OVERVIEW

# LIFECYCLE OF AN ENTREPRENEUR

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## Chapter 1

# FORMING A BUSINESS/ANGEL ROUND

Entrepreneur toolkit

# ESTABLISHING ADVISORY RELATIONSHIPS

## WHY IS IT IMPORTANT TO ESTABLISH ADVISORY RELATIONSHIPS WHEN STARTING A BUSINESS?

- Establishing a strong advisory team that provides legal, tax/accounting, investment banking and financial/investment advice allows business owners to rely on professional experience and expertise working in a coordinated manner to help the entrepreneur.

- A cohesive and responsive team will allow the entrepreneur to focus on the business and provide invaluable information and resources along the way to help one achieve both personal and professional goals.

- A good advisory team can help with both investment goals and broader wealth management needs.

# BUSINESS STRUCTURE

## HOW SHOULD ONE CHOOSE A BUSINESS STRUCTURE?

*The choice of business structure is a critical strategic decision, with wide ranging impacts, including how profits are taxed, the degree of creditor protection the structure affords business owners, and the range of exit strategies ultimately available. There are a variety of business structures. Below are some of the most common business entities:*

### GENERAL AND LIMITED PARTNERS

With general partnerships, the various partners control and manage the company. Further, each general partner assumes unlimited liability for the debts of the partnership and can incur obligations on its behalf. In the case of limited partnerships, there are normally one or more general partners who maintain full oversight over the management of the business. Limited partners do not engage in the daily oversight of the business and cannot incur obligations on the behalf of the partnership. Partnerships are a "pass-through: entity and pay no entity level tax on their income, but rather pass through any profits or losses to their partners.

### C CORPORATION

C corporations are a separate legal entity that exists apart from the business owners. One benefit if that is provides the owner substantial liability protection. As opposed to a "pass-through" entity such as partnership, the owners of a C corporation will be subject to taxation twice, once at the corporate level and then again when earnings are distributed to them in the form of dividends. Corporations also have the ability to attract investors through the issuance of stock. There may be additional benefits afforded by investment in Qualified Small Business Stock "QSBS."

### S CORPORATION

The primary advantage of S corporations is that they allow income and losses to be passed through to shareholders. Therefore, unlike C corporations, S corporations are only subject to one level of federal taxation. Each state has its own rules regarding how S corporations can be taxed. S corporations can have multiple shareholders, but not more than 100. As opposed to C corporations, S corporations can only be owned by individuals, charities, estates and certain types of trusts. Corporations, partnerships and non-resident aliens are not permitted to own stock in S corporations.

### LIMITED LIABILITY COMPANY (LLC)

Constructs that combine the elements of corporations and partnerships. Members of an LLC have limited liability. An LLC can elect to be taxed as a corporation or as a pass-through entity. As a pass-through entity, LLCs normally pass earnings and losses through to owners in a manner similar to partnerships. As with corporations, members of LLCs benefit from legal protection while participating fully in the operation of the LLC business.

FORMING A BUSINESS/ANGEL ROUND

# INSURANCE NEEDS FOR BUSINESS OWNERS

*Are there any insurance needs that are unique to business owners during the formation phase of the business?*

## IN MANY INSTANCES..

- The purpose of key man insurance is to help the company survive the blow of losing the person who makes the business work. The company can use the insurance proceeds for expenses until it can find a replacement person, or, if necessary, pay off debts, distribute money to investors, pay severance to employees and close the business down in an orderly manner. In a tragic situation, key man insurance gives the company some options other than immediate bankruptcy.
- A buy and sell agreement is an approach used by sole proprietorships, partnerships and closed corporations to divide the business share or interest of a proprietor, partner, or shareholder. The owner of the business interest being considered has to be disabled, deceased, retired or expressed interest in selling. In order to ensure the availability of funds in the event of a partner's death, most parties will purchase life insurance policies on the other partners. In the event of a death, the proceeds from the life insurance policy are used to purchase a portion of the deceased's business interest.

## WHAT ARE SOME OF THE MOST COMMON TYPES OF INSURANCE FOR BUSINESS OWNERS?

**Term Insurance**

- Temporary life insurance coverage for a period of years- typically used for income replacement purposes in the event of an unforeseen death.

**Whole Life, Universal Life and Variable Insurance**

- Permanent life insurance coverage often used to fulfill long-term estate planning needs.

**Key Man Insurance**

- Insurance protection on a key individual(s) within a business with the business named as the beneficiary.

**Property and Casualty Insurance**

- Insurance to protect against losses to property and other tangible assets. The types of coverage may vary depending upon the type of business engaged in and the potential liability exposure.

# ESTATE PLANNING COORDINATION FOR BUSINESS OWNERS

## WHY IS IT IMPORTANT TO COORDINATE ONE'S ESTATE PLAN AND THE GROWTH OF ONE'S BUSINESS?

- The early stage of a company's growth phase is often a particularly productive time for the owner(s) to conduct in-depth estate planning. Unfortunately, the demands associated with a growing business tend to be all-encompassing. As a result, business owners often fail to implement any type of estate plan until one is imposed upon them, or their successors, by virtue of an impending exit from the business or their own (untimely) passing.

FORMING A BUSINESS/ANGEL ROUND

# BASIC ESTATE PLANNING DOCUMENTS

## WHAT BASIC ESTATE PLANNING DOCUMENTS SHOULD ONE CONSIDER?

- One of the greatest challenges that a business owner may face is how best to transition wealth accumulated form the business to future generations.
- As the value of a business grows, so does the business owners’ potential exposure to estate and gift taxes.
- Fortunately, establishing a plan early in the life cycle of the business allows proactive business owners the opportunity to potentially sidestep many of these taxes by creatively distributing ownership interests to family members and other beneficiaries at a time when valuation levels are low.

## SOME OF THE KEY BASIC ESTATE PLANNING DOCUMENTS THAT A BUSINESS OWNER SHOULD ESTABLISH ARE:

**Basic Will**

- Outlines distribution of assets upon death

**Revocable Living Trust**

- Avoids probate and distributed assets upon death

**Durable Power of Attorney**

- Appoints an agent to act on your behalf

**Health Care Directive**

- Appoints an agent to make healthcare decision on our behalf if you are unable to

**Irrevocable Life Insurance Trust**

- Removes life insurance proceeds from your estate

Chapter 2

# EARLY STAGE/SERIES AB ROUNDS

Entrepreneur toolkit

EARLY STAGE/SERIES AB ROUNDS

# ESTATE AND GIFT TAX PLANNING

## WHAT IS THE CURRENT TAX LANDSCAPE WITH REGARD TO ESTATE AND GIFT TAX PLANNING?

- Currently, the applicable federal legislation provides individuals with an opportunity to engage in sophisticated wealth planning – one where the estate tax, gift tax and generation-skipping tax (GST) exemption thresholds each exceeds $10 million dollars.
- Furthermore, the corresponding maximum federal tax rate is 40% (in those instances where the imposition of tax cannot be completely avoided).
- Business owners who actively plan can leverage sophisticated estate and tax planning and can position themselves to distribute substantial wealth to future generations (should they so desire) with little and possibly no transfer tax consequences.

## THE CHART BELOW SUMMARIZES THE HISTORICAL FEDERAL ESTATE, GST AND GIFT TAX EXEMPTIONS:

| Calendar Year | Estate Tax Exemption | GST Tax Exemption | Lifetime Gift Tax Exemption | Maximum Estate Tax Rate |
|---|---|---|---|---|
| 2010 | $5,000,000 or $0* | $5,000,000 | $1,000,000 | 35% or 0%* |
| 2011 | $5,000,000 | $5,000,000 | $5,000,000 | 35% |
| 2012 | $5,120,000 | $5,120,000 | $5,120,000 | 35% |
| 2013 | $5,250,000 | $5,250,000 | $5,250,000 | 40% |
| 2014 | $5,340,000 | $5,340,000 | $5,340,000 | 40% |
| 2015 | $5,430,000 | $5,430,000 | $5,430,000 | 40% |
| 2016 | $5,450,000 | $5,450,000 | $5,450,000 | 40% |
| 2017 | $5,490,000 | $5,490,000 | $5,490,000 | 40% |
| 2018 | $11,180,000** | $11,180,000** | $11,180,000** | 40% |

*If carryover basis and no estate tax was chosen in 2010. **The official numbers have not yet been released by the IRS.

EARLY STAGE/SERIES AB ROUNDS

# ENTREPRENEUR BASIC ESTATE PLANNING

## IF AN ENTREPRENEUR HAS A BASIC ESTATE PLAN IN PLACE, ARE THERE ADDITIONAL PLANNING STRATEGIES ONE SHOULD CONSIDER?

*As a general rule, estate planning is most effective when undertaken early on within the life cycle of a business. Early on, company valuations tend to be lower and the time horizon remaining until the eventual "exit" from the company can allow an entrepreneur to engage in a broad range of impactful planning activities.*

### ENTREPRENEURS WHO UNDERTAKE THOUGHTFUL BUSINESS AND ESTATE PLANNING MAY ACHIEVE:

- A more efficient business transition (via inter-family transfer, IPO or sale)
- An increased likelihood of successfully achieving financial and familial goals
- A minimization of estate and gift taxes

EARLY STAGE/SERIES AB ROUNDS

# TRUST BENEFITS DURING BUSINESS GROWTH

**HOW CAN TRUSTS BE USED TO BENEFIT FROM THE (ANTICIPATED) APPRECIATION IN A COMPANY'S VALUE DURING ITS GROWTH PHASE?**

*As the value of a company appreciates, it can become increasingly difficult to effectively redistribute the wealth among family members. One solution to this dilemma involves establishing estate planning structures that permit beneficiaries to profit from the appreciation in company value while still minimizing the impact of estate and gift taxes.*

*Two planning structures that are commonly used in this regard are Grantor Retained Annuity Trusts ("GRATs") and Intentionally Defective Grantor Trusts ("IDGTs").*

**BOTH APPROACHES ARE ESPECIALLY POPULAR WITH BUSINESS OWNERS,**

**REGARDLESS OF WHETHER THEIR ULTIMATE EXIT STRATEGY IS EXPECTED TO CONSIST OF:**

- A transfer of the company to family members
- An Initial Public Offering ("IPO")
- A sale of the company

- In each case, the basic methodology associated with wealth planning consists of gifting ownership interests to beneficiaries while valuations are as low as possible. This approach removes the assets from the estate of the donor(s) and allows for much of the subsequent appreciation in value to accrue on behalf of beneficiaries.

# GRANTOR RETAINED ANNUITY TRUST (GRAT)

## HOW DOES A GRAT WORK?

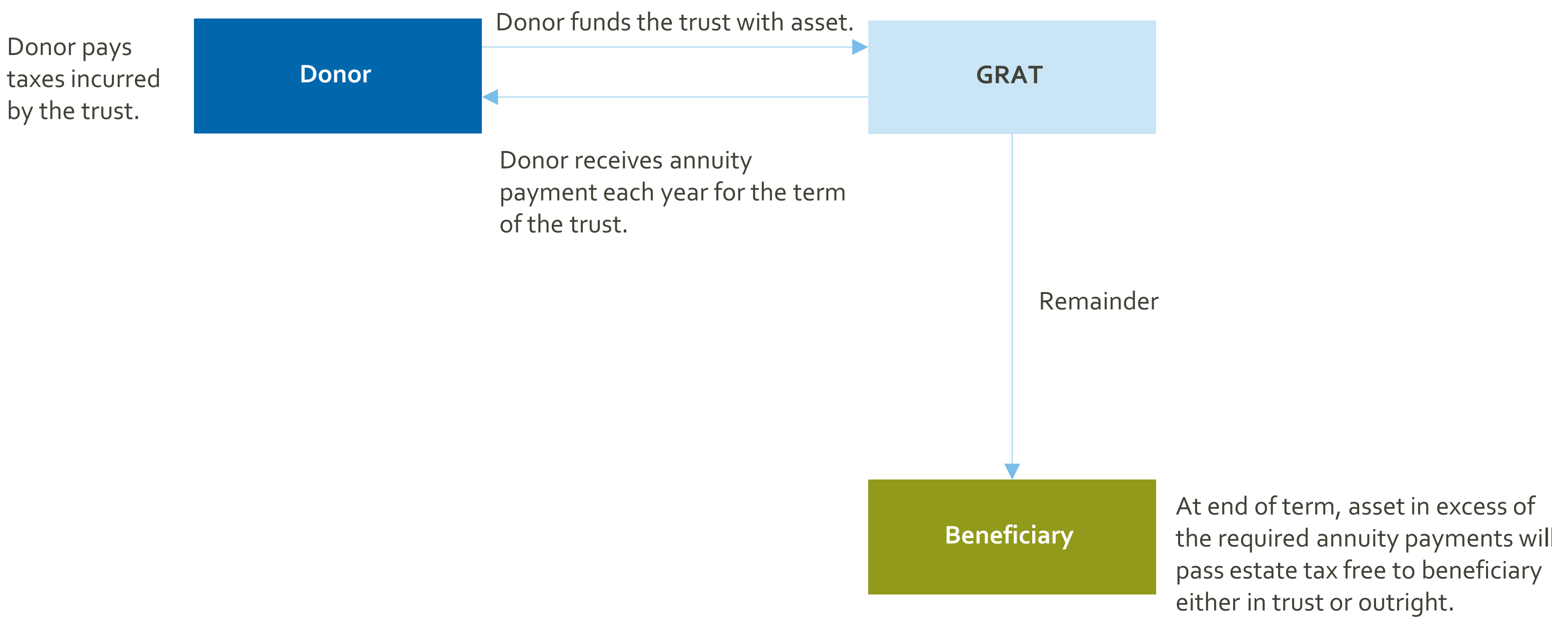
- The donor creates a trust and in it directs that (i) the trust pays the donor an annuity for a fixed period of time and (ii) the remainder (whatever is left in the trust at the expiration of the annuity) is paid to one or more designated beneficiaries. The beneficiaries that can be designated include close family members like ancestors, descendants and siblings or trusts for their benefit. The GRAT can be structured so the annuity payment is not a series of equal amounts, but rather increases by up to 20% year to year.

- The donor is deemed to make a gift of the remainder interest in the trust to the designated remainder beneficiaries. The value of the taxable gift to the remaindermen is determined by subtracting the value of the donor's retained annuity from the fair market value of the assets transferred to the trust. The value of the annuity is based on an IRS discount rate known as the 7520 rate. The transfer to the trust can be structured so the value of the grantor's retained interest is virtually equal to the market value of the property placed in trust, in which case only a very small taxable gift results ("zeroing out" the GRAT). This small taxable gift will be reported on the donor's gift tax return.

- The GRAT can produce estate and gift tax savings if the trust property produces an annual return in excess of the IRS discount rate over the term of the annuity. The donor effectively shifts all of the return on the trust property in excess of the benchmark IRS discount rate to the remainder beneficiaries without making an additional taxable gift. Additionally, the donor will have separately paid any income tax liability of the trust, further leveraging this gifting technique. And if the GRAT is structured so the annuity "grows" by up to 20% per year, more principal can compound for the benefit of the remainder beneficiaries potentially allowing more property to pass to them at the expiration of the donor's annuity.

HYPOTHETICAL ILLUSTRATION

# GRANTOR RETAINED ANNUITY TRUST (GRAT)



HYPOTHETICAL ILLUSTRATION

# GRANTOR RETAINED ANNUITY TRUST (GRAT)

## "ZEROED-OUT" FLAT ANNUITY GRAT

- The following is an illustration of a "zeroed-out" flat annuity GRAT funded with $1,000,000 marketable securities.
- In this hypothetical scenario, the donor receives an annuity worth $349,460 per year for 3 years and the remainder beneficiaries receive (outright or in continuing trust) asset worth $55,953.

**Assumptions:**

| | |
|---|---|
| Term of Trust | 3 |
| Principal | $1,000,000 |
| 7520 Rate | 2.4% |
| Annual Investment Return | 5.0% |

**Key Outputs:**

| | |
|---|---|
| Annuity to Donor (%) | 34.9% |
| Annuity to Donor ($) | $349,460 |
| Remainder | $55,953 |

*Hypothetical example is for illustrative purposes only.*
*Not representative of any specific investment.*

| Year | Beginning Principal | Growth | Annuity Payment | Remainder |
|---|---|---|---|---|
| 1 | $1,000,000 | $50,000 | $349,460 | $700,540 |
| 2 | $700,540 | $35,027 | $349,460 | $386,107 |
| 3 | $386,107 | $19,305 | $349,460 | $55,953 |

HYPOTHETICAL ILLUSTRATION

# GRANTOR RETAINED ANNUITY TRUST (GRAT)

## "ZEROED-OUT" GROWING ANNUITY GRAT

- The following example is the same as the "zeroed-out" flat annuity GRAT except the annuity grows 20% per year. There is still no taxable gift on funding the trust (i.e., the value of the annuity stream is still roughly equal to the principal contributed to the trust).
- However, the amount of asset passing to the beneficiaries at the end of the term may increase reflecting the potential benefit of having asset stay in the trust longer and generate compounded returns for the beneficiaries. In this hypothetical scenario, the remainder beneficiaries receive asset worth $59,296 , or $3,343 more compared to the flat annuity scenario.

### Assumptions:

| | |
|---|---|
| Term of Trust | 3 |
| Principal | $1,000,000 |
| 7520 Rate | 2.4% |
| Annual Investment Return | 5.0% |
| Annuity Growth | 20.0% |

### Key Outputs:

| | |
|---|---|
| Remainder (Growing Annuity) | $59,296 |
| Remainder (Flat Annuity) | $55,953 |
| Difference | $3,343 |

*Hypothetical example is for illustrative purposes only.*
*Not representative of any specific investment.*

| Year | Beginning Principal | Growth | Annuity Payment | Remainder |
|---|---|---|---|---|
| 1 | $1,000,000 | $50,000 | $288,844 | $761,156 |
| 2 | $761,156 | $38,058 | $346,613 | $452,601 |
| 3 | $452,601 | $22,630 | $415,935 | $59,296 |

HYPOTHETICAL ILLUSTRATION

# GRANTOR RETAINED ANNUITY TRUST (GRAT)

## ROLLING GRATS

- Relative to a standard GRAT, so-called "Rolling GRATs" may provide greater opportunity for compounding returns while reducing mortality risk through the creation of a series of sequential short-term GRATs with each subsequent GRAT being funded with an annuity payment from an earlier-created GRAT. The potential compounding benefit results from Rolling GRATs keeping all principal (and interest, in some cases) "at work" over a longer period of time.
- The following is an illustration of two sequential two-year rolling GRATs. In this hypothetical scenario, the remainder beneficiaries receive asset worth $63,435 , or $7,482 more than they would with one three-year GRAT.

### Assumptions:

| | |
|---|---|
| Rolling Period | 3 |
| Principal | $1,000,000 |
| 7520 Rate | 2.4% |
| Annual Investment Return | 5.0% |

### Key Outputs:

| | |
|---|---|
| "Remainder Trust" Ending Principal | $63,435 |
| 3-Year Flat GRAT Remainder | $55,953 |
| Difference | $7,482 |

*Hypothetical example is for illustrative purposes only.*
*Not representative of any specific investment.*

### Rolling GRATs

| Year | Principal | Growth | Annuity | Remainder |
|---|---|---|---|---|
| 1 | $1,000,000 | $50,000 | $518,071 | $531,929 |
| 2 | $531,929 | $26,596 | $518,071 | $40,454 |

| Year | Principal | Growth | Annuity | Remainder |
|---|---|---|---|---|
| 2 | $518,071 | $25,904 | $268,398 | $275,577 |
| 3 | $275,577 | $13,779 | $268,398 | $20,958 |

### Remainder Trust

| Year | Beginning Principal | Growth | Remainder Added | Ending Principal |
|---|---|---|---|---|
| 1 | $0 | $0 | $0 | $0 |
| 2 | $0 | $0 | $40,454 | $40,454 |
| 3 | $40,454 | $2,023 | $20,958 | $63,435 |

# INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

## HOW DOES AN IDGT WORK?

- The donor creates an irrevocable trust designed to permit an individual to transfer the appreciation of assets in the IDGT with minimal gift tax consequences (through the use of a promissory note back to the grantor).

- A donor can establish a trust and the donor or his or her spouse can intentionally retain certain powers with respect to the trust which cause the donor to be treated as the owner of the trust property for income tax but not estate or gift tax purposes. By paying taxes on trust income, the donor, in effect, makes additional transfers to the beneficiaries of the trust, which are not subject to gift tax.

- The donor can sell assets to the trust in exchange for the trust's interest-bearing promissory note. The interest rate will be based on IRS published rates and is often less than the rate used in GRATs. The note may provide for level payments of principal and interest, be self-amortizing or bear interest only with a balloon payment of principal. No gain or loss is recognized by the donor on the sale to the trust and the repayment of the promissory note has no income tax consequences to the donor or the trust, because the donor is treated as the owner of the trust for income tax purposes.

- The trust should be funded prior to the sale in order to protect it against possible estate tax inclusion. Most commentators suggest that the "seed gift" be at least 10% of the principal amount of the promissory note. The transfer of property to the trust can be made utilizing both the gift tax annual exclusion (if the trust is structured properly), or the gift tax exemption amount. Once gifts exceed the gift tax exemption amount, any additional gifts (other than annual exclusion gifts) are fully taxable. The IDGT can be effective for gifts to grandchildren and other remote descendants if GST is properly allocated to the trust.

EARLY STAGE/SERIES AB ROUNDS

# GRAT, IDGT, DIRECT GIFTING

**WHAT ARE THE CIRCUMSTANCES UNDER WHICH ONE WOULD USE A GRAT OR AN IDGT, VERSUS FOR EXAMPLE, DIRECT GIFTING?**

- GRATs and IDGTs are both mechanisms that are used to "leverage" the gifting that a business owner seeks to undertake.
- This can be useful when the business owner wants to utilize some of none of his or her lifetime estate tax exemption amount, perhaps preserving it for other wealth transfer opportunities.
- In other cases, the entrepreneur may have exhausted his or her lifetime estate tax exemption or the entrepreneur's net worth is so large that even the full utilization of the unleveraged lifetime exemption amount will not reduce his or her estate in a meaningful way.
- In each of these instances, a GRAT or IDGT can be an appealing alternative to direct gifting.

# FAMILY LIMITED PARTNERSHIP

## WHAT IS A FAMILY LIMITED PARTNERSHIP AND HOW CAN IT PROVIDE A PLANNING BENEFIT TO ENTREPRENEURS IN THE EARLY PHASE OF THE LIFE CYCLE?

- A Family Limited Partnership (“FLP”) is a structure that allows individuals to gift limited partnership (“LP”) interests to family members or trust while retaining a general partnership (“GP”) interest for themselves.
- As GPs, the individuals maintain management and investment control over the FLPs underlying assets as well as broad discretionary authority to determine the amount of timing and distributions.
- The meaningful restrictions imposed upon limited partners, as well as their lack of control over the broader FLP structure may provide substantial valuation discounts which, in turn, may minimize the impact of gift and estate taxes that the family might otherwise incur.

EARLY STAGE/SERIES AB ROUNDS

# STOCK OPTIONS AND EQUITY COMPENSATION

*Companies grant 2 kinds of options: **Non-Qualified Stock Options** (NQSOs), the most common type, and Incentive **Stock Options** (ISOs), which offer some tax benefits but also raise the risk of the alternative minimum tax (AMT).*

## WHAT ARE THE DIFFERENCES BETWEEN THE VARIOUS TYPES OF STOCK OPTIONS AND EQUITY COMPENSATION?

| Type | Description |
|---|---|
| NQSO | • A NQSO is a type of stock option that does not qualify for special favorable tax treatment. When a NQSO is exercised, the spread (difference between strike price and fair market value on date of exercise) is compensation income and reported on IRS Form W-2. The company will withhold income tax, Social Security tax and Medicare. When the shares are sold, the proceeds are taxed under the rules for capital gains and losses. |
| ISO | • ISOs qualify for special tax treatment under the Internal Revenue Code and are not subject to Social Security, Medicare, or withholding taxes. However, to qualify they must meet rigid criteria under the tax code. It's important to note that ISOs can be granted only to employees, not to consultants or contractors. There is a $100,000 limit on the aggregate grant value of ISOs that may first become exercisable (i.e. vest) in any calendar year. Also, for an employee to retain the special ISO tax benefits after leaving the company, the ISOs must be exercised within three months after the date of employment termination.<br>• After you exercise ISOs, if you hold the acquired shares for at least two years from the date of grant and one year from the date of exercise, you incur favorable long-term capital gains tax (rather than ordinary income tax) on all appreciation over the exercise price. However, the amount by which the fair market value of the stock exceeds the price paid on exercise will be subject to the AMT. This can be problematic if you are subject to the AMT on theoretical gains but the company's stock price then plummets, leaving you with a big tax bill on income that has evaporated. ISO taxation is complex. It's important to understand how the alternative minimum tax can affect you. |
| Restricted Stock Units (RSUs) | • Restricted Stock Units of RSUs are a grant of stock units with an unfunded promise to issue a specific number of shares (or a cash payment) at a future time once vesting conditions have been satisfied. Stock-settled RSUs are much more common than cash-settled RSUs (which are subject to unpopular variable accounting), and they are used widely enough to rival the use of standard restricted stock. RSUs are a stock grant in which the stock itself is not issued until both vesting and the release of shares. Generally, restricted stock units are subject to the same tax rules as restricted stock once the shares are received. |

THE TAX IMPLICATIONS OF STOCK OPTIONS

# EXERCISING INCENTIVE STOCK OPTIONS (ISO)

## HYPOTHETICAL ILLUSTRATION: EXERCISE VESTED IN-THE-MONEY OPTIONS AND HOLD STOCK (AS OF 01/01/2018)

| Bull Scenario | Today | In One Year |
|---|---|---|
| Stock Price | 25 | 40 |
| | Exercise Options | Sells Shares |
| (Acquired Stock) | 3,750,000 | |
| Exercise Price | -1,050,000 | |
| AMT Due | -756,000 | |
| Total Outflow | -1,806,000 | |
| Sale Price | | 6,000,000 |
| Capital Gain Tax Due | | -1,836,450 |
| AMT Credit[2] | | 756,000 |
| Total Inflow | | 4,919,550 |
| Net Proceeds | | 3,113,550 |
| Cost of Capital[1] | | -36,120 |
| | | Exercise Options & Sell Shares |
| (Acquired Stock) | | 6,000,000 |
| Exercise Price | | -1,050,000 |
| Ordinary Income Tax Due | | -2,489,850 |
| Total Outflow | | -3,539,850 |
| Sale Price | | 6,000,000 |
| Total Inflow | | 6,000,000 |
| Net Proceeds | | 2,460,150 |
| **Net Impact of Exercising Early** | | **617,280** |

| Bear Scenario | Today | In One Year |
|---|---|---|
| Stock Price | 25 | 10 |
| | Exercise Options | Sells Shares |
| (Acquired Stock) | 3,750,000 | |
| Exercise Price | -1,050,000 | |
| AMT Due | -756,000 | |
| Total Outflow | -1,806,000 | |
| Sale Price | | 1,500,000 |
| Capital Gain Tax Due | | -166,950 |
| AMT Credit[2] | | 166,950 |
| Total Inflow | | 1,500,000 |
| Net Proceeds | | -306,000 |
| Cost of Capital[1] | | -36,120 |
| AMT Credit[2] | | 589,050 |
| | | Exercise Options & Sell Shares |
| (Acquired Stock) | | 1,500,000 |
| Exercise Price | | -1,050,000 |
| Ordinary Income Tax Due | | -226,350 |
| Total Outflow | | -1,276,350 |
| Sale Price | | 1,500,000 |
| Total Inflow | | 1,500,000 |
| Net Proceeds | | 223,650 |
| **Net Impact of Exercising Early** | | **23,280** |

1. "Cost of Capital" represents the interest return forgone on the cash utilized – an expense associated with exercising options early and holding the stock.
2. The amount of AMT Credit available may be less than the additional AMT paid in the year of ISO exercise due to a difference between LTCG tax rate and AMT rate. Note that while one is entitled to an AMT Credit for the additional amount of AMT paid in the year of ISO exercise attributable to such exercise, the amount of the AMT Credit that may be utilized in a given future tax year is limited. **See "AMT Credit" Appendix – Glossary for additional information.**
3. "Capital Gain Tax Credit" reflects the potential tax savings one may receive for realizing long-term capital losses.

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# GIFTING OF OPTIONS

## IS IT POSSIBLE TO GIFT OPTIONS?

- Although it is possible to gift options, the approach normally entails a degree of complexity that is not present when gifting shares of the company stock.
- For example, ISOs must, by definition, be non-transferable.
- As a result, gifting opportunities are normally limited to NQSOs.
- Event within the context of NQSOs, gifting can only take place if permitted under the terms of the company stock plan.

# Chapter 3

## MID AND LATE STAGE/ SERIES CD ROUNDS

Entrepreneur toolkit

MID AND LATE STAGE/ SERIES CD ROUNDS

# LENDING SOLUTIONS

## WHAT LENDING OPPORTUNITIES SHOULD AN ENTREPRENEUR CONSIDER DURING THE MID AND LATE STAGES OF THE BUSINESS LIFECYCLE?

*Morgan Stanley clients may qualify for lending solutions. Lending solutions can help finance almost any personal or business need. Entrepreneurs often need access to a flexible line of credit to manage cash flows, purchase real estate, make improvements or simplify cash management. A holistic review of both assets and liabilities is an important exercise to perform at this stage of the business lifecycle.*

### Securities Based Lending

- Securities based loans may provide access to capital, without having to sell assets, that can be used to pay tax obligations or provide financing for personal or business needs.

### Tailored Lending

- Customized borrowing options that can help provide the necessary funding and flexibility as entrepreneurs manage the diversification and expansion of wealth.

### Morgan Stanley Home Loan Solutions

- Residential mortgage solutions that may help meet home financing goals.

For discussion purposes only.
Please see important disclosures at the end of this material.
Borrowing against securities may not be suitable for everyone. You should be aware that there are risks associated with a securities based loan, including possible maintenance calls on short notice, and that market conditions can magnify any potential for loss. For details please see the important disclosures at the end of this presentation.

MID AND LATE STAGE/ SERIES CD ROUNDS

# CHARITABLE GIVING STRATEGIES

## WHAT CHARITABLE GIVING STRATEGIES SHOULD AN ENTREPRENEUR CONSIDER AS A LIQUIDITY EVENT APPROACHES?

*There is a range of philanthropic approaches that an individual may wish to consider within the context of pre and post IPO planning. The choices range from community foundations, to direct gifts to private foundations, donor advised funds or the non-profit itself. Each option also has unique characteristics from various forms of donor control, varying degrees of flexibility, cost and complexity. There are also varying amounts of tax deductibility. Philanthropy should be considered for entrepreneurs during the pre-liquidity and pre-sale planning process.*

### THREE OF THE MOST COMMON CHARITABLE PLANNING STRATEGIES PRE LIQUIDITY EVENT INCLUDE:

- Establishing a Charitable Remainder Trust
- Forming a Private Foundation
- Contributing to a Donor Advised Fund

- Q: What is a Charitable Remainder Trust and how can it benefit an individual engaging in an IPO?
- Q: How does a Private Foundation work?
- Q: What is a Donor Advised Fund?
- Q: Should charitable gifts be make pre or post IPO?

# CORPORATE TRUSTEE IN FAMILY BUSINESS PLANNING

## HOW MIGHT A CORPORATE TRUSTEE BE INTEGRATED INTO A PLANNING STRUCTURE THAT INVOLVES A FAMILY BUSINESS?

- When establishing a trust for the benefit of family members, the question of who should act as trustee merits particular attention.
- Although individuals often appoint a family member or friend to act as trustee, such people often lack the experience or expertise required to understand and undertake their fiduciary duties.
- Further, in instances when an individual acting as trustee is also a stakeholder in the family business, the potential conflict resulting from their dual roles can undermine their effectiveness in either capacity.
- For these and other reasons, an increasingly popular alternative involves the appointment of a corporate fiduciary to act as sole or co-trustee.

# PRE-LIQUIDITY VALUATION CONSIDERATIONS

**WHAT ARE SOME OF THE VALUATION CONSIDERATIONS THAT AN ENTREPRENEUR SHOULD BEAR IN MIND WHEN ENGAGING IN PRE-LIQUIDITY WEALTH TRANSFER PLANNING?**

- Many of the techniques associated with pre-IPO wealth transfer planning involve taking advantage of lower business valuations prior to the liquidity event.
- For gift tax purposes, an appraiser can take into account the fact that the business is not publicly traded, and that an ownership interest is therefore considered illiquid.
- If the gifted interest is a minority position (which is the most common scenario), this will also be taken into consideration by the appraiser.
- It's important to note that valuation for gift tax purposes may differ from 409A valuations as different factors are considered for each valuation.

# QUALIFIED SMALL BUSINESS STOCK

## WHAT IS QUALIFIED SMALL BUSINESS STOCK?

- The government gives people incentive to start business in the form of QSBS.
- If their stock qualifies (i.e., if the company is structured as a C-Corp, they received the shares directly from the company when assets were less than $50mm and have held them for 5 years), they could receive a tax break between 50-100% for the first $10mm of gain.
- A further benefit stems from the reinvestment of the proceeds (within 60 days) in another qualifying business.
- To the degree that a qualifying rollover occurs, the original sale will not be currently taxable.
- Ultimately, the gain will be subject to taxation upon disposition; however the ability to defer taxation for a period of time may be a benefit to the taxpayer.

# Chapter 4

## PREPARING FOR A LIQUIDITY EVENT

Entrepreneur toolkit

PREPARING FOR A LIQUIDITY EVENT

# PERSONAL TAX PLANNING

**I'VE SPENT MY LIFE FOCUSED ON GROWING THIS BUSINESS AND NOT ON MY PERSONAL PLANNING, NOW THAT I AM CONTEMPLATING A SALE OF THE COMPANY, WHAT TAX PLANNING SHOULD I BE CONSIDERING?**

*As a primary matter, you should consider your overall wealth and estate plan. If your goal is to transfer wealth to the next generation, consider pre-liquidity estate planning.*

## Estate Taxation and Lifetime Transfers

- As mentioned earlier, under current law, estates in excess of $11.18 million* ($22.36 million* for a married couple) (*although the official numbers have not yet been released by the IRS) will attract a 40% federal estate tax (under current law).
- Lifetime transfers can reduce the estate tax exposure.
- For transfer tax purposes, the value of a closely-held business interest is speculative and must be appraised by a professional appraisal company.
- In arriving at the value of a minority interest in a closely-held business, the appraiser likely will discount the value to reflect lack of marketability, illiquidity and lack of control.
- These discounts may enhance estate planning transfers.

# WEALTH TRANSFER TECHNIQUES

## WHAT ARE SOME OF THE MOST COMMON WEALTH TRANSFER TECHNIQUES THAT ENTREPRENEURS ENGAGE IN PRIOR TO A LIQUIDITY EVENT?

*Generally speaking, pre-liquidity tax planning falls into two broad categories: income tax reduction planning and estate tax reduction.*

| Type | Description |
|---|---|
| INCOME TAX REDUCTION PLANNING | • Income tax strategies typically involve attempting to accumulate a long term stock position in the company, rather than ordinary income positions such as Non-qualified stock options, Incentive Stock Options, restricted stock and restricted stock units. Generally speaking, since long term capital gains rates are lower than ordinary income tax rates, it is better to hold the company stock long term.<br>This means:<br>• It is generally better to exercise stock options earlier rather than later in order to keep the tax cost low and start the long term holding period;<br>• An executive may wish to make an 83(b) election upon receipt of restricted stock in order to start the long term holding period.<br>• Note that the above risks the loss of both the exercise price and the tax cost if the company is not successful. |
| ESTATE TAX REDUCTION PLANNING | • Involve transfer of wealth prior to appreciation to children.<br>• These strategies are detailed on a separate slide. |

PREPARING FOR A LIQUIDITY EVENT

# ESTATE FREEZE TRANSACTIONS

*A number of estate planning techniques call for the donor to retain the current value of the transferred asset, while giving away future appreciation. The following are examples of two of the more popular estate freeze transactions:*

## Sales

- A simple example of an estate freeze is a sale of an asset in exchange for a promissory note. Continuing with the example above, instead of making a gift of a 20 percent interest, you sell the 20 percent interest to a child and take back a promissory note for its current discounted fair market value (as appraised). The promissory note, in the principal amount of $1.4 million, must bear interest at a minimum rate so as not to be deemed a gift by the IRS. That rate typically is low. (The June 2017 rate for a 9 year note is 1.95%). When the business is sold, the child will receive $2 million (or more, if there is greater appreciation above the undiscounted appraised value) and pay off the note with $1.4 million. The excess sale proceeds pass to your child free of gift tax. This strategy can be enhanced by selling the asset to a trust of which you, as donor, are treated as the income tax owner (many refer to this as a "sale to an income tax (or "defective") grantor trust"). In that event, there would be no capital gain recognized upon the sale to the trust in which your child has a beneficial interest, interest payments from the trust would not be taxable income, and you (not the trust or your child) would be required to pay the capital gains tax upon the sale of the business to the third party. Under this structure, you are able to transfer additional wealth as a result of the valuation and the income tax structure.

## GRATs

- A grantor retained annuity trust (GRAT) is a trust to which you, as donor, will transfer assets, such as a minority interest in the business. Under the terms of the trust, you will receive an annual annuity for a term of years. In structuring the GRAT, the present value of the annuity stream will equal the value of the transferred assets so that there is no taxable gift (a "zeroed-out" GRAT). For example, following the prior example, if, instead of gifting or selling your 20 percent interest for $1.4 million, you transferred a 20 percent interest to a GRAT with a 5 year term, the GRAT would require the Trustee to pay you $280,000 per year (5x $280,000 = $1,400,000). The IRS requires you to include a growth rate in the present value calculation, which is published by the IRS monthly. Similar to the rate for intra-family loans, this rate has been fairly low (the June 2017 rate is 2.4%). Therefore, in order to zero-out the GRAT, the annuity must include this assumed rate of growth. If, during the 5 year period, the business is sold, the GRAT will receive cash, and owe you $280,000 a year (plus 2.4%). If the sale proceeds exceed that amount (which, given the imbedded discount, should be assured), the excess value may pass to your children free of transfer tax. A GRAT also is a "grantor trust" for income tax purposes, meaning that you would pay the capital gains tax upon sale out of other funds, allowing the pre-tax proceeds to pass to the next generation.

# GIFTING TECHNIQUES

## ARE THERE TECHNIQUES TO ASSIST IN GIFTING?

*Numerous tools exist to assist in gifting. Below is a non-exhaustive list of some of them.*

### Outright gifts

- A donor may decide to make simple gifts to his or her children, or to a trust for their benefit by giving them privately held stock.
  - Example: Executive gifts $15,000 worth of his company's stock to a trust for his child. One year later, the company goes public, and the stock in the trust is now worth $42,000.

### Use of the Estate Tax Exemption

- A donor may, in addition to the annual exclusion amount, gift assets worth up to the total Estate Tax Exemption during their life without incurring gift tax.
  - Example: In addition to gifting the $15,000 annual exclusion gift noted above, the same executive gifts $10MM worth of their stock to the child's trust. Once year later the company goes public and the stock in the trust is worth $30MM.

### Estate Freeze Transactions

- A number of estate planning techniques call for the donor to retain the current value of the transferred asset, while giving away future appreciation.
  - Two examples of the more popular estate freeze transactions are on a separate slide

PREPARING FOR A LIQUIDITY EVENT

# GIFTING TECHNIQUES (CRT)

*An additional income tax planning tool to assist in gifting is a Charitable Remainder Trust.*

## CHARITABLE REMAINDER TRUST (CRT)

- Similar to a GRAT, the donor transfers property to a trust that makes an annual annuity payment to the donor for a period of time. In this case, the annuity can be a fixed percentage of the initial value, or a fixed percentage of the value of the trust property redetermined annually. The remainder interest will pass to one or more charitable organizations. The remainder interest must be at least 10 percent of the initial gift. If the assets increase in value, any excess will inure to the benefit of charity.

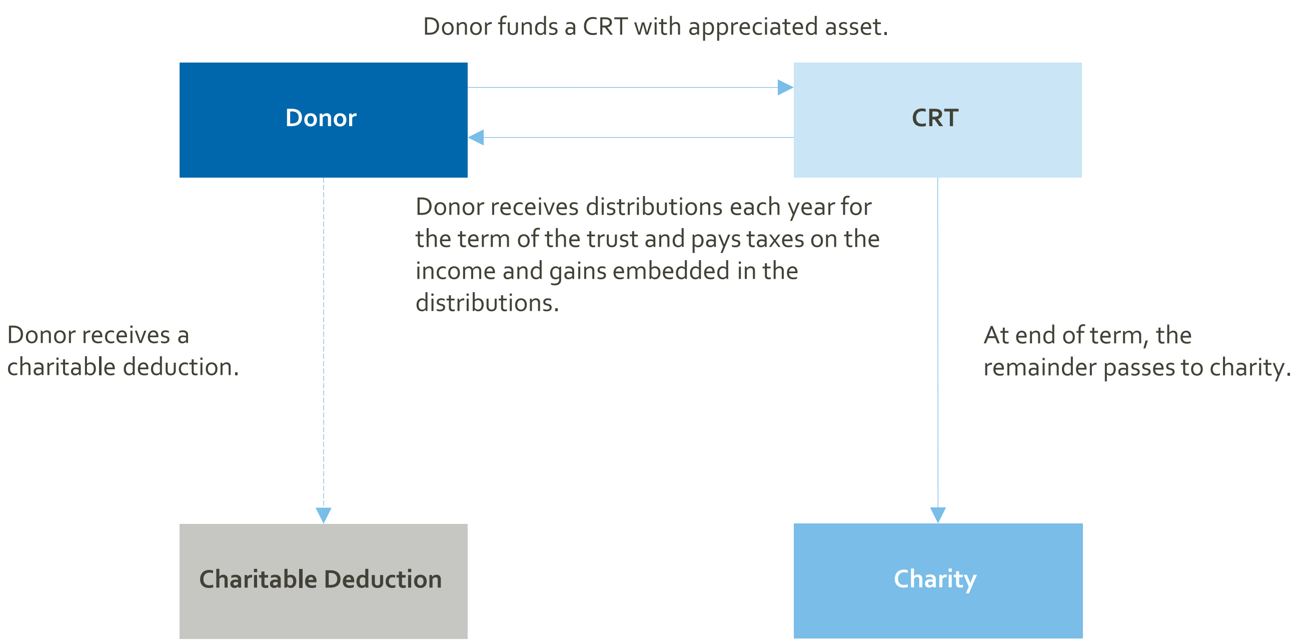
- However, the CRT may provide additional income tax benefits. The initial gift of a remainder interest (no less than 10% of the initial value) can generate an income tax deduction.

- Moreover, CRTs are tax exempt entities, therefore, there is no immediate capital gains tax upon the sale of the business. Each annual annuity payment to the donor will carry out a portion of the imbedded capital gain.

- As a result, additional wealth may be created via the income tax deferral. In this case, the donor can achieve both tax planning and charitable goals simultaneously.

HYPOTHETICAL ILLUSTRATION

# CHARITABLE REMAINDER TRUST (CRT)



HYPOTHETICAL ILLUSTRATION

# CHARITABLE REMAINDER TRUST (CRT)

## FUNDING A CRUT WITH APPRECIATED ASSET

- The following is an illustration of a Charitable Remainder Unitrust (CRUT) funded with $1,000,000 appreciated asset (zero cost basis). The trust has a 5-year term and a 10% charitable deduction. The donor's personal account collects the unitrust distributions from the CRT.
- In this hypothetical illustration, the charity receives a remainder of $136,391 at the end of the term, whereas the personal account has an ending value of $900,697.

### ASSUMPTIONS:

**CRT**

| | |
|---|---|
| Gross Principal | $1,000,000 |
| Cost Basis | $0 |
| 7520 Rate | 2.6% |
| Term of Trust | 5 |
| Unitrust Rate | 37.9% |
| Annual Investment Gross Return | 5.0% |
| CRUT Remainder | $136,391 |

| Year | Beginning Principal | Growth | Total | Unitrust Amount | Remainder |
|---|---|---|---|---|---|
| 1 | $1,000,000 | $50,000 | $1,050,000 | $378,638 | $671,362 |
| 2 | $671,362 | $33,568 | $704,930 | $254,203 | $450,727 |
| 3 | $450,727 | $22,536 | $473,264 | $170,662 | $302,601 |
| 4 | $302,601 | $15,130 | $317,731 | $114,576 | $203,155 |
| 5 | $203,155 | $10,158 | $213,313 | $76,922 | $136,391 |

**Personal Account**
**(initial value reflects tax savings from charitable deduction)**

| | |
|---|---|
| Charitable Deduction | $100,000 |
| Marginal Tax Rate | 40.8% |
| Potential Tax Savings | $40,800 |
| Investment Period | 5 |
| Effective Investment Tax Rate | 20.0% |
| Annual Investment Gross Return | 5.0% |
| Ending Portfolio Value | $900,697 |

| Year | Personal Account | Net Unitrust Payment | After Tax Growth | Total |
|---|---|---|---|---|
| 1 | $40,800 | $290,422 | $1,632 | $332,854 |
| 2 | $332,854 | $194,978 | $13,314 | $541,146 |
| 3 | $541,146 | $130,901 | $21,646 | $693,693 |
| 4 | $693,693 | $87,882 | $27,748 | $809,323 |
| 5 | $809,323 | $59,001 | $32,373 | $900,697 |

*Hypothetical example is for illustrative purposes only. Not representative of any specific investment.*

# EXECUTIVE PRE-LIQUIDITY CHARITABLE GIVING

## SHOULD A PRE-LIQUIDITY EXECUTIVE ENGAGE IN CHARITABLE PLANNING?

*While a decision to engage in philanthropy is inherently personal, there are good tax reasons to transfer pre-liquidity stock to charity rather than waiting for a liquidity event. Timing, however, is key to success. Compare the following hypothetical scenarios.*

- An executive holds stock in their private company. The company sells in an all cash transaction. The executive incurs long term capital gain tax on the sale of their stock, and then makes a gift of $1MM to charity. They receive a $1MM charitable income tax deduction.
- An executive holds stock in their private company. A few months prior to a planned sale of the company, the executive transfers $1MM worth of their stock to a public charity willing to accept the stock. Upon sale, the charity pays no tax and receives $1MM. the executive receives a $1MM charitable income tax deduction. The executive avoids long term capital gain tax on the gifted stock since they did not own it at the time of sale.

- Timing is important. The executive would like to maximize the value of the stock upon transfer to charity, while at the same time avoiding the tax when a sale occurs. A transfer too close to the sale, however, could result in the executive be attributed the capital gain on the stock even though the charity owned it at the moment of sale.
- There are advantages to giving private stock to a public charity rather than a private foundation. A gift of private stock to a private foundation generally results in a charitable income tax deduction limited to cost basis rather than fair market value. A gift of the same stock to public charity results in the deduction being valued at fair market value. It can be difficult, however, to find a public charity to accept such stock. In such a case, the executive may wish to consider a gift to a Donor Advised Fund ("DAF").

# PUBLIC VERSUS PRIVATE CONSIDERATIONS

## WHAT CONSIDERATIONS ARE THERE IN A PUBLIC RATHER THAN A PRIVATE SALE?

*Generally speaking, there are three basic liquidity scenarios: a cash sale, a tax-free stock acquisition (usually by a public company), or an IPO. Each involves different considerations.*

### CASH SALE

- A cash sale will trigger long term capital gains tax on stock held for the requisite holding period, short term gain on stock held short term, and ordinary income on option spread if options are cashed out as a result of the sale.

### TAX-FREE REORGANIZATION

- A stock acquisition generally results in an executive trading private stock for fully liquid stock in a public company (assuming it is a public company which acquires the private firm). There is no tax effect to this transaction until the executive sells his or her shares. Their tax basis remains the same. However, the executive has traded risk in holding their private company stock (a company which they may have controlled) for public market risk and specific risk in the acquiring company (which the executive likely does not control). Options may or may not be transferred to the new company as a result of the transaction. If not transferred, they may be cashed out, resulting in ordinary income tax on the options spread.

### IPO

- An IPO has no immediate tax effect on a long term stock position held by an executive of the newly public company. However, several restrictions on sale may be imposed on the executive, preventing him or her from liquidating their position. Options, restricted stock and RSUs are typically unaffected by an IPO, but the fact that there is a public market for the stock can make exercise of options easier. The spread on NQSOs is still deemed ordinary income and disqualified ISOs are also treated like NQSOs.

# SECURING THE FAMILY BUSINESS FOR THE NEXT GENERATION

**WHAT STRATEGIES ARE AVAILABLE TO A FAMILY BUSINESS THAT SEEKS TO SECURE THE FOUNDERS' RETIREMENT AND CONTINUE THE BUSINESS IN THE HANDS OF THE NEXT GENERATION?**

- If instead of going public or engaging in an outright sale of the business, the plan is for the entrepreneur to pass the business to the next generation, such planning should be done prior to appreciation of the stock. Many families find themselves in a difficult position when they realize, after a family business is successful and the founding generation wishes to retire, that the estate and gift tax legislation noted above makes it difficult to transfer ownership to the next generation of family members.

- Consequently, it is better to begin to move ownership using (among others) the techniques discussed above sooner rather than later. Also, a family can consider an employee stock ownership plan in order to provide liquidity to the retiring owners on a tax advantaged basis. A family could also consider an installment sale to the next generation, which would allow the purchasers to use the cash flow of the business to pay the retiring owners.

# BUSINESS AT DEATH

## WHAT WILL HAPPEN TO MY BUSINESS AT MY DEATH?

- Generally, the shareholder or operating agreement of the entity, or a separate "buy/sell" agreement will govern (i) how your equity in the company passes, and (ii) the valuation, liquidation and other rights of your successors in interest.
  - For example, many businesses provide that the equity interests pass under the deceased shareholder's Will. The governing instruments may give put rights to the beneficiary or provide for mandatory redemption. Voting rights of a beneficiary may be limited so that management of the company remains with the employee shareholders. It is important to identify these provisions in your existing governance documents and review any buy/sell agreement.

- Consider whether additional planning is necessary.
  - For example, will your family want to hold on to the equity in the company or will they need to be cashed out in order to maintain their lifestyle without your current income? If they will need cash, how will the company raise the cash? Many buy/sell agreements are funded with life insurance on the deceased shareholder's life and/or provide for installment payments over a term of years.

# TRANSITION OF COMPANY AT DEATH OR PRIOR

## HOW CAN I PLAN FOR A SEAMLESS TRANSITION OF THE COMPANY AT MY DEATH OR EARLIER RETIREMENT?

*The key is to have an up-to-date succession plan in place. In order to create a plan, there are a number of considerations regarding the transition of ownership and management, including the following:*

1. **FAMILY BUSINESS SUCCESSION**
   - If the goal is to pass the business ownership and management to family, a succession plan may include:
     - (a) Gifts of equity to children, either outright or in trust, in a tax efficient manner, similar to preparing for a liquidity event, discussed earlier.
     - (b) Bequests of equity at death along with a liquidity plan for estate taxes.
       - (i)The estate tax generally is due 9 months after the date of death. If the estate consists primarily of illiquid business interests, consider life insurance funding, the potential for borrowing and any estate tax deferral opportunities for closely held business interests. For example, under current law, if the business represents a significant part of the taxable estate, the executor may be able to defer the tax and pay in installments over a 10 year period.
       - (ii)Consider the allocation of equity among family members. Will each child inherit an equal share? Should the equity pass only to the child who works in the business? Address family conflict issues that may arise based on shared ownership.
2. **MANAGEMENT/EMPLOYEE SUCCESSION**
   - If your goal is for employees to continue the business you must have a sound and well-rounded management team. You should plan as far in advance as possible, prepare the company for transition and consider financing options and tax consequences. Methods of transferring ownership to key employees include:
     - (a) Employee Stock Ownership Program (ESOP);
     - (b) Sale to existing or new management (with or without private equity investment); and
     - (c) Gifts to key employees.
3. **GOVERNANCE ISSUES**
   - (a) Will any/all family members participate in management?
   - (b) If employees receive the business, who are the key employees who will oversee day-to-day operations and serve in management positions?
   - (c) How will conflicts be resolved?

Chapter 5

# POST LIQUIDITY PLANNING

Entrepreneur toolkit

# CONSIDERATIONS FOR AN EXECUTIVE HOLDING NOW-PUBLIC STOCK

## WHAT CONSIDERATIONS ARE THERE IN A PUBLIC RATHER THAN A PRIVATE SALE?

If the executive's company goes public, there are several considerations they should consider, including:

### WHETHER AND HOW DO LIQUIDATE THE STOCK IN AN ORDERLY AND TAX-EFFICIENT MANNER

- If the executive decides to liquidate, they should be aware of any regulatory (144/16b), corporate (blackout periods) or contractual (lock-up agreements) restrictions which may be imposed on the amount of stock they can sell in any given quarter;
- If possible, they may wish to engage in a hedging transaction to mitigate the risk of holding their concentrated position;
- The executive may wish to consider a 10b5-1 plan to sell stock in an orderly manner and mitigate claims of insider trading;
- Once liquid, the executive may wish to consider re-investing the proceeds to mitigate the risk of their concentrated position. For instance, they may wish to invest away from the sector in which their company operates.

### HOW TO ENGAGE IN PHILANTHROPIC PLANNING THAT IS TAX-EFFICIENT

- An executive holding public stock can consider gifts to public charities or private foundations;
- The executive may wish to consider the strategies noted above in the pre-liquidity planning section.

An executive should also consider:

- Family Governance and Wealth Education
- Lifestyle Advisory

# CONSIDERATIONS FOR LIQUIDATED/CASH POSITION

## WHAT ARE THE CONSIDERATIONS FOR A LIQUIDATED POSITION?

### CONSIDERATIONS FOR LIQUID POSITIONS INCLUDE:

- Philanthropic planning
- Family governance and education
- Lifestyle advisory

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This presentation was designed to illustrate the financial impact of a particular planning decision. The slides herein do not constitute a recommendation.

Caution: many estate techniques share the common risk of the loss of control of the assets once the gift of the assets is complete.

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