Morgan Stanley

PRIVATE WEALTH MANAGEMENT

Insights for Entrepreneurs

Part One: Choosing a Business Structure

Working as part of an integrated advisory team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources needed to help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management.

How Should I Structure My Startup Business?

The choice of business structure is a critical strategic decision with wide-ranging impacts on the future of your business. These include how your profits will be taxed, the degree of creditor protection you will be afforded and the range of exit strategies that will ultimately be available to you. Below are some of the most common business structures:

- **GENERAL AND LIMITED PARTNERSHIPS.** In general partnerships, the partners control and manage the company. 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 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.** A C Corporation is a separate legal entity that exists apart from you and any other owners of your firm. One of the key benefits of the C Corporation structure is that it provides you with substantial liability protection. C Corporations also have the ability to attract investors through the issuance of stock, and there may be additional benefits afforded by investment in Qualified Small Business Stock (QSBS). As it is not a pass-through entity, however, you and the other owners are subject to taxation twice, once at the corporate level and then again when earnings are distributed to you in the form of dividends.
- **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 one hundred and there are limits on who can own the shares. 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 S Corporation stock.
- **LIMITED LIABILITY COMPANIES (LLCS).** LLCs are constructs that combine the elements of Corporations and partnerships. As the name suggests, members of an LLC have limited liability protection. There is also considerable flexibility. You can elect to have your LLC taxed as either 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.

What Is Qualified Small Business Stock and Do I Qualify?

Qualified Small Business Stock is part of a U.S. government program to incentivize entrepreneurs to start businesses. If your stock qualifies, you could receive a tax break between 50-100% for the first $10 million of gain when you sell the business. If you reinvest the proceeds within 60 days in another qualifying business, the original sale will not be currently taxable, at least to the degree that a qualifying rollover occurs. While the gain will ultimately be subject to taxation upon disposition, the ability to defer taxation for a period of time may provide you with a significant benefit. Speak to your tax advisor to determine whether the shares in your company qualify. A typical scenario might be a company that is structured as a C Corporation, where you received the shares directly from the company when assets were less than $50 million and have held them for five years.

THE INSIGHTS FOR ENTREPRENEURS SERIES COVERS THE FOLLOWING ADDITIONAL TOPICS:

- Early-Stage Trust and Estate Planning
- Overview of Wealth Planning Structures
- The Public Sale of Privately Held Businesses
- Family-Owned Business Succession Strategies
- Philanthropic Strategies and Structures
- Understanding Equity Compensation

FOR FURTHER INFORMATION

If you wish to discuss which corporate structure is best-suited to your business goals, please speak to your Private Wealth Advisor. He or she can schedule a meeting with a Morgan Stanley Tax, Trust and Estate specialist.

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Part Two: Early-Stage Trust and Estate Planning

Working as part of an integrated team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources needed to help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management.

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%

*If carryover basis and no estate tax was chosen in 2010.

Do I Need to Focus on Estate Planning This Soon?

In the early stages of your company's growth, it can be difficult to focus on anything other than running your business. Personal financial planning is often overlooked and estate planning appears to be a distant concern at best. Those early stages, however, is also a particularly important and productive time to conduct in-depth estate planning.

Here's why: When your business succeeds, one of the greatest challenges you may eventually face is how best to transition wealth to future generations. As the value of a business grows, so does your potential exposure to estate and gift taxes. Under current law, you have a lifetime estate tax, gift tax and generation-skipping tax of $5.49 million, or roughly $11 million for a married couple. After that, the wealth you gift or leave to your heirs is subject to a 40% federal estate tax. Fortunately, establishing a plan early in the life cycle of the business may provide opportunities to sidestep many of these taxes by creatively distributing ownership interests to family members and other beneficiaries at a time when valuation levels are low. Thoughtful planning early on can lead to more efficient and successful transitions when you eventually decide to exit the business, or even to pass ownership to younger generations of your family.

What Basic Planning Documents Should I Have in Place?

- Basic Will: Outlines distribution of assets upon death
- Revocable Living Trust: Avoids probate and distributes assets upon death
- Durable Power of Attorney: Appoints an agent to act on your behalf
- Heath Care Directive: Appoints an agent to make health care decisions on our behalf if you are unable to do so yourself
- Irrevocable Life Insurance Trust: Removes life insurance proceeds from your estate

What Types of Insurance Should I Consider?

Many business owners purchase "key man" insurance, the purpose of which 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.

YOU MAY ALSO WANT TO CONSIDER:

Whole Life, Universal Life and Variable Life Insurance: Permanent life insurance coverage often used to fulfill long-term estate planning needs.

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.*

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Choosing a Business Structure

Overview of Wealth Planning Structures

The Public Sale of Privately Held Businesses

Family-Owned Business Succession Strategies

Philanthropic Strategies and Structures

Understanding Equity Compensation

FOR FURTHER INFORMATION

If you wish to discuss which estate planning strategies and structures are best suited to your personal and business goals, please speak to your Private Wealth Advisor. He or she can schedule a meeting with a Morgan Stanley Tax, Trust and Estate specialist.

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Part Three: Overview of Wealth Planning Structures

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How Can I Use Trusts to Reduce My Long-Term Tax Exposure?

As the value of your company increases, 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 their ultimate exit strategy. Though not a trust, Family Limited Partnerships (FLPs) are also used in similar fashion. In each case, the basic methodology is to gift ownership interests to beneficiaries while valuations are as low as possible.

By removing the assets from your estate, you allow for much of the subsequent appreciation in value to accrue on behalf of beneficiaries. This can be useful if you have already exhausted your $5.49 million lifetime estate and gift tax exemption ($10.98 million for married couples) or if you wish to preserve it for other wealth transfer opportunities.

It is important to note that for these strategies to be effective, they should be deployed prior to any sale or transfer of your business.

How Does a GRAT Work?

As the donor, you create a trust that pays you an annuity for a fixed period of time, either a series of equal amounts or amounts that increase up to 20% per year. You then direct that any assets left after the annuity is paid, the "remainder interest," be paid to the trust beneficiaries, often close family members to whom you wish to transfer wealth. That remainder interest is deemed to be a gift to the beneficiaries. The values of the taxable gift is the fair market value of the assets transferred into the trust, minus the value of the annuity you "retained" as the donor (which 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. That results in a very small taxable gift on the creation of the GRAT ("zeroing out" the GRAT), which will be reported on the donor's annual gift tax return.

Your 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 the entire value of that excess to the beneficiaries without making an additional taxable gift. The donor will also 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 annuity.

How Does an Intentionally Defective Grantor Trust (IDGT) Work?

An IDGT is an estate planning tool used by those who are attempting to freeze the value of an asset for estate planning purposes, assets like shares of your early-stage or pre-IPO company, for example.

The first step is to create the irrevocable trust, the IDGT. As the donor, you then can sell assets to the IDGT in exchange for the trust's interest-bearing promissory note. The sale of the asset to the IDGT removed the asset from your estate. 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 on your sale to the trust, and the repayment of the promissory note has no income tax consequences to you or the trust because you are treated as the owner of the trust for income tax purposes. By paying taxes on trust income, you, in effect, make additional transfers to the beneficiaries of the trust, who are not subject to gift tax.

Most commentators suggest that a "seed gift" be at least 10% of the principal amount of the promissory note should be contributed to the IDGT. The transfer of such seed gift to the IDGT can be made utilizing both the gift tax annual exclusion or the gift tax exemption amount. The IDGT can be effective for gifts to grandchildren and other remote descendants if the GDT exemption is properly allocated to the trust.

What Is a Family Limited Partnership?

A Family Limited Partnership (FLP) is a structure that enables you to gift limited partnership (LP) interests to family members or to a trust while retaining a General Partnership (GP) interest for yourself. As GPs, you maintain management and investment control over the partnership's 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 can provide substantial valuation discounts. This may minimize the impact of gift and estate taxes that your family might otherwise incur.

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Part Four: The Public Sale of Privately Held Businesses

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What Considerations Are There in Different Types of Public Sales?

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.

- 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.
- A tax-free stock acquisition generally results from the exchange of private stock for fully liquid stock in the public company that acquires your privately held firm. There is no tax effect to this transaction until you sell your shares, and your tax basis remains the same. 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.
- An IPO has no immediate tax effect on a long-term stock position you hold in the newly public company. However, several restrictions on sale may be imposed, preventing you from liquidating your position. Options, restricted stock and restricted stock units 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 nonqualified stock options, and disqualified incentive stock options, is still deemed ordinary income.

What Tax Planning Measures Should I Consider Ahead of the Sale?

If your goal is to transfer wealth to the next generation, consider implementing your estate-planning measures well ahead of the sale of your business, particularly if you expect the proceeds to exceed your $5.49 million lifetime gift and estate tax exclusion (roughly $11 million for a married couple). In most cases, the value of your business will have a lower value, for transfer tax purposes, than it will after the sale. This is because the value of a closely held business interest is speculative and must be determined by a professional appraisal company. In arriving at the value of a minority interest in your business, the appraiser will likely discount the value to reflect lack of marketability, illiquidity and lack of control. The resulting discounts can enhance estate-planning transfers.

What Are Some of the Most Common Pre-Liquidity Income Tax Strategies?

Income tax strategies typically involve attempting to accumulate a long-term stock position in the company, rather than ordinary income positions such as nonqualified stock options, incentive stock options, restricted stock and restricted stock units. This is because long-term capital gains rates are lower than ordinary income tax rates. This means:

- It is generally better to exercise stock options earlier rather than later in