Non-Competition Provisions Can Help Protect the Business. Utilizing confidentiality and non-competition provisions within the plan can help protect the business from future competition by the key employees covered under the plan.

4. Avoids Creating Minority Shareholders. A key employee covered under a plan is not entitled to the legal rights of a shareholder.

5. No Legal Right to Financial Statements or to Object to Owners Compensation. A key employee covered under a plan has no legal right to detailed financial statements or to object to the owners compensation. However, as a practical matter, access to financial statements and fairness provisions to avoid adversely affecting the value of phantom stock plans will need to be addressed.

6. Payout Directly Related to Performance of Business. If the business is successful, the resources will be available to fund the plan benefits. In other words, the payout is directly related to business performance.

V. **TAX TREATMENT OF PHANTOM STOCK PLANS**.

A. **Income Tax Consequences of Phantom Stock Plans**.

1. IRC Section 83 Does Not Apply to Phantom Stock Plans. The regulations under IRC Section 83 state it does not apply to an unfunded and unsecured promised to pay money or property in the future.

2. No Taxable Income Upon Creation of the Plan or Increases in Value of Phantom Shares. Generally speaking, there is no taxable income to the key employee upon creation of the plan and during the build up in its value, while the plan remains in effect.

3. Income Tax Consequences Upon a Triggering Event. Upon a triggering event which results in the termination of the plan or a payout of benefits, i.e., a retirement or sale of the business, payments made by the employer to the key employee will be taxed as ordinary income to the employee when received and are fully deductible by the employer, as compensation for the year in which payments are made.

4. Plan Can Be Structured to Permit Deferral of Payout. The plan can be structured to permit the deferred payment of benefits so that payments to

the key employee are made over a period of time to avoid the bunching of income in a single tax year.

5. Need to Avoid Constructive Receipt of Income. The plan needs to be structured to avoid the doctrine of "constructive receipt". When the employee recognizes ordinary income under a plan is governed by IRC Section 451. An employee will recognize ordinary income under the doctrine of constructive receipt when his or her right to receive the benefits under the plan are vested and are not subject to a substantial risk of forfeiture. This generally occurs when an employee has the unrestricted right to receive the benefits under the plan.

6. Favorable Guidance Granted Under Revenue Ruling 80-300. This revenue ruling grants favorable income tax treatment to a plan which utilizes stock appreciation rights, which is a type of phantom stock plan. This ruling held there is no "constructive receipt" of income by the employee upon creation and during the build up in the value of plan benefits.

7. No Problem With S Elections. The IRS has ruled that a phantom stock plan does not constitute a second class of stock which would terminate an S election.

8. Application of IRC Section 409A. The technical rules of IRC Section 409A applies to these plans.

B. **FICA Tax Treatment of Plans**.

1. The Regulations Treat Stock Appreciation Rights and Phantom Stock Plans Differently for FICA Tax Purposes Only. The regulations under IRC Section 3121(v)(2) treat stock appreciation rights and phantom stock plans differently for FICA tax purposes only.

2. Definition of Stock Appreciation Right for FICA Tax Purposes. A "stock appreciation right" is the benefit granted to an employee under a plan to receive an amount equal to the increase in value of the phantom stock in accordance with the terms of the plan.

3. Example of Stock Appreciation Right. An employee is entitled to receive 10% of all increases in the book value of the company until an employee reaches age 62, his or her normal retirement age for plan purposes.

4. Definition of Phantom Stock Plan for FICA Tax Purposes. A "phantom stock plan" is the right to receive the full value of the phantom stock in accordance with the terms of the plan.

5. Example of Phantom Stock Plan. An employee is entitled to receive 10% of the book value of the company when an employee reaches age 62, his or her normal retirement age for plan purposes.

6. FICA Tax Treatment of Stock Appreciation Rights. The regulations state that the income earned under a stock appreciation right does not constitute a deferral of compensation for FICA tax purposes and the result is that payments will be subject to FICA taxes in the year in which they are received by the employee.

7. Example of FICA Tax Treatment of Stock Appreciation Rights. An employee under a stock appreciation plan is entitled to receive 10% of the increases in the book value of the company until the employee attains the age of 65. The plan is set up when the employee is age 50 and the book value is $500,000. At age 65, the book value has grown to $1,500,000. The $100,000 which the employee is entitled to receive under the plan is subject to full FICA taxes as "wages" at the time the benefit is paid.

8. FICA Tax Treatment of Phantom Stock Plan. The regulations state that in a phantom stock plan the full value of stock will be treated as "non-qualified deferred compensation" and will be taken into account as wages for FICA tax purposes only: upon the later of the date on which the services creating the right are performed or the date on which the right to the amount is no longer subject to a substantial risk of forfeiture.

9. Benefit is Subject to FICA Tax in the Year Vested. The benefits under the plan are subject to FICA taxes in the year in which they are vested. However, if the benefits under a phantom stock plan are vested in the year in which the employee's other wages would put him or her over the social security limit ($113,700 for the 2013 calendar year), the benefits received under the plan would only be subject to the 2.9% medicare tax (and possibly the additional 9/10^{ths} of 1% medicare surtax for 2013) as opposed to the full 15.3% FICA tax.

10. Planning Opportunity Utilizing Phantom Stock Plans Versus Stock Appreciation Rights. In structuring the plan, it may make economic sense to give an employee a smaller percentage of the full value of the phantom stock thus qualifying as a phantom stock plan, as opposed to a larger percentage of the appreciation in the value of the stock which will be treated as a stock appreciation right. A phantom stock plan might be structured so that the benefit is vested for FICA tax purposes in the year in which the employee has other wage income and is over the social security limit, so that only the 2.9% medicare tax (and possibly the 9/10^{ths} of 1% surtax) is paid on the benefits.

11. Example of Planning Opportunity Utilizing a Phantom Stock Plan. A key employee is entitled to 10% of the book value of the stock if the employee remains employed until age 65. The book value of the company when the employee is age 50 is $500,000 and it grows to $1.5 million at age 65, at which time the employee is entitled to receive $150,000 under the plan. If in that year, the employee is over the social security limit ($113,700 for the 2013 calendar year under the additional 9/10ths of 1% medicare tax starting in 2013), the $150,000 amount will only be subject to the 2.9% medicare taxes (and possibly the 9/10^{ths} of 1% surtax), resulting in a savings of the 12.4% FICA tax up to the social security limit.

VI. FORMATION AND OPERATION OF PHANTOM STOCK PLANS INCLUDING STOCK APPRECIATION RIGHTS.

A. Who Can Participate.

1. Ability to Pick and Choose Among Key Employees. Provided the "traditional" discrimination laws are not violated, i.e., discrimination based upon race, age, marital status, disability, sex, religion, etc., the employer is able to pick and choose, which key employees are eligible to participate.

2. Single Person or Multiple Member Plan. Often times plans are set up for one single key employee or are structured to accommodate three or four different key employees, which may have different percentages of participation among the employee group.

B. Valuation of Phantom Stock.

1. Use of Simple Consistent Methodology. It is important to have a simple, consistent methodology for valuing the company. An example of such a methodology is book value.

2. Need for Adjustment Clauses in Valuation Formula. Incorporating "adjustment clauses" into the valuation formula in certain situations to avoid dilution attributable to excessive rent, compensation or S dividend distributions can be very important to insure fairness to plan participants.

3. Booking of Liability of Vested Portion for Financial Accounting Purposes. The vested portion of the benefits due the employees under the plan needs to be booked as a liability on the company's financial statements, for financial accounting purposes.

C. Development of a Vesting Schedule.

1. Employer Has a Lot of Flexibility. The employer has a lot of flexibility in the development of a vesting schedule.

2. Vesting Schedule Acts as Golden Handcuff. A plan can provide for gradual vesting over a period of 10 or 15 years or can require an employee to remain employed until normal retirement age, i.e., age 60 or 62, in order to receive the benefits under the plan.

3. Example of Gradual Vesting Schedule. The plan could provide that Steve is vested with 6.66% of his interest in the phantom shares, for each year he is employed by the company. This would mean he would need to remain with the company for 15 years, in order to receive the full benefits under the plan. The plan also could provide that Steve is vested with 10% for each year, so that full vesting would occur after 10 years.

4. Example of Cliff Vesting. The plan could also provide that Steve must remain with the company until age 60 in order to receive the benefits under the plan. If he leaves prematurely, he receives nothing.

5. Provisions for Automatic Full Vesting. A plan would generally provide for "automatic full vesting" of an employee's interest under the plan, if the company were sold or in the event of the employee's premature death, disability, or termination of employment without cause.

D. **Plan Provisions for Severance Compensation and Non-Solicitation of Customers**.

E. **Funding of the Plan**.

VII. **PRACTICAL PLANNING CONSIDERATIONS UTILIZING PHANTOM STOCK PLANS**.

A. **Example of Phantom Stock Plan for Single Key Employee**. Mark is the 100% owner of a closely held family business. Mark is age 45 and the company has sales of approximately $3 million and a book value of $1 million. Mark hires Steve as executive vice president of operations. Steve is also age 45. Mark's goal is to continue to run the business until he reaches age 62 and then sell the business.

In order to entice Steve to leave his current job as manufacturing manager at a large company, Mark promises Steve 20% of the company if Steve stays with the company until age 62. Mark needs to make sure that Steve does not prematurely leave the business or start a competitive business, thereby forcing an unanticipated cash payment and defeating the purpose of hiring Steve to help build the business.

Steve needs to be assured that if Mark sells the company prior to Steve's retirement, that he is okay financially. Also, Steve is concerned that if things do not work out, he has appropriate severance compensation.

B. **<u>Plan Provisions</u>**.

The following phantom stock plan is developed to meet everyone's objectives and address their respective concerns, thereby creating a win-win situation:

1. <u>Awarding of Performance Shares</u>. Steve is awarded performance shares equal to 20% of the full value of the business. This plan will constitute a "<u>phantom stock plan</u>" for <u>FICA</u> tax purposes.

2. <u>Vesting of Plan Benefits Over 17 Years</u>. Vesting occurs over 17 years. No vesting takes place for the first two years of employment and thereafter, Steve is vested in 6.66% of the value of his performance shares for each year he remains employed until the age of 62. At that time, he is <u>fully</u> vested. Steve is also <u>fully</u> vested in the event of his prior <u>death</u>, <u>disability</u> or <u>termination of employment without cause</u>.

3. <u>Full Vesting Upon a Sale of the Business</u>. In the event the business is sold, Steve is also fully vested in the year of sale.

4. <u>Valuation of the Business and Possible Kicker if Business is Sold</u>. <u>Book value</u> is the methodology used to measure the value of Steve's interest in the business. If Steve remains with the business until his retirement at age 62, he will be entitled to receive 20% of its them book value. However, if the business is actually <u>sold</u>, the 20% amount will be based upon the <u>actual sales price</u>.

5. <u>Valuation Adjustment Clause</u>. The plan provides that the <u>spread</u> between Mark and Steve's compensation, including S dividends in excess of the amount required to pay income taxes on business income for plan purposes cannot exceed $80,000. Mark has the right to pay himself dividends in excess of the agreed upon spread amount, but any excess over the $80,000 spread will be <u>added back</u> for <u>valuation purposes</u>.

6. <u>No Adverse Impact on S Election</u>.

7. <u>Plan Benefits are in Lieu of Severance Compensation</u>. If Steve's employment is terminated <u>with or without cause</u>, other than due to theft, fraud, or gross neglect, he is then <u>fully vested</u> in 20% of the then book value of the business. However, as a condition to receiving this payment under the plan and in lieu of any additional severance compensation, Steve will be required to execute a <u>full release</u>. This is to avoid a <u>double dip</u> in the event he files a law suit alleging an <u>unlawful termination</u> of his <u>employment</u>.

8. <u>Life Insurance Used to Help Fund Plan Benefits</u>. Mark and Steve agree that the company shall purchase a $500,000 variable life insurance policy

on the life of Steve owned by the company. The annual premiums are structured so that the estimated cash value of this policy when Steve reaches age 62 will help fund a portion of the estimated amount owed Steve under the plan.

9. No Income Taxes Due Upon Creation of Plan and Build Up in Value. The plan is structured so that there is no taxable income required to be reported by Steve upon the creation of the plan or the build up in value which occurs while the plan remains in effect. Likewise, no income tax deduction is allowed the business until the benefits are paid to Steve under the plan.

10. Payout of Benefits Upon Retirement After Age 62. Benefits shall be payable to Steve under the plan over a period of three years with interest at the AFR rate commencing with his retirement, which cannot take place prior to age 62. Special provisions apply for the commencement of benefits upon termination of employment, depending upon the circumstances.

11. Planning for FICA Tax Purposes. It is anticipated that Steve's benefits will fully vest at age 62 prior to his retirement, so that at the time of full vesting his wages will be over the social security limit. In the year of full vesting, the 2.9% medicare tax (and possibly the 9/10$^{\text{ths}}$ of 1% medicare surtax) will be due on the value of the plan benefits, but this will hopefully save payment of the 12.4% FICA tax up to the social security limit upon the actual payout of benefits.

12. Non-Solicitation of Company Customers. The plan provides that Steve cannot solicit company customers on behalf of a competitive business for a period of one year after the termination of his employment. In the event he does so, this will result in a forfeiture of benefits.

13. Annual Valuation of Business by Outside Accounting Firm. The company's outside accounting firm will annually value the vested portion of Steve's benefits under the plan and make any appropriate adjustments as may be required under the valuation adjustment clause. His vested portion will be booked as a liability by the company for financial accounting purposes.

14. Top Hat Filing With the Department of Labor and Summary Plan Description. In order to meet the requirements of ERISA, a one time top hat filing is made with the Department of Labor and a summary plan description is provided to Steve.

VIII. **USE OF CASH BONUS PLAN AS AN ALTERNATIVE**.

A. **Bonus Equal to 10% or 20% of Pretax Income**.

B. **Payment Should be Made Within 2 ½ months of Fiscal Year End in Order to Qualify for Short Term Deferral Exception to IRC Section 409A**.

C. **Plan is Discretionary**.

D. **Simple Plan and Immediate Impact**.

IX. **APPLICATION OF IRC SECTION 409A TO PHANTOM STOCK PLANS**.

A. **Technical Requirements**. Technical requirements of IRC Section 409A apply to phantom stock plans.

B. **Required Provisions**. All phantom stock plans need to strictly incorporate the definitions of "Separation of Service", "Disability", "Change in Control Events" and "Unforeseeable Emergency".

1. Separation from Service.

2. Disability.

3. Change in Control Events.

4. Unforeseen Emergencies.

C. **Acceleration of Plan Benefits Prohibited**.

D. **Consequence of Failure to Comply with IRC Section 409A**.

E. **409A Reporting Requirements**.

X. **Conclusion**.

A. Understand the Differences. Understand the differences between restricted and phantom stock plans.

B. Consider Alternative Cash Bonus Plan. Consider alternative cash bonus plan to avoid complexity.

SECTION 3

HAPPY 20TH BIRTHDAY TO THE WISCONSIN LLC! WHAT WE'VE LEARNED

XI. **<u>INTRODUCTION AND LANDMARK DEVELOPMENTS</u>.**

A. <u>Landmarks</u>

1. 1977 - Wyoming passes first Limited Liability Company Act

2. 1988 - IRS issues Revenue Ruling 88-76 Recognizing Wyoming LLC as a tax partnership.

3. 1993 - Wisconsin Limited Liability Company Law Adopted

4. Section 183.0201 was amended effective July 1, 1996 to allow for single member LLCs.

5. January 1, 1997 – "Check the box" regulations effective

B. <u>Characteristics That Have "Tilted the Field"</u>

1. Limited Liability

2. Flexible Taxation

3. Organizational and Operation Flexibility

XII. **<u>LIMITED LIABILITY</u>.**

A. <u>LLC Liability Shield</u>.

Wis. Stat. §183.0304(1).

"The debts, obligations and liabilities of an LLC, whether arising in contract, tort or otherwise, shall be solely the debts, obligations and liabilities of the LLC. A member or manager of an LLC is not personally liable for any debt, obligation or liability of the LLC, except that a member or manager may become personally liable by his or her acts or conduct other than as a member or manager".

B. <u>Exceptions to Limited Liability</u>.

1. 3rd party liability

a) Veil Piercing

(1) LLC Veil Piercing.

Wis. Stat. §183.0304(2). "nothing in this chapter shall preclude a court from ignoring the limited liability company entity under principles of common law of this state that are similar to those applicable to business corporations and shareholders…

(2) Corporate Veil Piercing Principles.

"According to firmly established legal principles, the corporation is recognized as a legal entity, separate and district from its shareholders. The obligations of the corporation are the responsibility of the corporate entity, not the shareholders, who are liable only for the amount the voluntarily put 'at risk' in the business venture. The insulation of shareholders is known as 'limited liability'. The purpose of limited liability is to promote commerce and industrial growth by encouraging shareholders to make capital contributions to corporations without subjecting all their personal wealth to the risks of the business." *Consumer's Co-op of Walworth County v. Olsen,* 142 Wis.2d 465, 474 (1988).

(a) "Piercing the Corporate Veil"- Generally.

(i) Notwithstanding the unwavering adherence to the general principal of shareholder nonliability, there exist exceptions justifying metaphorically, the piercing of the corporate veil…" Id. at 475.

(ii) Courts may "pierce the corporate veil" where "corporate formalities are so egregiously ignored, or that control so pervasively exercised, such as to constitute a situation where recognition of the corporate fiction would accomplish some fraudulent purpose operate as a constructive fraud or defeat some strong equitable claim." Id.

(b) Relevant Factors.

(i) failure to hold corporate board meetings

(ii) failure to maintain records

(iii) inadequate capitalization at the inception of the corporation

(iv) intermingling of personal and corporate funds." Id. at 491.

b) Liability for Members Own Acts

A member or manager of an LLC is not personally liable for any debt, obligation or liability of the LLC, except that a member or manager may become personally liable by his or her acts or conduct other than as a member or manager.

2. Liability to LLC and Other Members

a) Statutory Liability.

Wis. Stat. §183.0304(1). No member or manager shall act in a manner that:

(1) Constitutes a willful failure to deal fairly with the LLC or its members where the member or manager has a material conflict of interest.

(2) Constitutes willful criminal conduct.

(3) Constitutes a transaction from which the member derived an improper personal profit.

(4) Willful misconduct.

b) Common Law Fiduciary Duties.

(1) Good Faith

(2) Fair Dealing

(3) Loyalty.

XIII. **TAXATION**

A. Income Tax.

1. Historic Classification

a) State law not conclusive

b) Kitner Regulations

(1) Continuity of life

(2) Centralized management

(3) Limited liability

(4) Free transferability

If an entity had a majority of these characteristics it would be classified as a corporation.

2. "Check-the-box" Regulations

a) In General

(1) Effective January 1, 2007

(2) Allows eligible entities to choose their tax classification

(3) "Eligible Entities" Sole proprietorships, partnerships, limited partnerships, limited liability partnerships, and limited liability companies

(4) State law corporations are ineligible.

b) Classification of eligible entities

(1) Default rules

(a) An eligible entity with two or more owners will be a partnership.

(b) An eligible entity with a single owner will be disregarded as an entity separate from its owner.

(2) Elections out of Default Rules

(a) Eligible entity may elect to be taxed as a corporation by filing form 8832.

(b) An eligible entity may also elect to be taxed as an S corporation by making an S election on form 2553 (no need for a separate 8832).

(c) Normally, once the election is made, it can only be changed once every five years.

B. <u>Table of Tax Attributes</u> - See Next Page

Tax Attributes Derived from Different Entity Types

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC
Contribution of Property	Non-taxable only if transaction meets IRC Sec. 351 requirements	Non-taxable only if transaction meets IRC Sec. 351 requirements	Non-taxable transaction	Generally non-taxable transaction; Assumption of liabilities by partnership may trigger gain recognition	Generally a non-taxable transaction; Assumption of liabilities by LLC may trigger gain recognition
Taxability of income	Generally taxable to shareholder	Taxable to corporation	Taxable to proprietor	Taxable to partner	Taxable to member
Deductibility of losses	Generally deductible by shareholder: liabilities do not increase basis for deducting losses except for direct loans from shareholder	Deductible by corporation	Deductible by proprietor	Generally deductible by partner to extent of basis; Liabilities may increase basis for deducting losses	Generally deductible by member to extent of basis; Liabilities may increase basis for deducting losses
Special allocation of income/loss	Not permitted	Not applicable	Not permitted	Permitted as long as there is substantial economic effect	Permitted as long as there is substantial economic effect
Passive losses	May not offset active or portfolio income (limits apply at shareholder level)	May offset active income but not portfolio income of closely held corporation; May not offset active or portfolio income of personal service corporation	My not offset active or portfolio income	Cannot offset active or portfolio income (limits apply at partner level)	Cannot offset active or portfolio income (limits apply at member level); Unclear if members treated as limited partners
Tax year	Generally must use calendar year or make Sec. 444 election	May select any fiscal year if not a personal service corporation	Must use tax year of proprietor	Generally must use fiscal year of majority interest partners or make Sec. 444 election	Generally must use fiscal year of majority interest partners or make Sec. 444 election
Qualified retirement plans of employee owner	Payments are deductible if plan is nondiscriminatory	Payments are deductible if plan is nondiscriminatory	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible	Payments to a Keogh Plan or SEP are deductible
Life insurance for employee owner	Statute unclear; Assume deductible as compensation	Premiums for first $50,000 group term life are deductible and not taxable to employee	Premiums are not deductible	Premiums are not deductible	Premiums are not deductible
Health care for employee owner	Deductible by corporation as compensation; deductible by more than 2% shareholder without regard to 7.5% floor	Payments are deductible	Deductible without regard to 7.5% floor	Typically deductible by partnership as guaranteed payment; reported as income by partners; deductible by partner without regard to 7.5% floor	Typically deductible by partnership as guaranteed payment; reported as income by partners; deductible by partner without regard to 7.5% floor
Distributions to owner	Non-taxable to extent of basis in stock; Distribution of appreciated property results in gain recognition	Not deductible by corporation; Generally income to shareholder, taxed at minimum 15% rate (for 2003); distribution of appreciated property results in	Non-taxable	Non-taxable to extent of basis in partnership; disproportionate distribution of Sec. 751 assets may trigger gain	Non-taxable to extent of basis in partnership; disproportionate distribution of Sec. 751 assets may trigger gain.

Attribute	S Corporation	C Corporation	Proprietorship	Partnership	LLC
		gain recognition by corporation			
Gain on sale of interest	Capital	Capital; up to 50% of gain from qualified small business stock may be excluded	Capital and/or ordinary	Capital (unless collapsible partnership rules apply)	Capital (unless collapsible partnership rules apply)
Loss on sale of interest	Ordinary to extent of Sec. 1244 stock; otherwise, loss is capital	Ordinary to extent of Sec. 1244 stock; otherwise, loss is capital	Capital and/or ordinary	Generally capital	Capital
Liquidating distribution	At corporate level treated as sale of property; Gain passes through and increases shareholder basis; Could trigger built-in gains tax	At corporation level treated as sale of property; Gain to shareholder if FMV exceeds stock basis	Nontaxable	Generally nontaxable; Cash distribution in excess of basis will trigger gain; Disproportionate distribution of Sec. 751 assets may trigger gain	Generally nontaxable; Cash distribution in excess of basis will trigger gain; Disproportionate distribution of Sec. 751 assets may trigger gain
Accumulation of earnings	No restrictions	Corporation could be subject to accumulated earnings tax on unreasonable accumulation	No restrictions	No restrictions	No restrictions
Maximum Tax Rate	Generally taxed at individual shareholder level; Max 39.6%; If corporate level tax applies, it will generally be at 35% rate	35% with 3% increase for taxable income between $15 million and $18.33 million	35%; Max 39.6%	Taxed at individual partner level	Taxed at individual member level
Tax credits	Passed through to shareholders to be applied against their tax	Used to offset corporate tax	Used to offset tax of the individual	Passed through to partners to be applied against their tax	Passed through to partners to be applied against their tax
NOLs	Passed through to shareholder; Limits apply at shareholder level	Used to offset corporate income subject to certain limits	Used to offset individual's income subject to certain limits	Passed through to partner; Limits apply at partner level	Passed through to partner; Limits apply at partner level
At-risk rules	Limits apply at shareholder level	Only applicable to certain closely held corporations	Limits apply at proprietor level	Limits apply at partner level	Limits apply at member level
Charitable Contributions	Passed through shareholder; Limits apply at shareholder level	Deductible by corporation subject to certain percentage limits	Deductible by individual subject to certain percentage limits	Passed through to partner; Limits apply at partner level	Passed through to member; Limits apply at member level
Self-employment income to owners	No	No	Yes	Yes, general partners; No, limited partners	Unclear
Accounting method	Unrestricted	Restricted	Unrestricted	Unrestricted	Unrestricted
Classes of stock/ownership interest	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted
No. of investors	Limited to 75	Unlimited	N/A	Unlimited	Unlimited
Eligible investors	Restricted	Unrestricted	N/A	Unrestricted	Unrestricted

C. Additional Medicare Tax

1. Generally. Additional Medicare Tax of 0.9% applies to wages, and compensation received after 12/31/2012 and to self-employment income received in taxable years beginning after 12/31/2012. Additional tax only paid by employee (2.35% instead of current 1.45%), not by employer.

2. Thresholds. $200,000 if single, and $250,000 for married filing jointly.

3. Provides a little bit extra incentive to consider electing S corporation status.

D. 3.8 % Surtax on Net Investment Income

1. Generally. The new 3.8% Medicare Surtax is payable on the lesser of: (1) the taxpayer's net investment income; and (2) the amount by which his or her modified adjusted gross income exceeds a threshold amount.

2. Thresholds. $200,000 if single, and $250,000 for married filing jointly.

3. Net Investment Income

a) (i) Gross income from interest, dividends, annuities, royalties and rents, (ii) gains from the sale of stocks, bonds, mutual funds and investment real estate, and (iii) gains from the sale of an interest in a partnership or S corporation (to the extent you were a passive owner).

(1) Includes such income flowing through a partnership or S corporation.

(2) Income of the types noted are not subject to the tax if generated in a trade or business

b) Does not include:

(1) Active trade or business income except from a trade or business trading in financial instruments or commodities.

(2) Wages and self-employment income.

(3) Net gain "to the extent taken into account in computing taxable income."

XIV. **ADVANTAGES AND DISADVANTAGES OF LLCS**

A. Advantages

1. Provides limited liability with exposure for debt and obligations limited to the committed capital investment of the members.

2. The members may be active in the management of the entity without being subjected to liability.

3. Great flexibility as just about all matters, including, without limitation, distribution of profits, voting and management can be customized in the operating agreement.

4. Less formalities to follow than with a corporation:

5. Flexibility as to management.

- **a)** all members
- **b)** only a limited number of members
- **c)** a non-member
- **d)** a board of directors.

6. Allows for pass-through tax treatment; i.e., the entity is not taxed, with the members being taxed as a partnership.

7. Flexibility to allocate profits and losses between members if taxed as a partnership, so long as allocations have substantial economic effect.

8. Flexibility as to tax treatment—can elect out of default taxation to be taxed as a C corporation or S corporation.

9. As compared to the “S” corporation, allows any number of members and for corporations, trust, and any other form of organization and nonresident alien individuals to be members.

10. Members can generally withdraw assets without adverse tax consequences.

11. One can change to a corporate form without tax consequences. The reverse is not true.

12. A single member LLC can have limited tax liability, total control of the business and not have to file a separate income tax return.

13. The ability to make in-kind distributions without unanimous consent.

B. Disadvantages

1. Limited participation by members in fringe benefits and more complexity in self-employment tax issues and in offering equity options to employees.

2. On sale of a member's interest, the capital gain may be subject to IRC §751 ordinary income categorization.

3. While there is less likelihood of veil piercing than a corporation, there is a greater chance of liability than for a limited partner.

4. C Corporations are typically a better vehicle for attracting outside capital investment.

5. As a new entity, the case law and tax issues are not as settled and some of the older generation are more comfortable using the corporate format.

C. **SEE TABLE ON NEXT PAGE**

Summary of Entity Types

	Limited Liability Company	C Corporation	S Corporation	Sole Proprietor	General Partnership
Formation					
Initial Document	Articles of Organization	Articles of Incorporation	Articles of Incorporation	None	Partnership Agreement
Owners					
• Number	No limit	No limit	100	One	Two or more
• Type	No limitation	No limitation	Individuals, estates, certain trusts	Individual	No limitation
Capital Structure					
• Equity	No limitation	No limitation	Only 1 class of stock	No stock	No limitation
• Debt	No specific limits	No specific limits	Safe-Harbor for debt	No specific limits	No specific limits
Status Determination					
• Election	No requirement	No requirement	Required election	No requirement	No requirement
• Owner consents	None	None	Required	None	None
Status Determination					
Liability	Limited to member's capital contribution	Limited to shareholder's capital contribution	Limited to shareholder's capital contribution	Unlimited	Jointly & Severally unlimited
Operational Phase					
Tax on income	Member level	Corporate level	Owner level	Individual level	Owner level
Allocation of income/deductions	Permitted if substantial economic effect	Not permitted	Not permitted	N/A	Permitted if substantial economic effect
Character of income/deductions	Flow-through to members	No Flow-through to shareholders	Flow-through to shareholders	Flow-through to individuals	Flow through to partners
Owner Compensation Arrangements					
Fringe Benefits	Limited participation for members	Shareholder-officers qualify for benefits	Shareholder-officers qualify for benefits (except medical premiums which are treated as guaranteed payments)	Generally subject to limits applicable to individuals	Limited participation for partners
Retirement Benefits	Certain limits applicable to members	Shareholder-officers included in qualified plans	Certain limits on shareholder-officers	Generally subject to limits applicable to individuals	Certain limits applicable to partners
Reasonable Compensation limits	Not Applicable	Applicable to shareholder-officers	Applicable to shareholder-officers	N/A	Not Applicable

	Limited Liability Company	C Corporation	S Corporation	Sole Proprietor	General Partnership
Transactions with Owners					
Distribution of Cash	No effect except in calculation of basis	Dividends to extent of Earnings & Profits	Dividends generally no effect until AAA fully recovered	No effect	No effect except in calculation of basis
Distribution of Property	No gain or loss to entity	Dividend treatment; gain recognition to entity	Gain recognition to entity	No effect	No gain or loss to entity
Purchase of Owner's interest					
• Partial Interest	Capital gain treatment, except for ordinary income assets	Probably dividend treatment	Tax-free for portion equal to or less than basis	Treated as sale of each asset	\Capital gain treatment, except for ordinary income assets
• Entire Interest	Capital gain treatment, except for ordinary income assets	Capital gain treatment with exceptions	Capital gain treatment after basis recovered	Cannot sell entity interest; Sale of business treated as sale of each asset	Capital gain treatment, except for ordinary income assets
Termination of Entity or Owner Interest					
Sale of interest by owner to third party	Capital gain subject to §751 ordinary income categorization	Capital gain; no effect on basis of corporation's assets	Capital gain; no effect on basis of corporation's assets	Cannot sell entity interest; Sale of business treated as sale of each asset	Capital gain subject to §751 ordinary income categorization
Death of Owner	Estate as member subject to agreement	Estate continues as shareholder	Estates continues as shareholder	Estate takes over business	Estate as partner subject to agreement

XV. **PRACTICAL APPLICATIONS**.

A. Rules of Thumb.

1. Real Estate Investment Company - Typically LLC.

2. Active One Person Business

   a) Profit Approximates Salary – Typically LLC

   b) Profit Exceeds a Normal Salary – Typically S Corporation.

3. Multiple owner entity (less than 100 owners) with active business unlikely to need venture capital / angel investment – Typically S corporation

4. Multiple owner entity with active business with a need for venture capital / angel investment. – Typically C corporation

5. Multiple owner entity with more than 100 owners. – Typically C corporation

6. Service entity with multiple members where profit is zeroed out by salaries – Typically C corporation (S.C. for state law purposes)

7. Foreign owned entity – Typically C corporation.

B. Choice of State for Organization of LLC

1. Delaware, Nevada, Wyoming.

   a) Delaware has highly developed body of business law and expertise within its Court of Chancery.

   b) Like Delaware, Nevada has a special business court for litigating business disputes. The Nevada court does not issue written opinions with precedential value, so less predictable than Delaware. It is slightly tougher to pierce the corporate / LLC veil in Nevada.

   c) Wyoming LLC's are touted as superior due to Wyoming having the longest history with LLC's, low fees and low taxes.

2. Why Organize in Wisconsin?

   a) If members are here doing business will likely have to register in Wisconsin and pay Wisconsin filing fees and annual report fees even if registered in another state.

b) If members are Wisconsin residents they will be subject to Wisconsin income tax on income passed through from entity regardless of where registered.

c) Local professionals are likely to be most familiar with Wisconsin law.

d) Expensive to litigate in the special courts of Delaware or Nevada.

e) Wisconsin courts will often look to Delaware business law as persuasive authority in areas where Wisconsin business law is less developed.

C. <u>When does an LLC need an FEIN</u>?

1. Always when there is more than one member.

2. When wages will be paid if it is a single member LLC.

SECTION 4

RECENT DEVELOPMENTS IN EMPLOYMENT LAW

I. COURT AWARDS $1.8 MILLION FOR FAILURE TO PROVIDE COBRA NOTICES.

A. In *Pierce v. Visteon Corp., 2013 WL 3225832 (S.D. Ind. 2013),* a large employer, in its role as plan administrator of the company's group health plan, was ordered to pay penalties of $1.8 million in this class action lawsuit because it failed to ensure that its TPA provided COBRA election notices to hundreds of terminating employees.

B. The employer outsourced its payroll, benefits and COBRA administrative functions to several different TPAs. Employee terminations were processed through an automatic data feed system – a local human resources official recorded each termination in the company's timekeeping system, and the information was sent electronically to the payroll TPA, the benefits TPA, and the COBRA TPA. Neither the local human resources departments nor the TPA reported the terminations to the employer, and the COBRA TPA did not notify the employer when COBRA notices were furnished. The employer asserted that any failure to send COBRA notices was out of its control and caused by communication glitches among its TPAs.

C. The court disagreed, ruling that the employer willfully violated COBRA's notice provisions, or it was grossly negligent in performing its responsibilities as plan administrator. The court awarded statutory penalties of $2,500 per affected participant plus attorney's fees in an amount to be determined, citing the employer's lack of internal systems for tracking the status of employees, its failure to properly oversee its TPAs, and its refusal to accept responsibility for the COBRA notice system. The court also noted that the notice failure harmed participants by causing them to delay medical treatment and to incur unplanned out-of-pocket expenses. The court characterized the penalty as "large enough to act as a deterrent" to other companies.

D. Comment: Employers that use a TPA to handle COBRA duties must understand that this does not relieve it of its responsibilities as the plan administrator of a group health plan. The plan administrator is liable to qualified beneficiaries for failure to provide COBRA notices and is subject to statutory penalties. Consequently, employers should be aware of the COBRA compliance procedures used by the TPA and ensure that the TPA agreement provides protection to the employer if the TPA fails to properly perform its duties.

II. EMPLOYER SUED FOR WITHDRAWING COBRA OFFER FOLLOWING GROSS MISCONDUCT

A. In *Danios v. i3 Archive, Inc.*, 2013 WL 3556083 (E.D. Pa. 2013), two former employee officers of a company sued their employer in its role as plan administrator after they were denied COBRA because of their undisclosed romantic relationship.

B. During their employment, the two employees, who also served on the company's Board of Directors, kept their relationship and subsequent marriage a secret as they each promoted and implemented employment decisions that would benefit each other. When the company struggled financially, the employees (upon their own suggestion) were terminated as part of a larger reduction-in-force. The company provided timely COBRA election notices, but, a month later, when the company learned of the employees' secret marriage, it sent a letter to them terminating them for gross misconduct and concluding that they were not entitled to COBRA. The DOL later ruled that the employees had not been terminated for gross misconduct for purposes of COBRA and required the company to reinstate coverage. The employees asked the court to award statutory penalties of $110 per day, arguing that the company "effectively withdrew" their election notices through the letter. They also requested equitable relief to compensate them for health insurance premiums they paid under another plan during the months that they were without COBRA coverage.

C. The court noted that they had not stated a claim for penalties and it refused to rule on the claim for equitable relief without a trial, stating that the employees would have to prove at trial that the employer violated either ERISA by breaching its fiduciary duties or the terms of the plan when it erroneously classified them as having been terminated for gross misconduct.

D. Comment: Withdrawing an offer of COBRA is risky, especially when it is done retroactively. The court refused to impose notice penalties (presumably because a timely election notice had been provided) and stated that the employer must still stand trial to determine if it breached its fiduciary duty by withdrawing the COBRA offer after it learned of the employees' relationship. The DOL concluded that the employees were not terminated for gross misconduct probably due to the fact that the evidence of misconduct was not uncovered until after the employees' termination. The U.S. Supreme Court has rejected an employer's use of after-acquired evidence of gross misconduct in the COBRA context.

III. SUPREME COURT'S *MCCUTCHEN* DECISION IS GOOD NEWS FOR PLAN SPONSORS

A. The Supreme Court's recent decision in *US Airways, Inc. v. McCutchen* dealt with a narrow issue under ERISA regarding enforcement of a plan's reimbursement provision. The way in which the Supreme Court answered that question is good news for all plan sponsors. The Court's decision reaffirmed the primacy of the plan document, noting that the plan document "is at the center of ERISA," and that ERISA's statutory scheme "is built around reliance on the face of written plan documents." Accordingly, the Court held that in an action brought under § 502(a)(3) of ERISA, "equitable defenses" such as unjust enrichment cannot be used "to override the clear terms of the plan." A clearly worded reimbursement provision will be enforced as written, no matter how inequitable that result might seem from the plan participant's perspective.

B. McCutchen, a participant in the US Airways self-funded medical plan, was seriously injured in a car accident. The plan paid medical expenses on his behalf totaling approximately $67,000 and he had other damages (lost earnings, pain and suffering, etc.) that were likely more than $1 million. He hired a lawyer on a 40 percent contingency basis and sued the driver of the other vehicle. He ultimately settled that lawsuit for only $110,000 because of limited insurance coverage and multiple injured parties. After paying 40 percent to his attorney, his net recovery was $66,000. Upon learning of his recovery, the plan sued him for repayment of all of the medical benefits it had paid on his behalf ($67,000), citing the plan's reimbursement provision, which required him to reimburse the plan "out of any monies recovered from the third party."

C. McCutchen raised two equitable defenses to the reimbursement claim. He argued that he should not have to reimburse the plan at all because there had been no double recovery of medical expenses because he had not been fully compensated for his non-medical damages which far exceeded the amount of the settlement. He also argued that if the plan was going to share in the recovery, it should also be required to share in the attorney's fees incurred to obtain the recovery, and thus its reimbursement should be $67,000 minus 40 percent for attorneys' fees.

D. The plan brought its suit under ERISA § 502(a)(3), which authorizes a suit "to obtain … appropriate equitable relief … to enforce … the terms of the plan." The Court's ultimate holding was that "equitable rules … cannot trump a reimbursement provision." If the plan's reimbursement provision is drafted to give the plan the first claim to any money recovered from a third party, as was the case here, then that provision will be enforced as written. And if the plan's reimbursement provision clearly states that the plan is entitled to recoup every dollar it paid out in benefits, and that it does not have to bear any portion of the attorneys' fees incurred in obtaining the recovery, then that provision will also be enforced as written. In this case, the plan's reimbursement provision did not address the attorneys' fee issue, so the Court applied the equitable "common-fund" doctrine and held that the plan was required to share in those fees but the Court made clear it was doing so only because the plan was silent on that issue.

E. Comments:

1. Plan sponsors should review their reimbursement language to make clear precisely how it is intended to apply. A well-drafted provision should address all relevant items including first-dollar recovery and whether the plan is going to share in the legal fees incurred in pursuing the recovery because a well-drafted reimbursement provision will be enforced as written.

2. Plan sponsors should keep in mind that a completely one-sided reimbursement provision may give a participant (and the participant's attorney) little incentive to bring a lawsuit against a third party which will result in little or no reimbursement for the plan. It would be prudent for a plan sponsor to include language in the reimbursement provision stating that it is willing to consider alternative arrangements in individual cases which are negotiated in advance.

3. The plan is the controlling document and the SPD is a communication about the plan. If a plan sponsor wants to be able to enforce a reimbursement provision, the plan sponsor should make sure that provision is part of the plan, and not just in the SPD. This case in an exception because the reimbursement provision appears to have been in the SPD rather than the plan, but the Court stated it was overlooking that problem because the parties and the two lower courts had all treated the reimbursement provision as if it were part of the actual plan. This is usually not the case when conflicting provisions exist between the plan document and SPD

IV. **FMLA REVISIONS.** The Department of Labor ("DOL") recently issued final regulations clarifying the right of eligible employees to take Family Medical Leave Act ("FMLA") leave relating to military leave. These regulations are already in effect. The relevant changes to the DOL's prior FMLA regulations are:

A. FMLA leave is available for qualifying exigencies arising out of the active duty of the employee's spouse, son, daughter, or parent only when that active duty involves deployment to a foreign country.

B. Eligible employees may take leave to care for the parent of a military member if the parent is incapable of self – care and the care provided by the employee is necessary because of the military member's active duty.

C. The amount of leave an employee may take to spend time with a military member on rest and recuperation leave has been expanded from 5 days to 15 days.

D. The spouse, son, daughter, parent, or next-of-kin of a military member may take up to 26 work weeks of FMLA leave to care for a former service member who was discharged or released under conditions other than dishonorable discharge during the 5 years prior to the first day of leave.

E. The definition of serious injury or illness for a covered service member now includes conditions which existed prior to active duty which were aggravated in the course of active duty.

F. The list of healthcare providers authorized to complete a certification for service members has been expanded to include caregivers who are not affiliated with the Department of Defense, the Veterans' Administration or TRICARE. Second and third opinions may be required for certifications provided by these healthcare providers.

G. Documentation of enrollment in the Department of Veterans Affairs Program of the Comprehensive Assistance for Family Caregivers can be sufficient certification if the employee also provides information about the military member's familiar relationship to the employee, the military member's discharge date and the military member's status.

H. For employers who use the DOL's forms, the Department has issued new forms for the leaves affected by these regulations. They are available from the DOL's website. For employers who have developed their own forms, these changes will require modification only to the extent any of the current forms are inconsistent with the new regulations, or they fail to fully advise employees of their rights. Finally, the Department of Labor has issued a new FMLA poster which incorporates the new regulations. A copy of the poster is available at www.dol.gov/whd and local Wage and Hour District Offices.

V. INTERNS MUST BE PAID IF THEY PERFORM THE SAME WORK AS EMPLOYEES

A. A federal court in New York recently held that failure to follow the Fair Labor Standards Act requirements for internships will result in employer liability for minimum wage and overtime payments for all hours worked by interns. *Eric Glatt and Alexander Footman, et al., v. Fox Searchlight Pictures, Inc., Case No. 11-cv-6784, U.S. District Court, Southern District of New York.* Of prime concern to the court were: (1) whether defendants (Fox Searchlight) derived an immediate advantage from interns' work, (2) whether interns displaced regular employees, and (3) whether the internship program was for the benefit of interns.

B. Under the FLSA interns are employees unless:

1. The internship provides training similar to that which would be given in an educational environment;

2. The internship experience is for the benefit of the intern;

3. The interns does not displace regular employees, but works under close supervision of employer's staff;

4. The employer derives no immediate advantage from the intern's activities and, on occasion, its operations may be impeded;

5. The intern is not necessarily entitled to a job at the conclusion of the internship; and,

6. The intern and employer understand that the intern is not entitled to wages for the internship.

C. The U.S. Department of Labor will want to know whether the intern is part of an educational program, the intern receives credit for the internship and the intern is performing work previously or currently performed by employees. Employers should insure that the internship experience is educational and provide special programs for the interns in order to orient, advise and otherwise benefit them. Alternatively, interns should be paid at least the minimum wage and should receive time and one half their regular rate of pay for all work over 40 in a workweek.

VI. EEOC ISSUES GUIDANCE ON CRIMINAL BACKGROUND CHECKS & CREDIT CHECKS

<u>Background Checks</u>

A. This past year the Equal Employment Opportunity Commission (EEOC) announced its Enforcement Guidance on the Consideration of Arrest and Conviction Records in Employment Decisions under Title VII of the Civil Rights Act of 1964.

B. EEOC guidance had been expected given recent rulings against employers related to criminal background checks. The guidance does not prohibit criminal background checks, but rather requires a practice of "individualized assessment" in order for the employer to establish that they are not engaging in discriminatory behavior.

C. In engaging in this individualized assessment, the EEOC directs employers to consider the following factors:

1. Individualized assessment generally means that an employer informs the individual that he may be excluded because of past criminal conduct; provides an opportunity to the individual to demonstrate that the exclusion does not properly apply to him; and considers whether the individual's additional information shows that the policy as applied is not job related and consistent with business necessity.

2. The individual's showing may include information that he was not correctly identified in the criminal record, or that the record is otherwise inaccurate.

D. Other relevant evidence for employers to consider includes:

1. The facts or circumstances surrounding the offense or conduct;

2. The number of offenses for which the individual was convicted;

3. Older age than at the time of conviction, or release from prison;

4. Evidence that the individual performed the same type of work, post-conviction, with the same or a different employer, with no known incidents of criminal conduct;

5. The length and consistency of employment history before and after the offense or conduct;

6. Rehabilitation efforts (e.g., education/training);

7. Employment or character references and any other information regarding fitness for the particular position; and

8. Whether the individual is bonded under a federal, state, or local bonding program.

E. The EEOC asserts that while the individualized assessment is not required, the lack of a screen that includes the individualized assessment will make it difficult, if not impossible, for an employer to justify a criminal background check as job related and consistent with business necessity.

F. If an employer does decide to conduct an individualized assessment, the guidance suggests that the employer: (1) inform the applicant that he or she may be excluded based on the past criminal conduct; (2) provide an opportunity to the individual to establish that the exclusion should not apply; and (3) consider whether the individual assessment shows that the policy should not be applied to the applicant.

G. The EEOC suggests the following best practices for employers who consider criminal record information when making employment decisions:

1. Develop a narrowly tailored written policy and procedure for screening applicants and employees for criminal conduct;

2. The policy should identify essential job requirements and the actual circumstances under which the jobs are performed;

3. The policy should also determine the specific offenses that may demonstrate unfitness for performing such jobs, and the duration of exclusions for criminal conduct;

4. Record the justification for the policy, procedures, and exclusions, including a record of consultations and research considered in crafting the policy and procedures; and

5. Train managers, hiring officials, and decision makers on how to implement the policy and procedures consistent with Title VII.

H. The guidance also reiterates that an employer must apply its screening standards in an even-handed manner as between similarly situated applicants of different racial and ethnic backgrounds. The EEOC is making clear its position that criminal background checks can cause "disparate impact" discrimination. The EEOC is concerned that criminal background check and screening policies disproportionately affect protected class members. If a disparate impact resulting from these policies is shown, the EEOC maintains that the employer can be liable for discrimination unless it can demonstrate that its policy is job related for the positions in question and consistent with business necessity.

I. Comment:

Review the EEOC guidance and ensure policies are consistent with the guidance. Employers conducting criminal background checks should develop policies that adhere to the best practices described above and provide for individualized assessment. Employees making hiring decisions and administering the background checks should be trained in the policy and in the prevention of unlawful discrimination.

<u>Credit Checks</u>

A. The EEOC continues to question the use of credit checks as an employment screening device.

B. Since 2010, the EEOC has urged that legislation be passed barring the use of credit checks by employers, in large part due to the number of credit problems that had arise because of the severe downtown in the economy. The EEOC maintains its position that credit checks are not a valid predictor of job performance and that if protected groups are adversely affected by credit checks, then a violation of Title VII may occur. As the EEOC's Office of Legal Counsel put it:

   1. [I]f an employer's use of credit information disproportionately excludes African-American and Hispanic candidates, the practice could be unlawful unless the employer could establish that the practice is needed for it to operate safely or efficiently.

C. The EEOC noted that no law prohibits the use of credit checks and that courts have upheld their use in some jobs (cash handling, for instance). Employers are advised to examine whether credit checks (and all other screening devices) meet a "business necessity" standard.

D. Despite this enforcement and policy effort, the EEOC's high-profile suit against Kaplan Higher Education Corp., was recently dismissed. The EEOC sued Kaplan in 2010, alleging that its pre-employment credit check policies had a disparate impact upon black job applicants.

E. The U.S. District Court for the Northern District of Ohio dismissed the suit on Kaplan's summary judgment motion. The court excluded the EEOC's statistical expert, holding that the statistics relied upon were scientifically unsound. Expert witness testimony is crucial in disparate impact cases, because such cases depend on the percentage of job applicants from a given classification as compared to the percentage of hires in the same classification. Among the key problems for the EEOC was that Kaplan, like many employers, does not collect demographic information on the race of job applicants. As a result, EEOC had a hard time identifying the races of applicants who were rejected due to credit problems. In the absence of any statistical evidence demonstrating an adverse impact caused by the use of credit checks, the court held that the EEOC's case had to be dismissed.

F. One other problem with this litigation is that the EEOC, similar to many other employers, uses credit checks to screen applicants for its openings. The EEOC's utilization of this practice calls its hard-line stance into question.

G. Another problem is that the EEOC's past enforcement practices gave rise to many of its difficulties in this case. Employment law attorneys discourage their clients from collecting race, gender and other protected-characteristic data during the application process. In the past, the EEOC has used such information to support disparate hiring claims. Kaplan, in complying with EEOC best practices, deprived the EEOC of information that it needed to prove its case.

VII. ATTENDANCE MAY BE AN ESSENTIAL JOB FUNCTION UNDER THE ADA.

A. In *Samper v. Providence St. Vincent Medical Center,* the Court confirmed that attendance is essential, especially when an employee's presence at the worksite is an essential job function.

B. Monika Samper was a nurse in the neo-natal intensive care unit (NICU) who suffered from fibromyalgia. This condition disrupted her sleep and caused her chronic pain resulting in unplanned absences from work. Her employer attempted to provide a reasonable accommodation and allowed Samper to call in when she could not come to work and to move her shift to another day without finding a replacement. Despite these arrangements, Samper continued to have attendance problems and her employment was ultimately terminated by the hospital. Samper then filed a lawsuit claiming, among other things, that her employer failed to accommodate her disability in violation of the Americans with Disabilities Act (ADA).

C. While regular attendance is not always an essential function of all jobs, a majority of the federal circuits have held that attendance may be necessary for a variety of reasons including teamwork, face-to-face interaction with clients, and working with items or equipment that are at the employer's place of business. Here the Court found that the job of a NICU nurse clearly involved all three of these requirements. The court concluded that an employer is not required to provide a reasonable accommodation that exempts an employee from an essential job function.

D. It is important to remember that the employer has the burden of showing what job functions are essential. The employer in *Samper* was able to point to a written job description which required strict adherence to the attendance policy. The job description also listed punctuality as an essential function of the position.

E. Even though the Ninth Circuit looked favorably on the hospital's efforts to accommodate Samper, employers should also be aware that allowing employees to work from home or providing flex-time and telecommuting options for some employees may make it more difficult to argue that regular on-site attendance is essential.

F. Comments:

1. Employers should include regular attendance as an essential job function in its written job descriptions and explain why it is essential.

2. Employers should proceed with extreme caution when making personnel decisions allowing employees to work from home or providing other options including telecommuting and flextime as these decisions could have implications undermining attendance requirements.

VIII. **EMPLOYER RESPONSIBILITY UNDER THE AFFORDABLE CARE ACT**

A. As you know from last year, the United States Supreme Court decided to uphold the Affordable Care Act, the sweeping new health care law enacted by Congress and signed into law by President Obama in 2010. In light of the Supreme Court's decision the law remains intact but as of this print date, over half of the imposed deadlines required by the Act have already been delayed.

B. The Act puts in place comprehensive health insurance reforms and tax regulations that roll out over the course of several years. Because the legal and political issues surrounding the Act are numerous and complex, further amendments, regulations, and judicial challenges will likely occur in the future.

C. Small business tax credit. Certain small employers that offer health care coverage to their employees are eligible to receive tax credits. In order to be eligible for the tax credits, the business must employ no more than 25 employees, and must pay at least 50 percent of its employees' health care premiums. The amount of the credit is based on the number of employees and average employee compensation, but small businesses can receive credits of up to 35 percent of their premiums.

D. Nondiscrimination. The nondiscrimination rules that previously applied only to self-insured health plans will now apply to fully-insured group health plans as well.

E. Extended coverage for dependent adult children. Group health insurance plans that offer coverage to dependent children must extend coverage to dependent adult children until the year in which they turn 27 years old. (Until 2014, grandfathered plans must offer extended coverage only if the dependent child is not eligible for other employer-sponsored coverage.)

F. Elimination of lifetime limits, and restriction of annual limits. The new legislation prohibits group insurance plans from imposing lifetime limits on essential benefits and permits them to impose annual limits on such benefits only until January 1, 2014.

G. Some additional key provisions that are effective in 2013 include:

1. Form W-2. When issuing Form W-2 to employees in January 2013, employers must report the value of employer-provided health care coverage on Form W-2. In general, the amount reported should include both the portion paid by the employer and the portion paid by the employee. The reporting requirement is for informational purposes only.

The value of the coverage provided remains excluded from taxable income.

2. FICA Medicare Tax Increase. For tax years beginning after December 31, 2012, the FICA Medicare tax rate will increase by 0.9% for wages over $200,000 ($250,000 for married couples filing jointly). FICA taxes are comprised of Social Security and Medicare taxes, thus this change increases the employee's portion of the FICA Medicare tax from 1.45% to 2.35% for wages over $200,000 ($250,000 for married couples filing jointly).

3. Health Flexible Spending Account ("FSA") Contribution Limits. The maximum annual contribution limit permissible under a health FSA, effective for plan years commencing on or after January 1, 2013, is reduced to $2,500 subject to an annual cost-of-living adjustment. Prior to January 1, 2013, there were no legally imposed limits on the amount of money that could be contributed to a health FSA.

4. Written Notice of State Insurance Exchange. Starting in 2014, individuals and small employers will be able to buy health insurance from a state health insurance exchange.

H. The Act does not require employers to provide health benefits to their workers, but certain employers face penalties starting in 2014 if they fail to provide sufficient health care coverage to all full-time employees. The so-called "play or pay" mandate provides that employers with more than 50 "full-time equivalent" employees will be required to pay at least $2,000 for each full-time employee in excess of 30 if any of their full-time employees receive a tax credit because the employer (a) did not offer coverage at all, (b) did not offer coverage at affordable rates, or (c) did not offer coverage meeting the minimum standards established by law. Various means will be used to determine compliance with the law, but requirements (and penalties for non-compliance) will generally be more burdensome for larger employers than smaller employers.

I. How to proceed::

1. Determine the extent to which the new rules apply. Since the Act does not apply to all employers in the same manner, employers should review the law to identify the requirements applicable to them, and the compliance deadlines corresponding to each requirement.

2. If the law is applicable, employers should decide whether to "play or pay". If the Act is applicable to a particular employer, the employer should decide whether it will offer health care insurance to its employees or pay the penalties otherwise imposed by the law.

3. If you elect to provide insurance, confirm that your coverage complies with the new rules.

4. Seek tax advice regarding potential tax benefits resulting from the payment of premiums.

IX. IRS CORRECTION PROGRAM: A WHOLE NEW BALLGAME

A. The IRS issued Rev. Proc. 2013-12 on April 1, 2013. On that date, the old Rev. Proc. 2008-50 is out and the new is in. The good news is that the new procedure is broader, more flexible and more user-friendly.

B. The correction programs are known as the Employee Plans Compliance Resolution System (EPCRS). EPCRS provides for correction of most compliance failures in retirement and annuity plans, Simplified Employee Pension plans and SIMPLE IRAs. The programs have evolved over more than 20 years into an extensive and widely used framework for correction. There are three components of EPCRS. The Self Correction Program (SCP) has no compliance fee and no contact with the IRS. The Voluntary Compliance Program (VCP) requires a filing with the IRS and payment of a significant fee based on the number of participants. The Audit Closing Agreement Program (Audit CAP) results from an examination or a compliance failure discovered during a Determination Letter application or audit and often results in a hefty penalty sanction.

C. New Forms Required:

1. Effective April 1, all VCP submissions must include two new forms: Form 8950 (Application for Voluntary Correction Program) and Form 8951 (Compliance Fee for Application for Voluntary Correction Program). At this point, these forms are only available on the Internet.

D. Form 8950:

1. Form 8950 includes employer representations (penalty of perjury; abusive tax avoidance; diversion of plan assets; not under examination; and determination letter) and other information previously on other components of a VCP submission. Form 8950 includes a procedural requirements checklist. Form 8950 must be signed by the owner or an authorized employee of the plan sponsor. It cannot be signed by an authorized representative under a Power of Attorney.

E. Form 8951:

1. This form must be attached to Form 8950. It determines the VCP compliance fee. It is comparable to Form 8717 applicable to Determination Letter and other advisory letter submissions.

F. What to Include:

1. Section 11.14 of Rev. Proc. 2013-12 contains the assembly instructions for a VCP filing. It references the new forms and also makes clear that if a VCP submission must be accompanied by a Determination Letter application, separate copies of any documents that are common to both filings must be provided.

G. Enclosures:

1. Prior appendices C, D, E and F no longer apply. Appendices C and D have been completely revised. Appendices E and F no longer exist.

H. Appendix C:

1. The new Appendix C consists of Part I: Model VCP Submission Compliance Statement; and Part II: Model VCP Schedules 1-9. Submission of Part I may be voluntary but should be considered a requirement. It can be combined with any of the Part II schedules.

2. The Schedules 1-9 in Part II of Appendix C are similar to the Schedules listed in Part II of the former Appendix F. However, they have been revised and clarified. Completion of some of the schedules now will require more effort.

3. More comprehensive information is now required concerning the efforts made to locate former participants and former beneficiaries. This information must coordinate with the new procedure and the Appendix C compliance statement.

I. Appendix D:

1. Appendix D, Acknowledgement Letter, is the same as and now replaces the former Appendix E.

J. 403(b) Plans:

1. Under Rev. Proc. 2013-12, the full scope of EPCRS has been extended to the correction of document and operational failures with respect to Section 403(b) plans that fail to comply with the final 403(b) regulations for 2009 and subsequent plan years. The definitions and principles applicable to

403(b) plans have been modified or added and are substantially identical to those for qualified retirement plans. Sections 6.10(2) and (3) now contain additional correction principles and rules that are applicable to 403(b) plans. If the only purpose of the VCP submission is to correct failure to adopt a written 403(b) plan by the deadline in the final 403(b) regulations and Notice 2009-3 and the submission is postmarked no later than December 31, 2013 (see Form 8951), the VCP compliance fee will be reduced by 50%. Any VCP submission concerning a 403(b) plan submitted under Rev. Proc. 2008-50 that was not closed or returned by December 31, 2012, will be given the option to convert to the Rev. Proc. 2013-12 requirements.

K. Section 457(b) Plans:

1. Under Rev. Proc. 2008-50, corrections to Section 457(b) plans were limited to those sponsored by governmental organizations and were not available to plans of tax-exempt entities. Under Rev. Proc. 2013-12, the IRS may consider a submission for a plan sponsored by a tax-exempt organization if the plan was erroneously established to benefit non-highly compensated employees and has been operated in a manner similar to that required for a qualified retirement plan.

L. Funding Corrections with QNECs:

1. Where a non-discrimination test failure (ADP, ACP or multiple use) is to be corrected by qualified non-elective contributions (QNECs), the amounts must satisfy the definition of QNECs in Section 1.401(k)-6 of the 401(k) regulations. This means that a QNEC correction cannot be funded by forfeitures.

M. Defined Benefit Plan Underpayments:

1. The new procedure makes clear that funding of earnings for loss of use of underpayment amounts in a defined benefit pension plan must be based on the interest rate in effect for determining actuarial equivalence at the time the distribution should have been made and should not be based on any other standard. The new procedure: also makes clear that corrective distributions are not subject to the lump sum equivalence requirements of Code Section 417(e)(3) if the underpayments or missed payments themselves were not subject to Section 417(e)(3).

N. Missing Participants:

1. The new procedure recognizes that the IRS letter forwarding program was terminated effective as of August 31, 2012. It suggests alternatives including commercial services. As noted above, the VCP submission rules now require an enhanced description of efforts to locate missing participants. The procedure makes clear that a correction will not fail if reasonable steps are taken and the benefits will be available if the participant or a bona fide beneficiary is located subsequently.

O. Audit CAP:

1. A number of provisions in the new procedure make clear that the correction principles also apply when a correction is being made through Audit CAP.

P. Determination Letter Requirement:

1. Section 6.05 of the new procedure brings welcome clarification of when a separate Determination Letter application must be included with a VCP submission.

Q. VCP Fees:

1. The new procedure includes a number of additional discounted and flat fees for VCP submissions and CAP fees arising out of Determination Letter applications.

R. Appendices A and B:

1. Rev. Proc. 2013-12 makes clear that correction methods permitted in Appendices A and B are deemed reasonable and appropriate, making

them safe harbor methods of correction. Other correction methods may be reasonable and appropriate but must conform to the general correction principles.

2. Appendix A, Section .05, allows correction of matching contribution failures to be made in the form of corrective employer matching contributions instead of QNECs. Corrective employer matching contributions may be subject to any applicable vesting schedule.

3. Appendix A also has been modified to add safe harbor corrections for improper exclusions of employees from certain plans. These safe harbor corrections do not require or permit new ADP or ACP testing.

X. NATIONAL LABOR RELATIONS BOARD (NLRB) FOCUS POINTS

Social Media

A. In *Karl Knauz Motors, Inc. d/b/a Knauz BMW, 358 N.L.R.B. No. 164 (Sept. 28, 2012)*, an Illinois BMW dealership maintained a rule stating: "Courtesy: Courtesy is the responsibility of every employee. Everyone is expected to be courteous, polite and friendly to our customers, vendors and suppliers, as well as to their fellow employees. No one should be disrespectful or use profanity or any other language which injures the image or reputation of the Dealership."

B. A salesman was discharged for revealing embarrassing information about an incident of negligence at another dealership owned by the same employer. He had also posted mocking comments about the cheap hot dogs and cookies provided to buyers at a dealership event. The NLRB found that his disparagement of the hot dogs, chips and cookies was protected under the Act and found the rule regarding courtesy and language affecting the reputation of the Dealership violated the Act.

C. The NLRB found this rule unlawful because, "(A)n employer violates Section 8(a)(1) when it maintains a work rule that reasonably tends to chill employees in the exercise of their Section 7 rights because if a rule explicitly restricts Section 7 rights, it is unlawful. If it does not, the violation is dependent upon a showing of one of the following: (1) employees would reasonably construe the language to prohibit Section 7 activity; (2) the rule was promulgated in response to union activity; or (3) the rule has been applied to restrict the exercise of Section 7 rights."

D. The Board found the rule unlawful because, "(E)mployees would reasonably construe its broad prohibition against "disrespectful" conduct and "language which injures the image or reputation of the Dealership" as encompassing Section 7 activity, such as employees' protected statements—whether to coworkers, supervisors, managers, or third parties who deal with the Respondent— that object to their working conditions and seek the support of others in improving them.

E. The NLRB also held that, "An employee reading this rule would reasonably assume that the (Employer) would regard statements of protest or criticism as "disrespectful" or "injur[ious] [to] the image or reputation of the Dealership."

F. Nevertheless, the discharge was upheld because his comments about negligence at an affiliated dealership were not protected by the Act.

Facebook

A. In *Hispanics United of Buffalo Inc., 359 NLRB No. 37 (December 14, 2012)),* the NLRB reiterated that Section 7 of the National Labor Relations Act gives employees the right to organize, to form, join, or assist labor organizations and to "engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection."

B. Here Hispanics United violated the Act by discharging 5 employees for posting comments on Facebook in response to criticism of their job performance. In one posting an employee solicited co-workers for support in defending themselves against criticism that they "don't help clients enough." The discharged employees posted comments of support in contravention of the allegations relating to their work. The NLRB found that they had made "common cause" with the first poster and therefore were acting in concert with regard to protected activity.

C. The full text of Section 7 of the NLRA states: "Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment…"

D. Therefore, an employee who complains to his manager about his wages is not engaging in protected activity, but if he seeks mutual aid or protection by complaining to his co-workers in person or in social media, that is protected activity and he cannot be disciplined for it.

At-Will Employment

A. Here the NLRB has sounded the alarm that contractual disclaimers that define employment as "at will" may also be unlawful. *American Red Cross Arizona Blood Services Region*, 28-CA-23443 (Feb. 1, 2012); *NLRB v. Hyatt Hotel Corp.*, Case 28-

CA-061114 (complaint) (May 23, 2012). The concern in *American Red Cross*, centered on at-will employment language that could lead an employee to believe that she could not improve her job security and that of her co-workers through unionization. That clause stated that the at-will employment relationship could not "be amended, modified, or altered in any way." Employers should be sure to include language that does not so limit the at-will policy but rather specifies that the at-will relationship cannot be altered by supervisors or that the at-will status of employees cannot be modified without the written authorization of the president of chief executive officer of the employer.

SECTION 5

BYOD (*Bring Your Own Device to Work*) and Growth in Retaliation Claims: What An Employer Needs to Know

XVI. **EEOC UPDATE.**

A. Charge Data:

	2011	2012
Retaliation	37,334	37,836
Race	35,395	33,512
Sex/Gender	28,534	30,356
Age	23,465	22,857
Disability	25,742	26,379
National origin	11,833	10,883
Religion	4,151	3,811
GINA	245	280

Relief in 2012

Admin. Enforcement	$365.4 million
Litigation	$ 44.2 million

B. EEOC Priorities 2013-2014

1. Eliminate barriers in recruitment and hiring.

   - Arrest and conviction records

2. Protecting immigrant migrants and other vulnerable workers.

   - Human trafficking
   - Mississippi
   - Texas
   - Hawaii
   - Nebraska
   - Washington

3. Finding more GINA cases.

XVII. **BRING YOUR OWN DEVICE TO WORK.**

A. What are we talking about?

More and more of our employees are using smart phones and mobile devices to do their work. Most of these are owned by the employees.

How do you control the flow of proprietary information? How do you retrieve it at the end of the employment relationship?

B. Company owned – vs – employee owned.

1. Why ownership matters.

a) Termination of employee.

b) Ability to retrieve info.

c) Ability to restrict cloud based apps.

d) GPS tracking.

e) Company owned devices allows much greater control.

C. Planning a BYOD Program.

1. COD.

2. Are all employees going to be granted access to company info on BYOD:

a) Exclude:

- H.R.
- R&D
- Temp workers

3. Tech Control.

a) Mobile device management.

b) Encryption and backups.

c) Strong password.

d) Forcing wipes after 10 password attempts.

e) Citrix – vs. – Remote Access

4. Policies.

a) Tie back use to existing policies.

- Harassment
- Discrimination

b) Safety.

- Prohibition on texting or talking on handheld device while driving
- No use on production floor

c) Use.

- Make sure that it is clear that personal use is not permitted
- Not allowed to be used on restricted sites

d) Privacy.

- Policy must clearly state that the employee must provide access to their device upon demand
- Policy provides for the copying of the whole device including personal content
- Obtain written consent to
  - Review the device at anytime
  - Ability to remote wipe the device
  - Install security software
- Security
  - Employees to immediately report lost or stolen device
  - Prohibit use by others

XVIII. **RETALIATION CLAIMS.**

A. Most Common Claim.

EEOC processed 4,000 more claims for retaliation than race based claims.

B. Basis for claim.

1. Do not have to prove discrimination or part of a protective class.

2. Can arise out of an employee reporting violation of certain workplace laws and regulations.

- Can't take retaliatory action against an employee or others for a good faith reporting of a violation
- Source of potential liability is almost endless

C. Examples of retaliation claims.

1. Former employees.

a) Facts: Employee filed a discrimination claim against his employer. While the claim was pending, the employer was contacted for a reference on the employee. The employer slammed the employee.

b) Take Away:

- Court found that there could be a basis for a retaliation claim for former employees.
- Could expand the statute of limitation out almost indefinitely – 300 days from the bad reference.
- How does this interact with Wisconsin law that allows truthful references?
- Must control:
    - Reference checks
    - Other statements which could harm employees

2. Zone of interest.

a) Facts: Employee reports a problem of sex discrimination at work. She was engaged to be married to a fellow employee. Both were rated as average employees at the time.

- Within 3 weeks of the sex discrimination claim, the male fiancé was terminated.

b) Take Away:

- Does this raise to a retaliation claim?
- Yes, it does. The Court found that employers can't do indirectly what it can't do directly. The Company punished the female employee by firing the male worker.
- The Company found a way to go from 1 claim to 3 claims.
- How far does this "zone of interest" extend?
    - Son/daughter
    - Other family
    - Close personal friend

3. Prior Whistle Blowing.

a) Facts: An employee questions the decision of a company not to pay vacation pay to a terminated employee. The HR manager calls DILHR to ask if this was correct under the law. HR tells management that he/she called DILHR and was told vacation pay had to be paid. Performance issues with the HR manager developed months later. Ultimately the HR manager was terminated.

b) Take Away:

- The employer had very little in the way of documentation on the poor performance of the HR manager.
- No bright-line test from "whistle blowing" to adverse job action.
- Documentation, documentation.

4. Validity of Complaint.

a) Facts: A female worker complained about sexual harassment based on a single comment made by her male supervisor; "Making love to you is like making love to the grand canyon." Later she is transferred to a new position, a position she viewed as undesirable. She files both a sexual harassment complaint and a retaliation complaint.

b) Take Away:

- The Court looked at the underlining sexual harassment claim. The Court found that this was only one isolated remark and as such did not rise to sexual harassment. It further found that it did not form a good faith basis for a retaliation claim.
- The initial whistle blowing cannot be just about anything.
  - Good faith
  - Not based on a misunderstanding of the law
- Employer is not stopped in their tracks with an employee just because they may have made a prior claim or objection.
- For the employee, the person must understand the serious nature in bringing complaints of harassment and/or discrimination.

5. Participation in Investigation.

a) Facts: A female employee was interviewed as part of an investigation of sexual harassment of another female employee. The interviewed female complained she was harassed as well. She was later fired from her job. She brought a retaliatory claim.

b) Take Away:

- A retaliatory claim can be made even if the person was not the one complaining of the misconduct. It applies to those who participate, testify or cooperate in an investigation.

6. Change of Position.

a) Facts: A female worker complained about a gender-based discrimination claim she had with her supervisor. The Company investigated the claim and as a result, suspended the supervisor for 10 days and sent him to training. On the same day, they transferred the female worker to a different job within the same class of job with the same pay. The female worker brought a retaliation claim for her transfer.

b) Take Away:

- An adverse employment action does not mean a termination or demotion. Subtle adverse changes to the terms of employment is sufficient to establish retaliation. Anything other than "petty slights, minor annoyances or lack of good manners" can be the basis for a retaliation claim.

D. Conclusion.

This is another important issue which must be tracked when terminating or disciplining employees. As I have often said, these and almost all other potential claims can best be managed with good documentation.

IV. BONUS DISCUSSION

A. Important new changes in Wisconsin's unemployment insurance eligibility requirements. Good news for employers.

SECTION 6

WHAT TO EXPECT IN
LITIGATION, MEDIATION AND ARBITRATION

OVERVIEW

This presentation will focus on the nuts and bolts of civil litigation, including trial court practice, mediation and arbitration. Although you may be familiar with the way that the system works from popular media, you should know exactly what to expect if and when you are actually involved in a case.

I. LITIGATION

Litigation encompasses a broad range of activities. Generally speaking, litigation refers to the process of preparing a case for trial, trying the case to final judgment and, potentially, handling an appeal of the case after judgment.

A. Types of Court Cases

Wisconsin Circuit Courts hear criminal cases, forfeiture cases (mostly county traffic tickets and ordinance violations), civil cases, probate cases and juvenile cases. In 2012, there were 46,455 cases filed with the Racine County Circuit Court. Most of these, 26,964, were country traffic tickets and ordinance violations. These result in a fine and are mostly uncontested. There were 6,243 criminal cases filed, including 1,428 felony cases, 2,752 misdemeanor cases and 2,063 criminal traffic cases (mostly DWIs and operating with a revoked license cases). There were 11,243 civil cases filed, but only 2,563 of those were "conventional" civil cases. Most of the rest were small claims cases, as well as divorce and paternity cases. Finally, there were about 2,000 probate and juvenile cases filed in 2012. As you can see, litigation comes in many forms and civil cases comprise only a small part of the Circuit Court docket. This presentation will focus on civil litigation at the Circuit Court level.

B. State vs. Federal vs. Private

Litigation takes place in multiple forums. Most municipalities have their own courts that handle local ordinance violations, which may result in a fine. There are state courts, such as the Racine County Circuit Court, the Wisconsin Court of Appeals and the Wisconsin Supreme Court. Various state agencies, such as the Department of Workforce Development, also have their own administrative proceedings which, ultimately, may be reviewed by the state courts.

The structure is similar on the Federal level. Trials take place at the District Court level, such as the United States District Court for the Eastern District of Wisconsin in Milwaukee (the Western District is based in Madison). From there, appeals go to the regional appellate court, which in our case is the 7th Circuit Court of Appeals in Chicago, and from there to the United States Supreme Court. Numerous Federal agencies also have their own administrative tribunals, whose cases may eventually be reviewed by the applicable District Court. Finally, some disputes are handled through private arbitration, which is a completely different system that operates outside of the jurisdiction of the foregoing courts but whose ultimate decisions may be reviewed by them.

C. Multiple Stages

Civil litigation generally consists of 3 stages: pre-trial, trial and appeal. I will discuss these stages at length. Each has different procedures that apply, and each is extremely important in its own way.

D. Schedule

This is a rough schedule of a typical civil case:

January 1	Complaint filed
January 10	Summons and Complaint served on defendant
January 30	Defendant files answer and counterclaims
February 20	Plaintiff answers defendant's counterclaims
March 20	Court holds conference with parties to schedule case
April-September	Parties conduct discovery
May 31	Plaintiff files witness list with Court
July 31	Defendant files witness list with Court
September 15	Deadline for parties to file summary judgment
September 30	Deadline for parties to mediate dispute
October 1	Discovery deadline
October 15	Trial

Frequently, civil cases depart from this schedule. The parties may resolve the case relatively quickly, or they may agree to postpone the trial because they need more time for discovery or because of a scheduling conflict. Some civil cases are scheduled for trial a few times before actually being tried.

E. What you should know going in

Litigation can be a frustrating experience. It is expensive, time-consuming and stressful. When you enter into litigation, you are giving someone else—a judge or a jury--control over your fate. The final result is often uncertain, and there are no guarantees. What initially appears to be a strong case may wind up losing, and what looks like a certain loser may actually prevail.

II. ISSUES LEADING UP TO FILING A COMPLAINT

A. Investigation before filing a case

A trial attorney has a professional and ethical obligation to investigate a matter thoroughly before filing a case. This investigation may include:

1. Interviewing witnesses
2. Reviewing documents
3. Visiting locations where events occurred, such as a construction site or the scene of an accident
4. Inspecting physical items, such as photographs or videos
5. Research into legal theories and claims

An attorney has a statutory and ethical obligation to perform a reasonable inquiry into any representations that he makes to a Court, and may not file frivolous claims, claims unsupported by any evidence or claims intended merely to harass or cause unnecessary delay. *See* Wis. Stat. § 802.05(2); Supreme Court Rule 20:3:1 (similar language); SCR 20:3:3 (prohibiting lawyers from making false statements to a Court or offering false evidence).

A thorough investigation before filing a case assists the lawyer and client in numerous ways. It identifies potential legal claims that may be pursued, assists the lawyer and client in understanding the strengths and weaknesses of a case, and may uncover more information than if litigation were pending and an adverse party was involved. However, without pending litigation, an attorney lacks the power to compel the production of witnesses or documents by subpoena.

B. Statute of Limitations

Wisconsin law limits the amount of time that a party has to bring a claim. For example, a lawsuit for breach of contract must be filed within 6 years of the date that the breach occurred. *See* Wis. Stat. § 893.43. A personal injury lawsuit, on the other hand, must be filed within 3 years of the date that the injury occurred. *See* Wis. Stat. 893.54. However, the "discovery rule" may alter that time period. Sometimes, it may not be clear until years later that a plaintiff's injuries were caused by another party, even if the plaintiff has been reasonably diligent. Once the plaintiff discovers the causal connection, the 3-year statute of limitations begins to run. There is no corresponding "discovery rule" for breach of contract claims.

C. Jurisdiction and Venue

Wisconsin state courts generally have jurisdiction over cases arising in this state that affect residents of this state. *See* Wis. Stat. § 801.05. Wisconsin state courts also have jurisdiction over real estate located in this state. *See* Wis. Stat. § 801.07. Federal courts hear claims arising under the United States Constitution or Federal law, such as cases alleging discrimination. Federal courts may also handle cases involving residents of 2 different states, if the amount in dispute exceeds $75,000.

Venue means which county within Wisconsin may hear the case. Often, all parties are located in the same county, making the venue determination easy. But venue may be where the claim arose, where the real estate is located or where the defendant lives or does substantial business, if the defendant is a corporation. *See* Wis. Stat. § 801.50.

III. COMPLAINT, ANSWER AND COUNTERCLAIMS

A. Filing a lawsuit

A lawsuit commences with the filing of a written complaint. *See* Wis. Stat. § 801.02. The complaint identifies the parties to the case, the legal claims that the plaintiff has and the relief sought. Typically, the plaintiff seeks monetary damages as compensation for his claims. However, in some cases, the plaintiff may ask the court for injunctive relief. To prevent irreparable harm, a court may freeze the status quo while a case is pending if it feels that the plaintiff is likely to win. *See* Wis. Stat. § 813.02. There is a $265.50 fee to file a civil complaint in Wisconsin.

B. Small Claims Procedure

A separate procedure exists for small claims cases, which are typically cases where less than $10,000 is in dispute or where a landlord seeks to evict a tenant. *See* Wis. Stat. § 799.01. These cases are often heard by a court commissioner, not a judge, to expedite the process. Many of these cases are handled without a lawyer. A losing party may appeal to the Circuit Court.

C. Service of Process

Once a civil Complaint is filed, the plaintiff must serve it on the defendants, along with a written Summons. The Summons informs the defendant that he has been sued and that he must file an answer to the lawsuit with the Court and the plaintiff within a certain period of time or he will default. *See* Wis. Stat. §801.095. If the lawsuit contains a tort claim, such as a claim for personal injury, or an insurance company or the State of Wisconsin is named as a defendant, they have 45 days after being served to answer the Complaint. In all other cases, the defendants have 20 days to answer the Complaint after service of process. *See* Wis. Stat. § 801.09.

A process server typically hands a copy of the Summons and Complaint to the defendant in person, if the defendant can be located. Otherwise, the process server may leave the Summons and Complaint with an adult at the defendant's residence or business. *See* Wis. Stat. § 801.11. If none of that works, the plaintiff may publish a notice of the lawsuit in a local paper and mail the Summons and Complaint to the defendant's last-known address.

D. Answer and Counterclaim

A defendant must specifically answer each claim in the plaintiff's Complaint in writing. *See* Wis. Stat. § 802.02. Often, a defendant will also include counterclaims against the plaintiff, which are assertions that the plaintiff has actually wronged the defendant and owes the defendant money (or other relief). The counterclaims may relate to the same transaction as the plaintiff's Complaint, or may pertain to entirely separate matters. *See* Wis. Stat. § 802.07. The time for a plaintiff to answer a counterclaim is the same as for a defendant to answer a Complaint.

E. Default Judgment

If a defendant fails to answer a Complaint in a timely manner, a plaintiff may file a motion for default judgment. *See* Wis. Stat. § 806.02. The motion asks the Court to enter judgment against the defendant for failing to comply with the rules of civil procedure. The motion must also be served on the defendant, even though the defendant has failed to respond to the Complaint. Unless the defendant can show excusable neglect for failing to answer the Complaint in a timely manner, the motion will be granted.

IV. DISCOVERY

A. Purpose

Civil litigation is not supposed to be "trial by ambush." The parties are required to share information with each other, or at least provide the other side with an opportunity to review their information and speak with their witnesses. The parties usually cooperate through this process, and usually the Court does not need to be involved. Nevertheless, the discovery process can last several months.

When a case goes to trial, only certain evidence will be admissible. Discovery is not limited to that narrow class of evidence, however. A party may investigate any matter that *may lead* to the discovery of admissible evidence. For example, a defendant may ask a plaintiff for documents that the plaintiff considers to be irrelevant to the case. Nevertheless, the plaintiff may still be required to turn them over. The fact that the plaintiff disclosed the documents in discovery does not make them admissible at trial. The plaintiff will later have the opportunity to object if the defendant tries to use the documents at trial.

B. Depositions

Depositions are the most effective means of discovery because they most closely resemble trial testimony. A party may depose any witness to the case. *See* Wis. Stat. §804.05. All parties are required to make themselves available for deposition. In addition, a party may subpoena other witnesses and compel them to appear for a deposition. The subpoena may also require these witnesses to bring documents with them.

During a deposition, a witness swears under oath to tell the truth and is asked questions about the case and just about anything else that might be relevant. Discovery is intended to be broad and far-reaching because it is not always possible to predict what may or may not be important at trial. Thus, very few topics are off-limits in a deposition.

A court reporter records everything that is said during a deposition. That record is converted into a written transcript that is provided to the attorneys, and may be used at trial to impeach the witness if his testimony differs from the deposition. Occasionally, depositions are video-taped, especially if it is possible that the witness may not be available for trial.

Depositions usually take place in a law firm conference room. The attorneys, the court reporter, the witness, and sometimes the parties attend. Depositions may last as long as necessary to cover all the issues and allow all parties the opportunity to question the witness.

C. Interrogatories

Interrogatories are written questions served upon an opposing party. The recipient must answer the questions in writing, under oath, within 30 days of receipt. *See* Wis. Stat. § 804.08. Some counties, such as Milwaukee County, limit the number of interrogatories that you can submit to an opponent. It is not uncommon for an answering party to object to an interrogatory and refuse to answer it. Consequently, interrogatories are no substitute for a deposition. However, they can be an effective means of identifying witnesses and discovering the theory of an opponent's case.

D. Requests for Documents

In almost every case, each party requests documents from the other side. Generally speaking, the documents that are requested are those that pertain to the party's claims or defenses in the case. The term "document" is broadly defined to include electronic records, faxes, invoices, photographs, videos, handwritten notes and essentially anything else with writing on it. Once again, the party whose documents are being requested has 30 days to respond. *See* Wis. Stat. §804.09. It is not uncommon for thousands of pages of documents to be disclosed in a civil case.

A party to a lawsuit has an obligation to produce all documents that are requested. A party may not destroy any documents or conceal them from discovery. However, a party is only required to produce those documents that are in its custody and control. If, for example, the documents are in the possession of another person, the party does not have to go get them from that person. An exception to this is if the other person is an agent of the party, such as an accountant or a lawyer. In those circumstances, the party is considered to be in control of the documents because it is their agent who possesses them on the party's behalf.

E. Subpoenas

A party to a civil lawsuit has the power to subpoena third-parties for deposition and even compel them to produce documents relevant to the case. *See* Wis. Stat. §805.07. A third-party must be given "reasonable" notice of their deposition, and may not be compelled to travel more than 100 miles to that deposition. All other parties to the case must be given notice of the third-party deposition.

F. Privilege

Certain types of evidence are considered privileged and are protected from disclosure. These include communications between a person and his attorney, certain medical professionals or members of the clergy. *See* Wis. Stat. §§ 905.03-905.06. During a deposition, for example, a witness cannot be forced to answer questions about discussions that he has had with his attorney. If the question arises, the attorney for the witness will object and direct his client not to answer. Unfortunately, this is the basically the only time a witness can refuse to answer a question in a deposition.

G. Discovery Motions

Most discovery takes place without any involvement from the court. On occasion, however, it may be necessary to get the court involved in a discovery dispute. The most common situations are when a party refuses to comply with discovery or when a party seeks to protect certain information from disclosure. In the former situation, the party seeking discovery may file a motion to compel the non-compliant party to turn over the requested information. *See* Wis. Stat. § 804.12. The court holds a hearing on the motion and decides whether the information must be turned over or not. Judges generally dislike these motions, however, and sometimes punish the moving party instead.

If a party has legitimate reasons for refusing to disclose information in discovery, the proper procedure is to file a motion for a protective order. *See* Wis. Stat. § 804.01(3). To protect a party from annoyance, embarrassment, undue expense or to protect against the disclosure of confidential information (such as a trade secret), the court may grant the motion and order that the discovery not take place or take place under certain conditions. Sometimes, the court will order that a party file information under seal so that it does not become public.

V. SUMMARY JUDGMENT

Civil cases typically have factual and legal issues that need to be decided. Frequently, the parties disagree on the essential facts. For example, in a car accident case, the parties may disagree whether the traffic light was red or green. In that situation, a trial is necessary to decide the facts. The legal system relies on a jury of our peers to make those kinds of decisions and places great weight on the determinations made by jurors, especially when it comes to the credibility of witnesses.

However, if the facts are undisputed, the only decision that needs to be made in the case is a legal one. Juries are not allowed to make those decisions because they do not have the training or expertise to do so. Instead, only a judge can decide legal questions. No trial is necessary, and the judge can base his decision on the briefs of the parties.

A motion for summary judgment asks the Court to decide the case without a trial because there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. *See* Wis. Stat. § 802.08. It is common for a motion for summary judgment to be filed in civil cases. Each party files briefs with the Court regarding the motion, and the Court decides whether the grant the motion or not. If a defendant files a motion for summary judgment and it is granted, the case is dismissed. If a plaintiff files the motion and wins, he receives a judgment against the defendant. Motions for summary judgment are therefore pivotal motions in the case and much time and effort is devoted to preparing and briefing them.

VI. MEDIATION

Mediation is a procedure to settle a lawsuit short of trial. Circuit Courts routinely order that the parties in a civil case engage in mediation before trial. This is because the vast majority of civil cases do not go to trial. The Circuit Court's calendar is clogged with cases, so judges are always looking for ways to free up their schedule. It is also possible to mediate a private dispute where no lawsuit has been filed.

Mediation is usually conducted by an experienced attorney or retired judge who has no ties to the lawsuit or the parties involved. The mediator should be familiar with the type of case that is being mediated. The parties will also have an opportunity to submit information to the mediator in advance of the mediation so that the mediator understands the various claims involved in the case. However, the mediator does not decide the case and does not have the power to force either party to settle. Instead, the mediator uses his experience and his powers of persuasion to try to convince the parties to come to a resolution.

While the parties must initially participate, they are free to terminate the mediation at any time. Everything that is discussed in the mediation is confidential and cannot be used at trial. This is designed to encourage the parties to speak frankly about their cases and objectively evaluate the strengths and weaknesses of their case.

If the mediation is successful, the mediator will prepare a basic settlement agreement and have the parties sign it before they leave. This agreement is a binding contract that one party can enforce against the other.

VII. TRIAL

If the case has not been resolved through settlement or a motion for summary judgment, it will be tried to a judge or a jury. A party must request a jury trial at the outset of a lawsuit and pay a jury fee, typically $6 per juror. *See* Wis. Stat. § 805.01. A party may later decide to waive their right to a jury trial and have the case tried to the judge. There are advantages and disadvantages to trying a case to a jury as opposed to a judge. For example, judges are generally considered to be less emotional and more rational than jurors, whose personal biases may cloud their judgment. On the other hand, attorneys typically know individual judges fairly well, both from the years that the judge has spent on the bench and from their years as an attorney before that. An attorney may be aware of a judge's personal feelings, which may affect the ultimate decision at trial.

A jury trial begins with "jury selection," which is actually jury elimination. The attorneys have the right to preemptively strike certain jurors without explanation. *See* Wis. Stat. §805.08. Other jurors may exhibit prejudices or personal biases which requires their exclusion. Whoever is left from the jury pool will serve as jurors in the case. The process of jury selection typically takes up the first morning of trial.

Once the jury is empanelled, the attorneys give opening statements that attempt to summarize the evidence that will be introduced at trial. The plaintiff then calls witnesses in support of his case, who are subsequently cross-examined by the defendant's attorney. Once the plaintiff finishes his case, the defendant has an opportunity to call witnesses in support of his case. There are numerous rules of evidence which govern the testimony of witnesses (and that is a topic for another day). After the testimony is completed, the attorneys will give closing arguments and the jury will be instructed by the judge on the legal standards that govern its decision. The jury will be given a verdict to fill out, either in favor of the plaintiff or defendant, and excused from the courtroom to deliberate.

The jury's deliberations are self-governed and open-ended. In a civil case, a verdict must typically be agreed to by 5/6ths of the jury. *See* Wis. Stat. § 805.09. Occasionally, a jury will deadlock and be unable to reach a 5/6ths verdict. If the deadlock continues after the judge gives them additional time, the judge will declare a mistrial and the whole trial will have been for nothing. The parties will have the opportunity to try the entire case over again, if they wish.

VIII. JUDGMENT

The prevailing party in a civil lawsuit receives a monetary judgment against the losing party. *See* Wis. Stat. § 806.01. Simply put, a judgment is a piece of paper signed by a judge that says one party owes the other party a sum of money. Actually collecting that money is an entirely different matter.

After a judgment is issued by the court, it must be docketed with the Clerk of Courts for $5. Once docketed, the judgment shows up on credit reports and acts as a lien on any property owned by the defendant. Interest begins to accrue, although the Legislature recently lowered the post-judgment interest rate from 12% to prime plus 1%, which currently amounts to 4.25%. *See* Wis. Stat. § 815.05(8).

In addition to the actual damages awarded as part of the judgment, a plaintiff can recover court costs (such as the filing fee and service of process fee) and a nominal amount for attorney's fees. *See* Wis. Stat. § 814.04. Typically, a plaintiff may not recover his actual attorney's fees as part of a judgment. The only exceptions to this are if fees are authorized by statute or if the plaintiff is suing the defendant for breach of contract and the contract specifies that the prevailing party may recover fees.

If a defendant refuses to voluntarily pay a judgment, a plaintiff may compel him to disclose wage information, bank account statements and information concerning property that he owns. To collect on a judgment, a plaintiff may garnish wages or bank accounts or seize property owned by a defendant.

A major risk for any plaintiff is that a defendant is uncollectible. During the economic downturn of the past few years, bankruptcy filings skyrocketed, and many defendants were able to discharge judgments against them. In addition, some defendants simply have no money to pay a judgment. All plaintiffs should consider not only what is necessary to obtain a judgment but also how difficult it will be to actually collect on the judgment.

IX. APPEAL

The losing party at the Circuit Court level in Wisconsin has the absolute right to appeal that adverse decision to the Wisconsin Court of Appeals. The losing party must file a notice with the Clerk of Courts that it intends to appeal within 45 days of the Court's judgment. *See* Wis. Stat. § 808.04. This triggers the Court of Appeals' jurisdiction over the case. The Clerk of Courts then compiles the entire record of the case from the Circuit Court and sends it to the Court of Appeals, along with copies of the transcripts from all the court hearings and the trial, if there was one. Since the Court of Appeals is ultimately deciding whether the Circuit Court performed its job properly, the Court of Appeals must be able to review everything that happened at the lower court level.

Once the entire court record of the case is sent to the Court of Appeals, the losing party (now called the appellant) must file its brief in support of the appeal within 40 days. *See* Wis. Stat. 809.19. The prevailing party at the Circuit Court level, now called the respondent, must file a brief opposing the appeal within 30 days of receiving the appellant's brief. The appellant then has 15 days to file a final, reply brief. Once the briefing is complete, the Court of Appeals reviews everything and issues its decision. This may take several months.

While an appeal is pending, the underlying judgment is valid and enforceable. When the losing party files its appeal, it may also ask the Circuit Court to stay enforcement of the judgment pending appeal. If the Circuit Court stays the judgment, it may force the appellant to post a bond while the appeal is pending. *See* Wis. Stat. § 808.07.

The Court of Appeals generally either affirms the decision of the Circuit Court or overturns it and remands the case to the lower court for further proceedings consistent with the Court of Appeals' decision. A party which receives an unfavorable decision from the Court of Appeals may ask the Wisconsin Supreme Court to review the case. The Supreme Court has the discretion to refuse to hear any case, and typically chooses to review cases involving unsettled or unique areas of law. In its 2011-2012 term, for example, the Wisconsin Supreme Court received 824 Petitions for Review, and granted only 51 of them. It issued only 102 decisions during that term, and 40 of those involved attorney discipline cases (which, if contested, must be heard by the Supreme Court). Thus, the likelihood of the Supreme Court taking a case on appeal is quite low.

X. ARBITRATION

Arbitration is a mostly private procedure that can be a substitute for the courts. Arbitration arises by contract, so both parties must agree to engage in it. Arbitration is generally binding on the parties, meaning that they must abide by the result. A prevailing party in arbitration may seek to convert that decision into a court judgment.

Arbitration frequently arises in the employment context, but it can be seen in other contractual relationships as well. In the contract, the parties specify that any disputes will be subject to arbitration. There are several agencies which provide arbitration services, most notably the American Arbitration Association (AAA). The AAA has retained former judges and experienced attorneys around the country who are prepared to handle disputes. When two parties seek to utilize the AAA's procedure, the AAA will provide them with a list of potential arbitrators, and the parties will choose who they want to hear their case. The potential arbitrators usually have expertise and experience with the issues that are to be arbitrated. For example, if the case involves engineering issues, the AAA will provide the parties with a list of attorneys who have worked on similar matters before. Like a mediator, an arbitrator should be unbiased and have no prior relationship with the parties and no prior personal knowledge of the facts of the case.

There are substantial fees associated with arbitration. The AAA charges a fee to initiate the case which is tied to the amount in controversy and starts at approximately $1,000 for cases where less than $10,000 is at issue and can range as high as $7,500 for cases where $300,000 is in dispute. Additionally, the parties are responsible for paying the arbitrator's fees for his time. Like attorneys, arbitrators bill at an hourly rate which depends on their market. In Milwaukee, an arbitrator may charge upwards of $300 per hour while the rate can go as high as $600 per hour in Chicago. This can add up quickly, as the arbitrator reviews briefs and holds hearings on the case. However, unlike in the Circuit Court, the prevailing party in arbitration typically can recover all of its attorney's fees and costs, including what it has paid to the AAA and the arbitrator.

Arbitrations are not public record. In fact, most arbitrations have no record at all. The arbitrator simply reviews what is submitted and makes a decision. Arbitrations tend to move very quickly. If there is a hearing, the parties have to pay to have it transcribed, if they wish. The speed and secrecy of arbitration is a substantial incentive for many businesses.

An arbitrator's award cannot be enforced unless it is affirmed by a court and converted into a judgment. At that stage of the process, the party which lost at arbitration can ask the court to overturn the arbitrator's award. However, if there is no record to review, the court has little basis to set aside the arbitrator's decision. Further, courts generally defer to an arbitrator's decision. Consequently, it is extremely difficult to persuade a court to overturn an arbitrator's ruling.

SECTION 7

AWHAT EVERY LANDLORD MUST KNOW ABOUT THE LAW

I. RESIDENTIAL LEASES

A. What to Include:

1. Contact
   a) Landlord
   b) Agent
2. Description of Premises
   a) Unit
   b) Land
   c) Use of Common Areas
3. Term
   a) Month-to-Month
   b) 1-Year
   c) Multi-Year
   d) Options
4. Rent Amount
   a) Utilities
   b) Additional Items
5. Sale of Property
   a) Option to Terminate
   b) Release of Landlord Liability

6. Abandoned Property

    a) Landlord's Discretion

    b) Must also give Notice Upon Renewal

7. Insurance Requirements

8. Pets

9. Use

    a) Residential Only

    b) Prohibited Activities

10. Lead-Based paint

    a) Sign-off Sheet

    b) Pamphlet

11. Security Deposit

    a) Paid

    b) Amount Due

        (i) Use Separate Sheet

        (ii) Allows you to keep deposit and terminate if not paid

12. Smoke Detector/Carbon Monoxide

    a) Separate Form

        (i) In the Unit

        (ii) Working

        (iii) Tenant Responsible for Batteries

13. Automatic Renewals

    a) At Least 15 Days

b) Not more than 30 Days

14. Non-Standard Terms

a) Bold

b) Initial

c) Typical Terms

(i) All Additional Fees

(ii) Tenant Maintenance

1. Lawn Care

(A) Municipal Fines

(B) Indemnification

d) Anything Unusual

15. List of Appliances

a) Appliances Landlord will Maintain

b) Appliances Tenant will Maintain

c) Option to Remove Washing Machine

B. What Not to Include:

1. Tenant Rights

a) 21 Days to Return Security Deposit

2. Attorney Fees

a) Cannot be included in residential leases

3. Voidable Provisions: If included Lease is voidable by Tenant

a) Authorizes eviction other than by judicial eviction

b) Provides for acceleration of rent

c) Waives landlord's duty to mitigate

d) Provides for recovery of attorney fees

e) States that the landlord is not liable for property damage or personal injury caused by negligent acts or omissions of the landlord

f) Imposes liability on a tenant for any of the following:

(i) Personal injury arising from causes clearly beyond the tenant's control

(ii) Property damage caused by natural disasters or by persons other than the tenant or the tenant's guests or invitees

g) Waives any statutory or other legal obligation on the part of the landlord to deliver the premises in a fit or habitable condition or to maintain the premises during the tenant's tenancy.

h) Allows the landlord to terminate the tenancy of a tenant if a crime is committed in or on the rental property, even if the tenant could not reasonably have prevented the crime.

II. EVICTION PROCESS

A. Give Notice

1. Standard Notices

a) 5 Day:

(i) Overdue Rent

b) 14 Day

(i) Other Breach

1. Waste

2. Material Violation

c) 28 Day

(i) Month-to-Month

(ii) Prior to Commencement of Month or Period

d) 30 Day

(i) Leases longer than 1 year

2. How to Give Notice

a) Personal Service

b) Post and Mail

c) Certified Mail

B. File

C. Serve

D. Hearing on Writ of Eviction

E. Hearing on Damages

1. Given upon occupancy

2. 7 days to complete

F. Documentation

1. Starts Before Tenancy

a) Pictures or Video

(i) Include Date

2. Check-in Sheet

G. Checkout

1. Pictures or Video

a) Include Date

2. Inspection Sheet

III. SECURITY DEPOSITS

A. Only withhold amounts to pay for following:

1. Tenant Damage
2. Unpaid rent
3. Utilities pursuant to lease terms
4. Utilities owed by tenant that landlord becomes responsible for
5. Unpaid municipal permit fees

B. Cannot withhold for normal wear and tear

1. Carpet Cleaning
2. Paint

C. Transmittal Letter

1. Send within 21 Days
2. Treble Damages
3. Attorney Fees

IV. LOCAL ORDINANCES

A. Vary by location

B. Additional burden and fees on Landlord