Morgan Stanley

TAX TRUST AND ESTATE PLANNING CONSIDERATIONS WHEN SELLING A BUSINESS

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Selling a business is complicated. On the one hand, the owner is trying to realize the greatest potential for the business monetarily as well as strategically both of which will impact the owner and the employees. If this is the first monetization event for an owner, not only does the owner have to learn and evaluate his/her strategic business alternatives but also is tasked with learning and planning for his/her current and/or potential beneficiaries simultaneously. Oftentimes, the immediacy of the strategic deal overwhelms and usurps any thought of personal planning. It is for this latter reason that the sooner a business owner begins learning about financial as well as trust, tax and estate planning the better as it should afford peace of mind, confidence and flexibility later should a liquidity event present itself.

Additionally, consideration of the business liquidity event in the context of personal planning may inform the owner to accept a different offer whether it is all stock, all cash or a combination. Generally, an all cash offer may be for a lower dollar amount given the liquidity and immediacy of proceeds while an all-stock offer may be for a higher dollar amount given the embedded uncertainty of the future stock price. If the owner bases his/her risk tolerance on the offer alone, s/he may forgo other potentially increasingly beneficial outcomes. For example, if the owner anticipates the future appreciation of the stock then the owner should not just consider the appreciation in the context of the owner but also consider the potential value of this appreciation for the owner's beneficiaries. Embedded in the "fair market value" of the share of the company is not only the value of the company but also the value of the potential trust, tax and estate planning possibilities for the owner. In short, if an owner values shares in his/her company absent of trust, tax and estate planning, the owner may incorrectly value an offer for sale.

The coordination and management of the owner's corporate and personal advisors and consultants is critical. To determine the true integrated value of a company to the owner, all of the professionals consulting with the owner must understand how their advice and decisions may impact others' advice and decisions. The owner should have two "teams" of consultants, one for the company and one for him/herself. The company should have an investment banker consulting on the transaction working in concert with corporate counsel and accountant. The owner should have a financial advisor consulting on the planning in light of the transaction in concert with individual trust, tax and estate counsel and accountant. The cooperation between the investment banker and the financial advisor coordinating and managing the respective teams of professional advisors is paramount for the owner to achieve the most advantageous outcome.

In short, the investment banker working with the team of corporate consultants may influence the degree to which money goes to the acquiring and receiving companies as well as to the government via taxes. The financial advisor working with the team of personal consultants may influence the degree to which money goes to the owner's family, charity and the government via taxes. The following case study provides examples of how personal planning in the context of an impending sale may influence an owner's decision making process with regard to planning as well as to his/her preference for cash and/or shares.

Hypothetical Background

Mr. Smith has spent a lifetime creating and building his company. Over time, he has grown the business and welcomed additional shareholders to finance expansion. Currently, Mr. Smith owns 50% of the business whose estimated value is $100 million. His ownership consists of 50% shares, currently $10 with zero cost basis, as well as 25% incentive stock options (ISOs) and 25% non-qualified stock options (NQSOs), all granted many years ago with a strike price of $2. Mr. Smith earns $500,000 in salary each year and has accumulated $10 million in investment assets outside the company. Mr. Smith would like to sell the company in the near future after a new product is launched which he thinks will increase the company value by 40% in each of the next couple of years. After the sale of the company, Mr. Smith will work for five years and then retire to spend more time with his wife and two children. Mr. Smith expects to continue to need $500,000 each year post retirement to live.

General Assumptions

Company	Current Year	Current Year
	Sale Year	Current Year + 2 Years
	Options Grant Year	Many Years Prior to Current Year
	Options Strike Price	$2
	Current Value of Stock/Share	$10
	Company Valuation	$100,000,000
	Growth Rate of Stock	40%
	Client's Shares of Stock	2,500,000
	Value of Stock in 1 Year	$14
	Value of Stock in 2 Years	$20
	Stock Cost Basis	$0
Client	% of Shares Owned	50%
	Stock	50%
	NQSOs	25%
	ISOs	25%
Other Holdings	Personal Account	$10,000,000

* Hypothetical results are for illustrative purposes only and are not intended to represent future performance of any particular investment. Your actual results may differ. The principal value and investment return of an investment will fluctuate with changes in market conditions, may be worth more or less then original cost. Taxes may be due upon withdrawal.

Pre-Liquidity Planning

While preparing his company for a future sale, Mr. Smith consults his financial adviser to investigate the impact of a sale on his family's financial future. Mr. Smith's financial adviser, in conjunction with Mr. Smith's accountant and lawyer, assist him in evaluating opportunities to do income/capital gains and estate tax planning prior to the liquidity event.

Stock Options

Mr. Smith's financial adviser explains ISOs and NQSOs execution strategies to illustrate how exercising earlier rather than later, given Mr. Smith's expectation for the growth of the company, may enable Mr. Smith to lock in a lower price for income tax calculations and begin the holding period for capital gains tax treatment. Specifically, Mr. Smith learns that if he sells his ISOs at least two years from the grant date and one year from exercise, then he will effectively pay capital gains on the appreciation above the strike price otherwise he may be subject to the higher of the alternative minimum tax (AMT) rate and the income tax rate depending on when he sells the underlying stock. Additionally, while the NQSOs do not have the potential for such favorable tax treatment given income taxes apply to the difference between the exercise and strike price, Mr. Smith may benefit from exercising them sooner at a lower exercise price and beginning the holding period for capital gains calculation for the difference in value between the future sale price and the execution price. If Mr. Smith prefers to sell the NQSOs earlier than one year from exercising then ordinary income tax rates apply.

Once Mr. Smith understands the potential benefits of options exercising strategies, the adviser also explains the risk of using capital in the amount of the cost of exercise and payment of taxes in order to potentially realize an uncertain tax benefit and higher future stock price. If, however, liquidity and access to capital become an issue, executed shares could be sold and proceeds from the sale less the higher income tax rates would become available. (Mr. Smith could do a "cashless" exercise of the NQSOs whereby he would exercises and immediately sell the shares to cover the cost of exercise and taxes however he would then forgo the potential increase in value of shares Mr. Smith believes will happen in the next couple of years.)

Estate Tax

With regard to Mr. Smith's existing and future shares, the financial adviser introduces the concepts and benefits of estate tax planning. At death, an estate tax is applied to the fair market value of all assets in a person's estate (given the Smiths are married, each of Mr. and Mrs.'s assets would fall into their spouse's estate and the estate tax would apply on the death of the second spouse). The greater the estate, the greater the estate tax, so the extent to which the Smiths can get assets out of their estate and to their children and/or charity, the Smiths will mitigate estate tax. Underpinning estate planning decisions is the balance between retaining assets so that they may live comfortably during their lifetimes and getting assets outside their estates by utilizing available exemptions and legal structures so any potential future appreciation grows outside the estates.

Exemptions may be recurring as well as a specified amount. For example, $14,000 per parent per child may be given tax free each year (additionally, $14,000 per parent may also be given to other individuals each year tax free as well). Additionally, education and medical expenses may be paid on behalf of others tax free as long as the monies are given directly to the institutions and not to the individuals. Over the course of their lifetimes, each of the Smiths may give $5.49 million to beneficiaries tax free. Given the net worth of the Smiths

($50 million in company and $10 million in liquid assets) and the anticipated future appreciation of the company's shares, it may be prudent for the Smiths to begin utilizing their lifetime exclusions sooner rather than later if they have not already done so.

Given that the Smiths have not already used their lifetime exemptions, together between the two of them, they have the ability to get $10.98 million outside of their estates tax free which in the context of their $60 million net worth should not impact their ability to live comfortably (or in this case generate $500,000 per year to replace Mr. Smith's annual salary once the company is sold). The assets available to be gifted are the shares, options and the investible assets.

Additionally, it is not permissible to gift ISOs (NQSOs may be gifted if a licensing arrangement for the transaction is in place), so the remaining shares present the opportunity to do estate tax planning. However, if the valuation of the company does not hold or appreciate as anticipated, gifting the shares using the lifetime exclusions may not be prudent as the exemptions would be exhausted and the value of the gifts may decline below the original value thus potentially "wasting" some of the exemptions. Additionally, the cost basis of the stock goes with the gift, so a future sale of the company would incur a substantial tax liability negatively impacting the value of the gift.

GRAT

Alternatively, the Smiths could create a grantor retained annuity trust (GRAT) whereby any amount of shares could be put into the trust so that the potential future appreciation of the asset is captured outside the estate while the original asset itself flows back to the original owner, the Smiths. For (an overly simplified) hypothetical example, the Smiths could put $100 into a two year GRAT which might require two payments of $50 in each of the two years back to the Smiths. During the two years, the Smiths would pay any taxes incurred in the trust given its grantor status and any appreciation of the asset above the original $100 would flow out of the estate. Thus, the Smiths could get the potential appreciation of the company stock out of their estates and retain ownership of the original shares. Additionally, the technique may either not trigger any gifting or use some of the lifetime exemption depending on how it is structured and the laws prevailing at the time. While the above example is an oversimplification, it does generally illustrate the benefits of a GRAT. There are typically no major downsides to setting up a GRAT. If the GRAT does not work, assets flow back into the estate and the only loss is the initial cost of setting up the GRAT.

In the case of the Smiths, the degree to which they utilize the GRAT structure may be the company shares available to be put into the GRAT. So, the decisions concerning the degree and timing of the exercise of the options should be made in combination with the execution of the GRAT. Given that the Smiths will maintain their liquid assets to afford them flexibility and conservatism, a GRAT could be used with the Shares remaining after other shares are liquidated to pay the cost of option exercise and taxes. While the Smiths would like to benefit as much as they can from the potential increase in the stock price in the next couple of years, they will not use their $10 million in liquid assets to cover the cost of exercise and tax, rather they will use proceeds from the sale of stock. The stock they will sell is the stock they currently own as it will incur capital gains tax. If the Smiths sold the shares from the executed NQSOs then they would be forgoing the potential difference in income versus capital gains tax on the potential future appreciation of these shares.

Income Tax Rates

Federal Ordinary	43.40%
Federal Long-Term Capital Gains	23.80%
Federal AMT	31.80%

* These rates include the 3.8% Net Investment Income Tax that is applied to certain cases where income is above the statutory threshold amounts.

Pre-Liquidity Planning Scenarios

To analyze the questions of when to exercise options, how to fund the tax liability and cost of exercise by selling shares, and how many shares should be put in a GRAT, the adviser compares three hypothetical scenarios prior to the sale of the Smith's company. In all scenarios, the Smiths will sell their currently held shares to create the proceeds to fund the tax liability and cost of exercise. The remaining currently held shares are then available to be put into a GRAT so any future appreciation of the stock above the current price may be transferred to the Smith's children and not be included in their future estates. For all scenarios, the Smiths begin with $25 million in currently held stock, $12.5 million in ISOs and $12.5 million in NQSOs. Additionally, each GRAT is established in the current year and will have a two year term. Finally, in order to objectively evaluate the option/GRAT strategies, the scenarios temporarily disregard the potential future sale of the Smith's company and completely liquidate all strategies so the cash outcomes may be compared. Later in the analysis, this temporary assumption will be revisited and not done in order to show other potential beneficial effects of additional estate planning. The three scenarios are as follows:

1. The Smiths exercise the options now and sell the resulting shares in two years (in an attempt to benefit as much as possible from the potential higher future stock price);
2. The Smiths exercise options in one year and sell the resulting shares in two years (in an attempt to not only benefit from the potential higher future stock price but to also potentially increase the effectiveness of estate planning with a GRAT);
3. The Smiths exercise the options now and sell the resulting shares in one year (if the Smiths feel that the future potential appreciation in the stock may not be as favorable as initially anticipated).

Short Term GRAT Assumptions

Interest Rate on GRAT	2.0%
Inflation	2.0%
Term	2 Years

Scenario One

In the first scenario, in order to exercise the ISOs and NQSOs, the Smiths have to sell $15.9MM Stock to cover $12.1MM tax and exercise cost. Hence the GRAT has $9.1MM in year. In the current year + 1, the Smiths get back $4.7MM stock in kind from the GRAT. In the current year + 2, the Smiths get another $4.7MM stock from the GRAT. Because the stock grows at 40%, the Smiths get a total of $11.2MM stock. The children get a total of $6.6MM in the GRAT. For comparative purposes, both the Smiths and their children sell all stock in the current year + 2 resulting in the Smiths getting $49.9MM cash and their children getting $5.0MM cash for a combined outcome totaling $54.9MM.

Exercise Options Now and Sell in Two Years

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
ISOS			
Exercise Price	$2,500,000		
AMT Due on Exercise	$2,800,000		
Ordinary Taxes Due on Exercise	$0		
Sales Price			$24,500,000
Capital Gains Tax			$5,236,000
AMT Credit Applied			$420,000
Net Proceeds from ISOs			**$19,684,000**
Net AMT Credit Available			**$0**
NQSOs			
Exercise Price	$2,500,000		
Ordinary Taxes Due on Exercise	$4,340,000		
Sales Price			$24,500,000
Capital Gains Tax			$2,856,000
Net Proceeds from NQSOs			**$21,644,000**
Total Net Proceeds			**$41,328,000**

Sell Stock to Exercise Options

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
Cash to Cover Tax and Exercise Price	**$12,140,000**		
Gross Sale Proceeds	**$15,931,759**		
Shares of Stock Sold	1,593,176		
Shares of Stock Left	906,824		
% of Stock Left	36.27%		
$ of Stock Left	$9,068,241	$12,695,538	$17,773,753

Scenario 1 GRAT

Gross Principal	$9,068,241
Annuity Payment	$4,670,593

DONOR		BENEFICIARY		TOTAL	
Year 1 Balance	$4,670,593	Year 1 Balance	$8,024,945	Year 1 Balance	$12,695,538
Year 2 Balance	**$11,209,424**	Year 2 Balance	**$6,564,329**	Year 2 Balance	**$17,773,753**
Stock -> Cash	$8,541,581	Stock -> Cash	$5,002,019	Stock -> Cash	$13,543,600
Option -> Cash	$41,328,000			Option -> Cash	$41,328,600
Total	$49,869,581	Total	$5,002,019	Total	**$54,871,600**

Scenario Two

In the second scenario, the Smiths have $25 million to give the GRAT in the current year. However, the first GRAT annuity payment in the current year + 1 would only be $12.9 MM which would not cover the $20.6MM cost of exercise and tax. Therefore, in order to cover the cost of exercise and tax in the current year + 1, the Smiths keep $8.7 MM of currently existing stock out of the GRAT and instead give the GRAT $16.3 MM in the current year. In the current year + 1, the Smiths use the $8.4MM annuity in addition to the now $12.2 MM (the $8.7 MM stock grew at 40% over the year to appreciate to $12.2 MM) currently held stock not in the GRAT to cover the $20.6 MM exercise cost and tax. In the current year + 2, the Smiths get $8.4MM stock from the GRAT. The children get a total of $11.8MM stock in the GRAT. For comparative purposes, both the Smiths and their children sell all stock in the current year + 2 resulting in the Smiths getting $49.1MM cash and their children getting $9.0MM cash for a combined outcome totaling $58.1MM.

Wait to Exercise Options in One Year and Sell in Two Years

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
ISOS			
Exercise Price		$2,500,000	
AMT Due on Exercise		$4,200,000	
Ordinary Taxes Due on Exercise		$0	
Sales Price			$24,500,000
Capital Gains Tax			$5,236,000
AMT Credit Applied			$630,000
Net Proceeds from ISOs			**$19,894,000**
Net AMT Credit Available			**$0**
NQSOs			
Exercise Price		$2,500,000	
Ordinary Taxes Due on Exercise		$6,510,000	

Sales Price	$24,500,000
Capital Gains Tax	$1,666,000
Net Proceeds from NQSOs	**$22,834,000**
Total Net Proceeds	**$42,728,000**

Sell Stock to Exercise Options

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
Cash to Cover Tax and Exercise Price		**$15,710,000**	
Gross Sale Proceeds		**$20,616,798**	
Shares of Stock Sold		1,472,628	
Shares of Stock Left		1,027,372	
% of Stock Left		41.09%	
$ of Stock Left		$14,383,202	$20,136,483

Scenario 2 GRAT

Gross Principal	**$25,000,000**
Annuity Payment	**$12,876,238**
Stock not in GRAT	**$0**
DONOR	
Year 1 Balance	$12,876,238
After Paying Tax to Exercise Options	**-$7,740,560**
Year 2 Balance	**-$2,465,626**
Stock -> Cash	-$1,878,807
Option -> Cash	$42,728,000
Total	$40,849,193

Scenario 2 GRAT

Gross Principal	**$16,253,115**
Annuity Payment	**$8,371,159**
Stock Not in GRAT	**$8,746,885**

DONOR		BENEFICIARY		TOTAL	
Year 1 Balance	$20,616,798	Year 1 Balance	$14,383,202	Year 1 Balance	$12,695,538
After Paying Tax to Exercise Options	$0				
Year 2 Balance	**$8,371,159**	Year 2 Balance	**$11,765,324**	Year 2 Balance	**$20,136,483**
Stock -> Cash	$6,378,823	Stock -> Cash	$8,965,177	Stock -> Cash	$15,344,000
Option -> Cash	$42,728,000			Option -> Cash	$42,728,000
Total	$49,106,823	Total	$8,965,177	Total	**$58,072,000**

Scenario Three

In the third scenario, as the GRAT is the same as the one in the first scenario, the shares that the Smiths and the children get are the same as in the first scenario (the Smiths get a total of $11.2MM stock and the children get a total of $6.6MM stock). However, as the options are exercised and the underlying stock is sold one year earlier than the first scenario, the shares lose one year of 40% growth, and only grow at a 2% inflation rate. For comparative purposes, both the Smiths and their children sell all stock resulting in the Smiths getting $39.8 MM and their children getting $5.0 MM cash for a combined outcome totaling $44.8 MM. Again, this scenario is shown to illustrate an outcome should the Smiths decide they are less favorable on the stock and do not anticipate it growing 40% in the second year.

Exercise Options Now and Sell in One Year

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
ISOS			
Exercise Price	$2,500,000		
AMT Due on Exercise	$2,800,000		
Ordinary Taxes Due on Exercise	$0		
Sales Price		$17,500,000	
Capital Gains Tax		$3,570,000	
AMT Credit Applied		$420,000	
Net Proceeds from ISOs		**$14,350,000**	
Net AMT Credit Available		**$0**	
NQSOs			
Exercise Price	$2,500,000		

Ordinary Taxes Due on Exercise	$4,340,000	
Sales Price		$17,500,000
Capital Gains Tax		$1,190,000
Net Proceeds from NQSOs		**$16,310,000**
Total Net Proceeds		**$30,660,000**

Sell Stock to Exercise Options

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
Cash to Cover Tax and Exercise Price	**$12,140,000**		
Gross Sale Proceeds	**$15,931,759**		
Shares of Stock Sold	1,593,176		
Shares of Stock Left	906,824		
% of Stock Left	36.27%		
$ of Stock Left	$9,068,241	$12,695,538	$17,773,753

Scenario 3 GRAT

Gross Principal	**$9,068,241**
Annuity Payment	**$4,670,593**

DONOR		BENEFICIARY		TOTAL	
Year 1 Balance	$4,670,593	Year 1 Balance	$8,024,945	Year 1 Balance	$12,695,538
Year 2 Balance	**$11,209,424**	Year 2 Balance	**$6,564,329**	Year 2 Balance	**$17,773,753**
Stock -> Cash	$8,541,581	Stock -> Cash	$5,002,019	Stock -> Cash	$13,543,600
Option -> Cash	$31,273,200			Option -> Cash	$31,273,200
Total	$39,814,781	Total	$5,002,019	Total	**$44,816,800**

Summary of Pre-Liquidity Planning Scenarios

The following table is a summary of the three scenarios with all shares liquidated and taxes paid so the final cash values may be compared

	GRANTOR			BENEFICIARY			TOTAL		
	SCENARIO 1	SCENARIO 2	SCENARIO 3	SCENARIO 1	SCENARIO 2	SCENARIO 3	SCENARIO 1	SCENARIO 2	SCENARIO 3
Stock	$11,209,424	$8,371,159	$11,209,424	$6,564,329	$11,765,324	$6,564,329	$17,773,753	$20,136,483	$17,773,753
Stock -> Cash	$8,541,581	$6,378,823	$8,541,581	$5,002,019	$8,965,177	$5,002,019	$13,543,600	$15,344,000	$13,543,600
Option	$49,000,000	$49,000,000	$35,000,000	$0	$0	$0	$49,000,000	$49,000,000	$35,000,000

Option -> Cash	$41,328,000	$42,728,000	$31,273,200	$0	$0	$0	$41,328,000	$42,728,000	$31,273,200
Total	$49,869,581	$49,106,823	$39,814,781	$5,002,019	$8,965,177	$5,002,019	$54,871,600	$58,072,000	$44,816,800

It appears that scenario two is more advantageous. The 40% growth on the shares becomes an opportunity cost of using the shares to fund the option exercise and taxes in the first year. By forgoing the options exercise and tax one year to fund a larger GRAT, the Smiths benefit as the growth of the stock accrues more benefit to the children by an amount greater than the additional cost of exercise and tax in the current year + 1.

If the stock did not experience such a favorable growth rate, the prior scenarios would likely result in another scenario other than scenario two looking more advantageous. Given the uncertainty in the future potential growth of the stock, the Smiths did not use their lifetime exemptions to transfer assets completely out of their estates. Rather, it was more prudent to do a GRAT in case the stock price did not grow as anticipated so the Smiths would have enough money to live comfortably during their lifetimes and/or their lifetime exclusions would not be “wasted.”

Additionally, the scenarios described are for illustrative and comparative purposes to show how various strategies and techniques may influence planning. A caveat for the analysis is that it is assumed that there would be enough liquidity for a $100 MM company to liquidate a sizeable portion of its shares without adversely impacting price.

The advisor explains that in the analysis thus far, all stock was liquidated and taxes paid to create a more comparable comparison across scenarios. However, selling all of the stock given the Smiths’ favorable outlook for the company may not be prudent, so the following additional analysis continues in the current year + 2 having executed the strategy in scenario two. This way, the Smiths retain $69.1 MM in shares in addition to the $10 MM in liquid assets they have in a personal account.

Estate Planning

With performance of the Smith’s company proven and the sale of the company imminent, the Smith’s adviser continues to discuss estate planning concepts with them. The adviser re-introduces using their lifetime exemptions to fund a $10.98 MM Credit Shelter Trust, creating a GRAT, as well as considering being philanthropic by setting up a public charity and creating a Charitable Remainder Unit Trust (CRUT).

To illustrate the potential effectiveness of deploying these techniques, the adviser shares two scenarios with differing amounts in each of the aforementioned entities. In both scenarios, the Smiths put their combined $10.98MM lifetime exclusions into a Credit Shelter Trust (CST) which falls outside their estates. By doing so, not only is the $10.98 MM outside of their estates but any future appreciation of the assets within the trust will also be outside their estates. Additionally, the trust structure itself may provide protection against potential future creditors. To more fully capture the benefit of the lifetime exclusions, the Smiths liquidate stock and pay the capital gains before transferring the $10.98MM cash into the CST. This way they are not transferring a low basis embedded in an asset which accrues taxes to the beneficiary. The tax cost of transferring $10.98MM in cash is $2.6MM and is paid by their personal account.

Additionally, in both scenarios, all allocations within the legal entities (except for the concentrated positon which is held in scenario B) will be the same diversified portfolio. This way, it will be easier to compare the potential benefits of the estate planning techniques across scenarios. In actual practice, it is advantageous to do asset location within and across legal entities to take advantage of differing tax rates and cash flow characteristics to potentially create more efficient and effective outcomes for all of beneficiaries.

The grantor gift trust receives the annual $14,000 exemption per parent per child as well as the remainder of the GRAT. Because of the grantor status, the Smiths pay the taxes incurred by the trust, so in effect it may grow tax free. Again, any monies that may be transferred from the Smiths to their children are not included in the Smiths’ estates. Additionally, any appreciation on these monies may accumulate outside of the Smiths’ estates.

Monte Carlo Assumptions

CRT and GRAT Term	10
Marital Status	Married
# of Children	2
Age	60

	SCENARIO A	SCENARIO B
Total Value (Stock and Option)	$69,136,483	$69,136,483
Tax for CST	$2,584,680	$2,584,680
Tax for GRAT	$4,623,268	$3,467,451
Credit Shelter Trust	$10,860,000	$10,860,000
CRUT	$19,425,494	$14,569,121
GRAT	$19,425,494	$14,569,121
Public Charity	$19,425,494	$14,569,121
Personal Account	$2,792,052	$3,947,869
Grantor Gift Trust	$0	$0
Concentrated Equity	$0	$14,569,121
Total Portfolio Value	**$71,928,535**	**$73,084,352**
Unitrust Rate for CRUT	**22.4%**	**22.4%**
Total Deduction	**$720,000**	**$720,000**

Scenario A

In Scenario A, the Smiths put one third of the remaining value of the shares in each of the following: CRUT, GRAT and public charity. For the GRAT, the $4.6MM tax generated by selling the stock (to reinvest it in a diversified portfolio) is paid by the personal account because of the trust’s grantor status. For the CRUT, the sale of the stock to invest in a diversified portfolio does not immediately trigger a tax liability for the Smiths. Instead, because the CRUT remainder after a specified amount of time (here 10 years) distributing a fixed percentage to the Smiths (here 22.4%) goes to the public charity, the Smiths receive a charitable deduction at the time they fund the CRUT in the amount of $1.9MM (subject to Pease limitation and AGI limitations). The shares donated to the public charity also generate a charitable deduction for the Smiths in the amount of $23.0MM (subject to Pease limitation and AGI limitations) and because the public charity is tax-exempt, the sale of the shares does not trigger a tax consequence. Taking all of this into account, the personal account has a remaining value of $2.8MM and the total value of assets begins at $71.9MM.

Scenario B

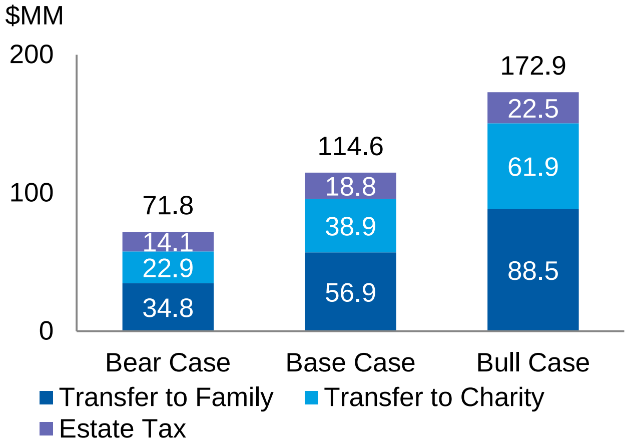
In Scenario B, the Smiths put one fourth of the remaining value of the shares in each of the following: CRUT, GRAT, public charity and retains shares. For the GRAT, $3.5MM tax generated by selling stock is paid by the personal account. For the CRUT, the Smiths receive a charitable deduction in the amount of $1.4MM (subject to Pease limitation and AGI limitations). The Smiths also receive a charitable deduction of $14.6MM (subject to Pease limitation and AGI limitations) for donating to the private charity. Taking all of this into account, the personal account has a remaining value of $3.9MM and the total value of assets begin at $73.1MM.

Summary of Estate Planning Scenarios

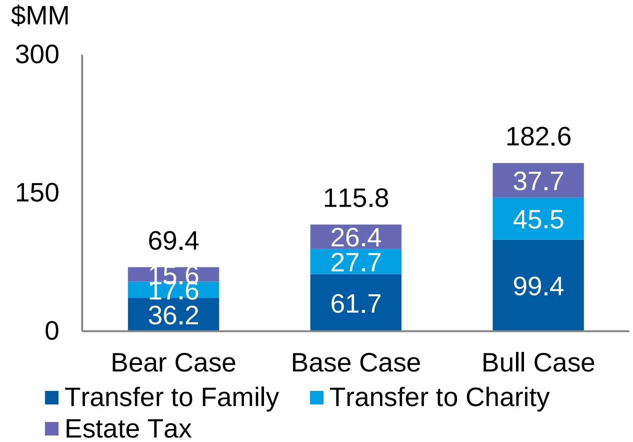
To run the analysis, the Smith's adviser runs a monte carlo analysis through a cash flow model which incorporates the taxes and cash flows previously mentioned. The monte carlo takes into account the variability of capital market assumptions and the effect on asset class returns and variability. The monte carlo generates 10,000 ten year period outcomes. The results are a range of outcomes for each scenario. It is important to compare good and bad case outcomes in addition to average outcomes to fully understand the opportunity costs between scenario A and scenario B.

The adviser reveals the results of the analysis assuming the Smiths pass away in the tenth year, estate taxes are paid and the assets flow to their designated beneficiaries. If the Smith's goal is to transfer as much as possible to their children then they might prefer scenario B. If the Smiths prefer to leave assets to their children and charity then they might prefer scenario A. The adviser explains that the difference in the results between what goes to charity and the family is largely attributable to the Smiths retaining shares in their company in lieu of giving additional monies to the CRUT and public charity. Because fewer estate planning strategies are used in scenario B, higher estate taxes are incurred. It is interesting to note that in scenario B, fewer monies are put into the GRAT in favor of retaining shares. The Smiths might expect the smaller GRAT to result in less transferring to their children however the retained shares and their growth compared to the diversified portfolio in the GRAT more than outweigh the benefit of a larger GRAT. In deciding between scenarios A and B, the Smith's expectation of the future performance of their company stock is critical. If the Smiths expect the stock to continue to grow substantially, then they should either retain more shares by either holding them outright in their estates or holding them in a GRAT for greater benefit to their children. If the Smiths hold the shares in their estate then the future value will be subject to estate tax but the children will inherit marked to market cost basis. If the Smiths consider a GRAT, then their decision to hold or sell the shares should consider the benefit of the Smiths paying the tax for diversification (when selling the share in a GRAT) rather than their daughters inheriting appreciated low basis stock and the accompanying tax future tax liability (if shares are held in a GRAT)

Scenario A



Scenario B



No Estate Planning

In weighing the potential alternatives, the adviser shows the Smiths what might happen if the Smiths do no estate planning after exercising their options, so they may compare and understand the potential effectiveness and benefits of estate planning. For the "no estate planning" outcomes, the adviser shows the effect of holding the shares versus selling the shares in the current year + 2. If the Smiths hold the shares and do no estate planning then they begin the ten year monte carlo analysis holding $69.1 MM in shares of their company in addition to having $10 MM in a diversified portfolio. If the Smiths sell their shares and do no estate planning then they begin the ten year monte carlo analysis holding $68.1 MM in a diversified portfolio

Wait to Exercise Options in One Year and Sell in Two Years

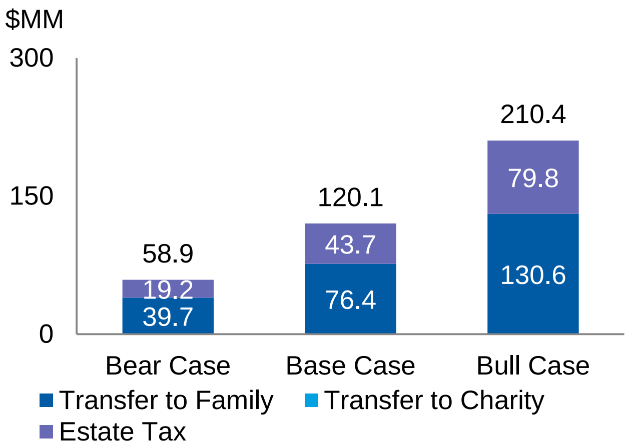
	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
ISOS			
Exercise Price		$2,500,000	
AMT Due on Exercise		$4,200,000	
Ordinary Taxes Due on Exercise		$0	
Sales Price			$24,500,000
Capital Gains Tax			$5,236,000
AMT Credit Applied			$630,000
Net Proceeds from ISOs			**$19,894,000**
Net AMT Credit Available			**$0**
NQSOs			
Exercise Price		$2,500,000	
Ordinary Taxes Due on Exercise		$6,510,000	
Sales Price			$24,500,000
Capital Gains Tax			$1,666,000
Net Proceeds from NQSOs			**$22,834,000**

Total Net Proceeds	**$42,728,000**

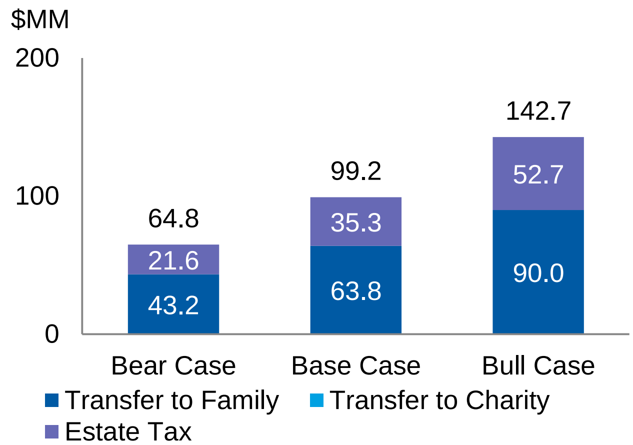
Sell Stock to Exercise Options

	CURRENT YEAR	CURRENT YEAR+1	CURRENT YEAR+2
Cash to Cover Tax and Exercise Price		**$15,710,000**	
Gross Sale Proceeds		**$20,616,798**	
Shares of Stock Sold		1,472,628	
Shares of Stock Left		1,027,372	
% of Stock Left		41.09%	
$ of Stock Left		$14,383,202	$20,136,483
Total Portfolio Value (Stock and Option)			**$69,136,483**
Equity -> Cash			**$15,344,000**
Option -> Cash			**$42,728,000**
Personal Account			**$10,000,000**
Total Cash			**$68,072,000**

Keep All Stock



Sell All Stock



Summary No Estate Planning Scenarios

The advisor explains that with no estate planning, selling the shares appears to be favorable in a bear case scenario or when the stock performance is not strong otherwise, retaining the shares appears to be more favorable in the base and bull case scenarios as one might infer.

When comparing the no estate planning and keeping the stock to the previous estate planning scenarios A and B, the Smiths may choose to keep the stock and do no planning if their intention is to try to get as much to family as possible. However, if the Smiths value passing monies to their family and charity, both Scenarios A and B propose more favorable outcomes. Please note that while the outcomes for no planning and keeping the stock are higher than either of the estate planning scenarios, holding such a concentrated position may be highly risky given the idiosyncratic nature of stock specific risk. Additionally, if Mr. Smith retires and relies on his portfolio for the $500,000 income per year (which would necessitate being adjusted for cost of living adjustments), the burden of the distributions may largely be dependent on the liquid diversified portfolio. Should there be adverse market developments that impact the liquid diversified portfolio, it would be unlikely that the concentrated position would better withstand the adverse market developments to provide an offset to any potential shortfall in the liquid diversified portfolio.

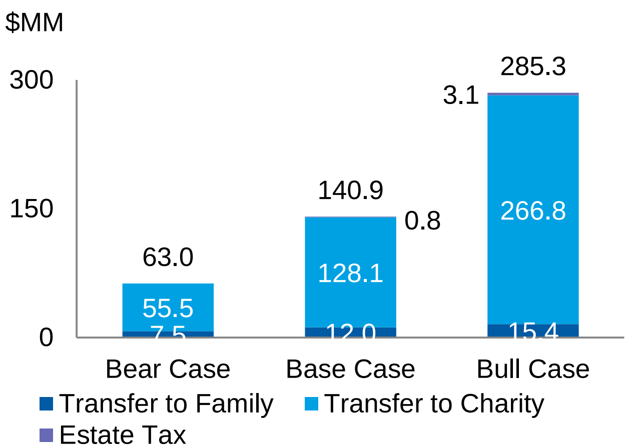
When comparing the no estate planning and selling the stock to the previous estate planning scenarios A and B, the Smiths may prefer scenario B in the bull case scenario although in the bear and base cases it appears that the no planning and selling the stock generates a more positive outcome. Again, this conclusion supposes that any benefit to charity is not taken into account.

Donating All/Most to Charity

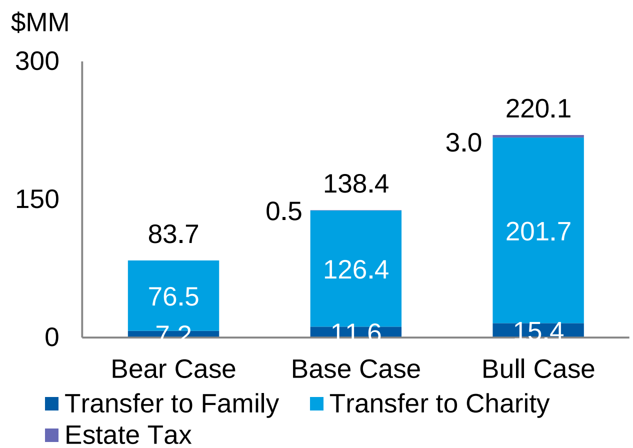
In weighing the potential alternatives, the adviser also shows the Smiths what might happen if the Smiths donate all of their shares to charity in the current year + 2. It makes little sense for the Smiths to sell the shares, pay tax and then donate cash as the charitable donation would be reduced by the tax liability. In the case of donating all stock, the Smiths maintain their $10MM liquid diversified portfolio and donate $69.1MM to charity. As a result of the gift to charity, the Smiths receive a charitable deduction. For comparative purposes, the adviser shows the charity both keeping the concentrated position and diversifying the concentrated position. It is the charity's decision to sell or hold the donated stock in the context of the rules and regulations governing charities as well as the charity's view on the future stock performance.

As expected, giving all the stock to charity results in the Smiths leaving the least amount of money to their family and the most to charity.

Charity Keeps Stock



Charity Diversifies



Charitable Deduction Calculation

The calculation of the charitable deductions throughout the scenarios is as follows. If the Smiths donate private stock to a public charity and to a CRUT, their income tax deduction is limited to the lesser 30% of their adjusted gross income (AGI) and the Pease limitation. In this analysis, the client's AGI is $0.5 MM each year, although the client donates more than $10MM in each charitable scenario, the annual deduction is capped at

$0.15MM. In the case of Mr. Smith, given his salary is constant and he will work for five years after the sale of the company, the deduction may be five years of $150,000, totaling $0.75MM. The Pease limitation subtracts the lesser of 80% of the charitable gift and 3% excess AGI over $0.3MM from the charitable gift, which is $9,994,297. Any excess deduction may be carried forward in the following five years subject to the AGI and Pease limitations. Since the AGI deduction limit is less than the Pease adjustment limit, we use the AGI deduction limit.

AGI and Deduction

	Year 1	$500,000
	Year 2	$500,000
Total AGI	Year 3	$500,000
	Year 4	$500,000
	Year 5	$500,000
	Year 1	$150,000
	Year 2	$150,000
AGI Limitation	Year 3	$150,000
	Year 4	$150,000
	Year 5	$150,000
Total AGI Deduction		**$750,000**
Deduction with Pease Adjustment		$9,994,297
Total Final Deduction		**$750,000**

Concluding Thoughts

Personal planning in the context of an impending sale may influence an owner's decision making process with regard his/her preference for cash and/or shares. In reviewing the possibilities for the Smiths in light of a potential liquidity event:

- Within the no estate planning scenario, the sell all stock might be a proxy for an all cash sale and the keep all stock might be a proxy for an all stock sale of Mr. Smith's company.
- Within the estate planning scenario, scenario B might be a proxy for a combination of cash and stock sale while scenario A might be a proxy for an all cash sale.
- Within the donating all/most to charity, charity keeps stock might be a proxy for all stock sale while charity diversifies might be a proxy for an all cash sale.

In light of this opportunity set, the advisor highlights the following considerations which may influence which scenario the Smiths follow given their preferences for family and charity:

- If considering the combined impact of monies to family and charity:
  - Donating all to charity has the largest impact (with the best outcomes for charity and the worst outcomes to family)
  - No estate planning has the least impact (with the best outcomes for family and the worst outcomes to charity)

  - The impact of estate planning falls between the prior two examples and also balances the benefit to both charity and family
- The decision to keep or sell the stock may have the most impact when there is no estate planning and the least impact when giving it all to charity.

Embedded in the “fair market value” of the share of the company is not only the value of the company but also the value of the potential trust, tax and estate planning possibilities for the owner.

Morgan Stanley

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