Morgan Stanley

THE PACIFIC WEALTH MANAGEMENT GROUP MAY 2015

Planning for a Liquidity Event

INTRODUCTION

The company in which you hold an equity stake is considering going public. The business you've built painstakingly over the years has attracted the interest of a potential buyer. These potential liquidity events may represent a significant magnification of wealth for you in the months to come.

PROTECTING THE WEALTH YOU'VE WORKED SO HARD TO CREATE

Liquidity events—so called because they may convert illiquid assets to cash or marketable securities—can increase your wealth substantially. With proper planning, the right timing and an experienced team of advisors, you may also mitigate the elevated personal income and estate tax liability usually associated with an Initial Public Offering or the sale of a privately held company.

For professionals and business owners at this stage, your choices over the next 24 months may be the most important decisions of your career. As you are pushed to the brink of execution to prepare your company for this transitional phase, attention will be singularly focused on getting across the finish line. To achieve the parallel success of preparing your household and family for probable wealth transformation, it is imperative to assemble a highly specialized team of advisors to ensure that your wealth management strategy successfully crosses the finish line as well.

TABLE OF CONTENTS

THE PACIFIC WEALTH MANAGEMENT GROUP

Dale T. Miller, CPM®
Senior Vice President
Corporate Client Group Director
Wealth Advisor

Larry J. Garcia, CFP®, CIMA®, CLU®, ChFC®
First Vice President
Senior Investment Management Consultant
Wealth Advisor

David C. Keller, CFP®, CIMA®, CMFC®
Vice President
Senior Investment Management Consultant
Wealth Advisor

Betsy N. Hansen
Financial Advisor

Preserving Your Windfall—Time Is of the Essence

Strategies may be available to you in advance of the sale that will not be available later. These measures may involve valuation discounts on transfers of stock into a Dynasty Trust or Grantor Retained Annuity Trust (GRAT). They may involve the early exercise of Incentive Stock Options and/or an 83(b) election to qualify for long-term capital gains treatment. Or they may involve the transfer of shares into Charitable Remainder Trusts to generate income on a diversified portfolio, defer taxation and generate a potential income tax deduction for a remainder charitable interest.

You may be in a position to utilize any combination of these strategies in advance of a liquidity event. The most important point to understand however is that individuals who have taken the time to plan ahead (up to 18-24 months in advance) will likely reap the greatest leverage from these strategies. This is due to the fact that they are most beneficial when you take action before your assets have risen significantly in value. As such, awareness of these techniques prior to a sale or IPO places you and your team of advisors in a significant place of strength.

Who Should Be On Your Team?

Assembling a team of trusted advisors should be one of the first steps in preparing for a liquidity event. Think of this as assembling your personal "Brain Trust" to bounce ideas, concerns and scenarios off of.

Preparing for a liquidity event is a good time to review your chosen team members, and may even trigger a change or two. It is critical to ensure that your team of advisors has the relevant expertise, experience, and successful track records in working through similar situations. A qualified, competent team will make things smooth and efficient, while having the wrong team can have costly results.

Who should be on this team? While every situation is different, here is a suggested list of essential members.

WEALTH ADVISOR—Work with an individual experienced in navigating through this process and who can help identify and address advanced wealth planning issues relevant to business owners.

ESTATE PLANNING ATTORNEY—Choose an attorney who has experience in this type of transaction and who works with high net worth individuals as well as being capable of executing advanced estate planning strategies for business owners.

ACCOUNTANT—Frequently this will be the company's certified public accountant (CPA). Again, as with the attorney, select a CPA who has experience in this type of transaction and the various tax aspects of monetizing a business, and is knowledgeable in structuring a sale to minimize the tax impact to the owners.

INVESTMENT BANKER OR BUSINESS BROKER—Depending on the particular characteristics of the company, either an investment banker or business broker can help you structure the deal. Additionally, they will conduct analyses and provide valuation assistance to help develop a possible range of values for the business.

CORPORATE ATTORNEY—Sometimes this may be the company's attorney, but there are attorneys who specialize in drafting purchase and sale agreements. Working with an experienced attorney can add tremendous value.

Make a point to engage your team as early as possible and make sure they are collaborating on your behalf proactively and not simply responding to your requests. As the deal gets closer, there will be many decisions made either through proactive planning, or through passive ignorance, which cannot be undone.

Four Key Steps for Successful Planning and Execution

Ideally, you will begin this process 18-24 months in advance of liquidity. While this may seem a distant reality, it is during this earliest phase that you will set many of the most important wealth management decisions into motion.

1. IDENTIFY YOUR TEAM OF TRUSTED ADVISORS

Life can quickly become busy and hectic beyond the scope of your control and involve planning issues outside of your realm of expertise. Assembling a team of trusted advisors early can help alleviate pressure related to wealth planning and strategy while increasing the likelihood that you achieve an optimal result. When selecting your team of advisors, choose professionals who have experience in liquidity planning and who are able to work with other advisors in a collaborative setting.

2. DEVELOP A COMPREHENSIVE FINANCIAL PLAN

Attempting to develop a wealth strategy during the home stretch is particularly challenging due to the numerous commitments, stress and focus required to ensure business execution at the highest level. Whether or not you have an existing plan, it is critical that you articulate your long-term planning objectives to your advisory team so that they may build an effective and timely road map.

3. REVIEW EXISTING ESTATE PLAN

In conjunction with reviewing your overall wealth management strategy, a review of your estate plan is important. This goes beyond the basic will, living trust or health care power of attorney (although it is surprising how many executives and business owners do not have these steps addressed!). This is the primary opportunity to coordinate with your financial planner and estate attorney to determine which specific strategy or combination of strategies make the most sense. Remember, timing is critical to ensure greatest leverage from placing “undervalued” pre-liquidity holdings into specialized trusts.

4. COMMIT TO MONTHLY PROGRESS REPORTS

Once planning objectives are in place, schedule monthly progress reports to ensure that you are executing on the proper time line. Conference calls or meetings should be brief wherein the lead planner reviews executed steps, pending initiatives and administrative items (signatures, drafts, etc). The meeting should end with clear objectives for your advisory team over the next 30-90 days, enabling you to focus on the priorities of your company.

The Liquidity Timeline — A Hypothetical Example

This hypothetical illustration lays out the significant impact that simple pre-liquidity planning strategies can have on your net worth in the long run.

Say you're an executive at a start-up that received one million shares of incentive stock options. The fair market value of the shares is currently $1/share, and you have the option of exercising those shares at $0.0001/share. If you were to exercise your stock options and hold the stock for more than one year before an expected liquidity event, you could potentially save a significant amount in taxes. By exercising options and holding your shares for a year or more before selling, any resulting gain would qualify for the lower long-term capital gains tax rate vs. being treated as short-term capital gains taxed at higher ordinary income rates. The amount that you would be taxed on is called the "bargain element," i.e., the price difference between the current market value of the shares and your exercise price. You are best off exercising before the bargain element has grown too significantly because you will have to pay tax on that amount. Assuming long-term capital gains taxes are 20%, and income taxes are near 40%, the following two scenarios are crystal clear — simple planning techniques can save an individual millions in the long run.

ASSUMPTIONS

- 1 million ISOs
- Stock's fair market value at grant date: $1.00
- Long-term capital gains rate: 20%
- Alternative minimum tax rate: 28%
- Income tax (top bracket): 39.6%* (Does not include PPACA tax 3.8%)
- Fair market value of stock at liquidation: $10.00
- Federal estate tax: 40% top marginal rate
- State of Washington estate tax: 20%
- Annual rate of return: 5%
- Tax calculations assume a taxable estate (*See note)

*Please note that tax rates were simplified for ease of illustration. Please consult your financial advisor and accountant for exact rates pertaining to your specific situation.

NO PLANNING

Wait for liquidity event and exercise/sell all shares.

A Liquidity Event With No Planning

Over half of the estate is collected in taxes upon passing.

L-3*

ONE MILLION ISOs
$1MM MARKET VALUE

*Notes on periods isolated in time line: L-3 = Three years before a liquidity event. Liquidity = Year of liquidity event L+35 = Value upon death (35 years after the liquidity event)

LIQUIDITY

$10MM
-$3.96**
= $6.04MM

**Federal income tax applied to the bargain element

VALUE UPON DEATH L + 35

$33.32MM

RESULTING WEALTH PASSED TO HEIRS NET ESTATE TAXES

$33.32MM
-$6.3MM Wash. state estate tax
-$8.6MM FED estate tax
= $14.9MM DUE IN TAXES***
PASSED TO HEIRS: $18.42MM

***This would be the Federal estate tax over and above the $5.34MM exemption and Washington state has a $2.01MM exemption.

The Power of Planning

As you can see in this example, planning before a liquidity event can make a profound difference. With proper planning, you're able to: 1. keep more of the wealth generated from the liquidity event; 2. pass more to your heirs; and 3. give meaningful amounts to charity.

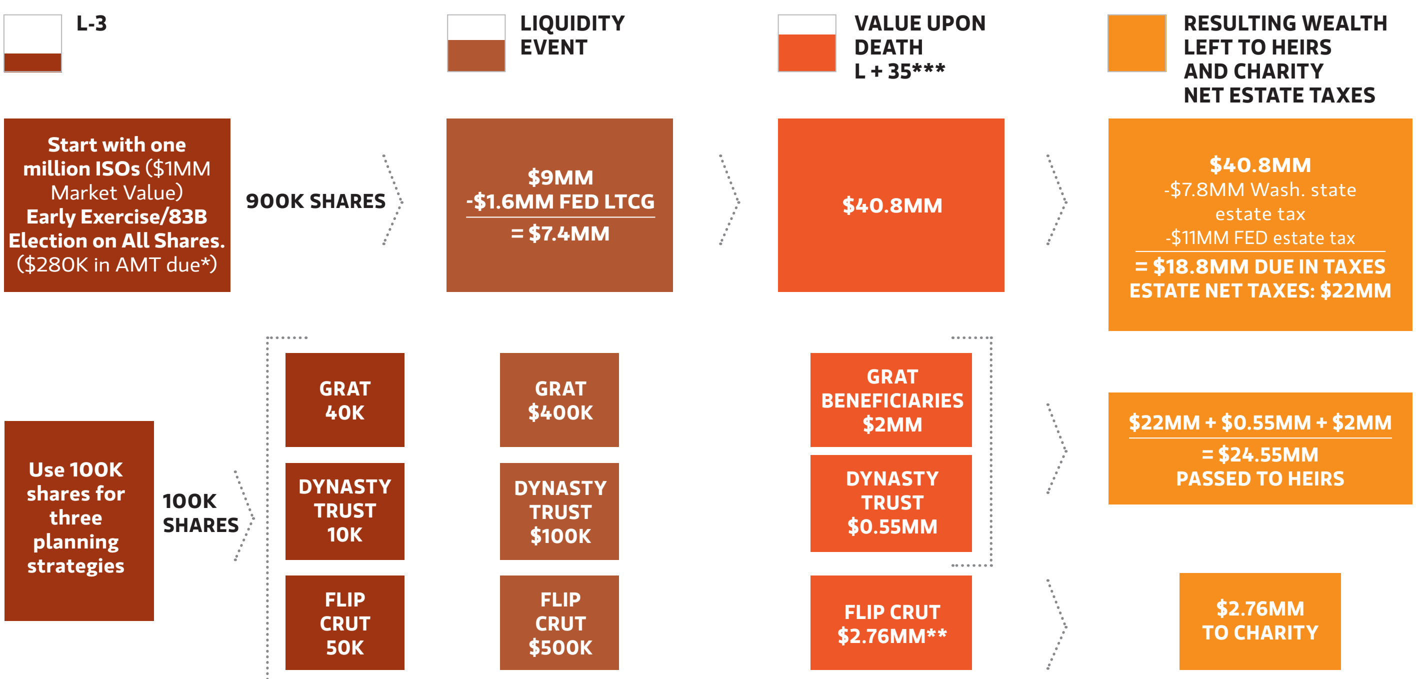
EXAMPLE

PRE-LIQUIDITY PLANNING USING THE FOLLOWING STEPS:

1. Exercise ISO shares to start holding period
2. Transfer 100K shares into zeroed-out GRAT
3. Transfer 20K shares into a Dynasty Trust that allows life insurance
4. Transfer 80K shares into a FLIP CRUT

With Some Simple Planning Techniques, Taxes Can Be Significantly Reduced

Thanks to a few key steps taken at grant and one year prior to any sale.



*Please note that AMT taxes are assumed to be funded with outside cash. No shares are liquidated to cover this tax bill in the illustration. **Assumes distributions have not been started for illustrative purposes. Income distributions of 5% (minimum) could be started at any time for the benefit of the grantor. ***Values at death reached by assuming a 5% annual rate of return over 35 years.

The following pages explain the purpose and impact of three key pre-liquidity strategies:
1. Grantor retained annuity trust;
2. Dynasty trust; and
3. Flip charitable remainder unitrust.

Grantor Retained Annuity Trust

PURPOSE

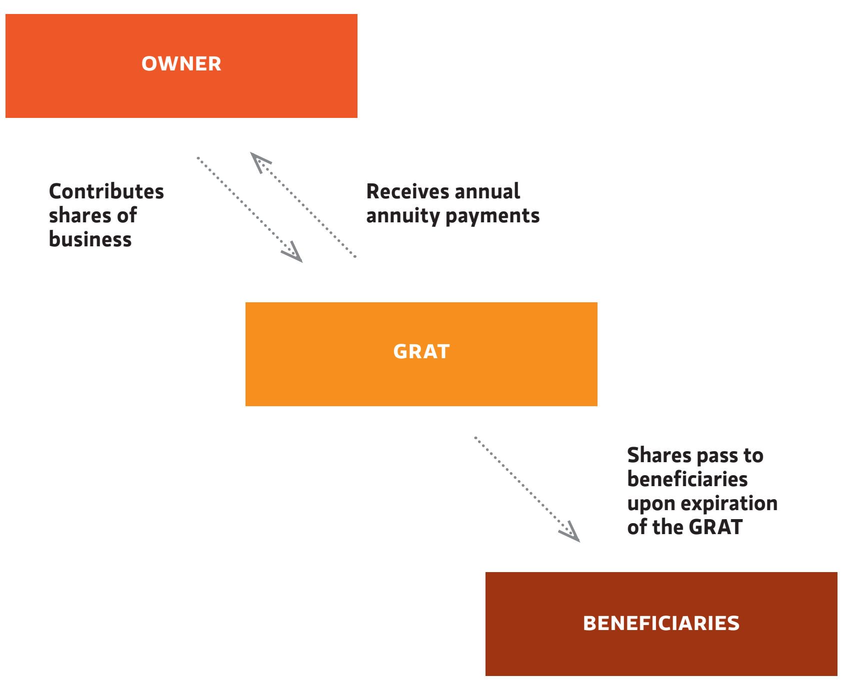
The Grantor Retained Annuity Trust is a technique which enables an individual to transfer future appreciation of founder's stock to future generations in exchange for a stream of payments based on the current (lower) value of stock, term of the trust and an interest rate determined by the IRS.

Since the grantor is receiving all or a portion of the original principal back in the form of an annuity with a prescribed hurdle rate, the transferor is able to minimize utilization of his or her lifetime gift exemption. As the appreciation of pre-liquidity stock occurs in the GRAT (outside of the grantor's estate), the eventual beneficiary at the end of the term will receive the presumably higher post-acquisition value in his or her estate, free of additional estate or gift tax. Should the grantor die before the end of the GRAT term, the trust "fails" as the assets revert to the estate of the grantor.

THE VALUE OF THIS STRATEGY

- Preserve lifetime gift/ estate exemption
- Receive principal of transfer back in form of shares or cash
- Appreciation (less annuity payments and hurdle rate) accrue to next generation outright or in trust

Anatomy of a GRAT



Dynasty Trust/ Irrevocable Trust

PURPOSE

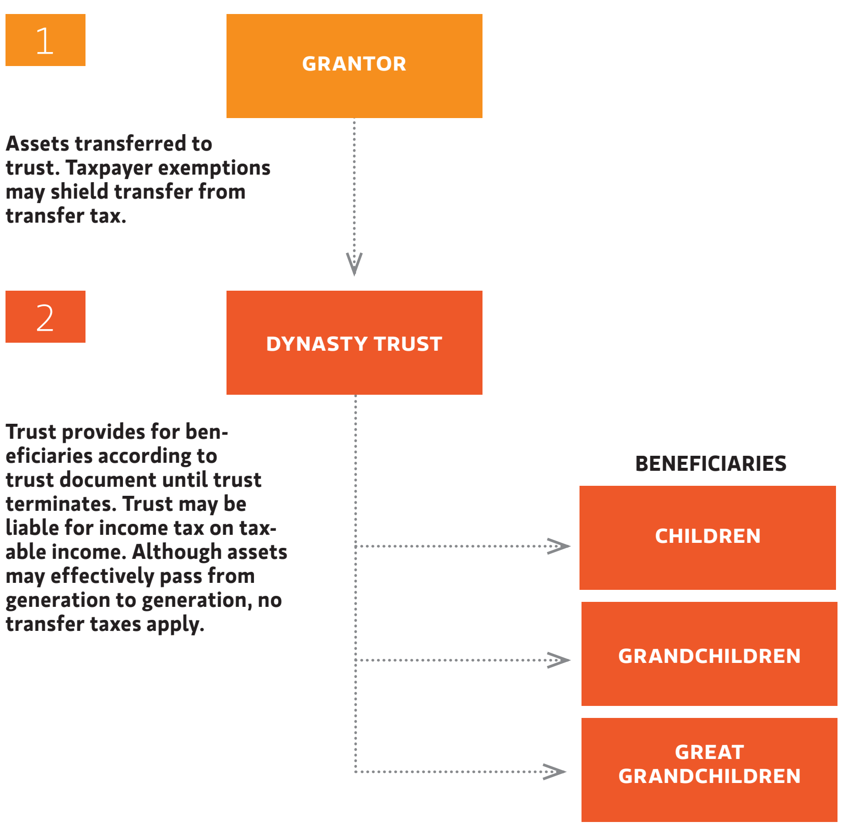
By utilizing the Generation Skipping Transfer (GST) exemption for a transfer into an Irrevocable Trust, future appreciation of pre-liquidity shares is shifted into trust outside of the grantor's estate for the benefit of future generations.

THE VALUE OF THIS STRATEGY

- Pre-liquidity shares transferred into trust. This translates into greater appreciation shifted to future generations and not exposed to estate tax liability.
- Design the trust to provide income (and corpus at discretion of trustee) to children, grandchildren and subsequent generations.
- Simultaneously protect assets from creditors, divorce and spendthrift beneficiaries.

Additional leverage may be created through the purchase of second-to-die life insurance with proceeds from sale of highly appreciated stock.

Anatomy of an Irrevocable Trust/Dynasty Trust



Flip Charitable Remainder Unitrust (FLIP CRUT)

PURPOSE

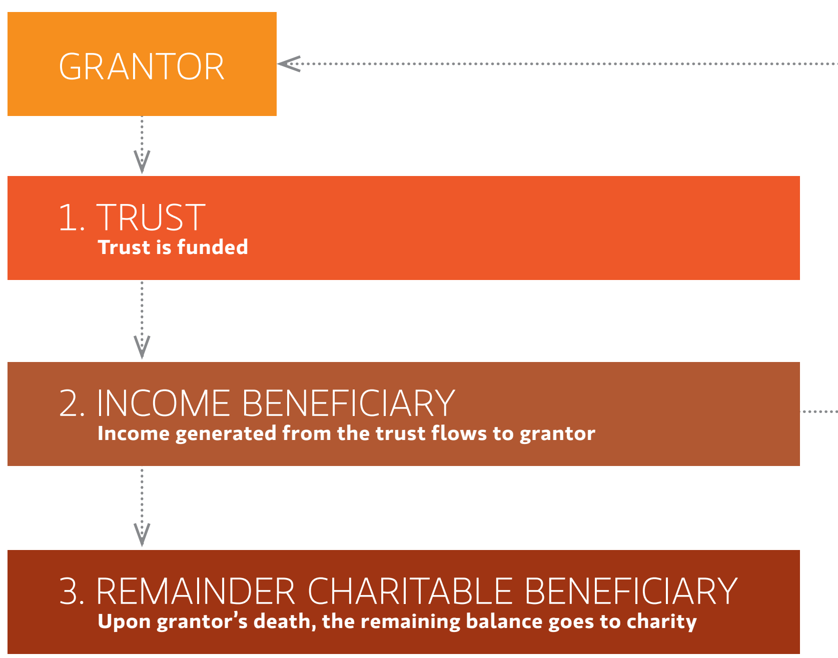
Transfer underappreciated assets with expectation of value increase in the future.

At a specified term, the trust objective "Flips" from appreciation to current income. The appreciated corpus is invested in a diversified portfolio to generate lifetime income and capital appreciation. In addition, the trust spreads the capital gains tax liability over several years and provides a charitable deduction for remainder interest to charity.

THE VALUE OF THIS STRATEGY

- Pre-liquidity shares transferred into Flip Charitable Remainder Unitrust
- Income interest (term or lifetime) taxed in priority of ordinary income, short-term capital gains, long-term capital gains and return of principal
- Charitable income deduction may be available for the value of the remainder interest determined when establishing the trust
- Maximize invested capital as capital gains tax is spread over time

Anatomy of a Flip Charitable Remainder Unitrust



Other Strategies to Consider

EXERCISE AND HOLD INCENTIVE STOCK OPTIONS (ISOs)

Unlike Non-qualified Stock Options which are taxed as ordinary income, Incentive Stock Options (ISOs) may be eligible for long-term capital gains treatment so long as the sale of exercised stock occurs at least two years after option grant and at least one year and one day after exercise. The bargain element (spread between exercise price and grant price) may not be subject to ordinary income but is considered an alternative minimum tax (AMT) preference item. Exercising ISOs early may be beneficial to minimize AMT liability and subject a majority of appreciation to a more favorable capital gains treatment. As ISO planning is a very specialized strategy, it is important to consult with your accountant to evaluate the range of outcomes related to the exercise of Incentive Stock Options.

83(b) ELECTION

Rather than vesting restricted stock or options over a graduated schedule, the 83(b) election enables the holder to pay ordinary income tax on the unvested stock based on the difference between the value of the stock and the grant price within 30 days of receipt. Thereafter, any gain on the stock after 12 months from the election will be treated as a long-term capital gain. Since the value of the stock and the grant price are typically very close (if not the same), little to no income tax is realized upon election.

INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

Gifts to an Intentionally Defective Grantor Trust remove assets from the grantor's estate for estate tax purposes. The trust, however, is considered "defective" for income tax purposes, keeping the responsibility for income taxes on the grantor. This strategy enables the grantor to maximize assets retained in the IDGT (which would otherwise have been paid out for taxes) without utilizing annual exclusion gifts for the beneficiaries of the trust. This strategy may be further enhanced by a Note Sale to the Defective Trust which enables the grantor to place greater assets in the IDGT in exchange for an installment note from the trust without incurring a gift tax.

NET INCOME WITH MAKEUP CRUT (NIMCRUT)

NIMCRUT is an enhanced variation of the FLIP CRUT, wherein a makeup account is established to accumulate income that would otherwise have been paid annually leading up to a specified term. Based on very specific rules (seek guidance from tax and estate attorney), the trust may pay out the accumulated income at term in addition to scheduled annual payments from the trust. The NIMCRUT enables the grantors to recognize greater cash flow via the makeup account over the life of the trust. As this is a form of Charitable Remainder Trust, the grantor may also receive a charitable deduction for the remainder interest to charity.

PLANNING FOR SECTION 16 INSIDERS

Lock-up Agreements
IPO stock or stock acquired through a merger or acquisition will most likely be subject to a lock-up agreement (typically six months) which prevents pre-IPO or pre-transaction shares to enter the market. One of the primary objectives of the lockup is to prevent potential weakness in the share price due to an oversupply of shares flooding the market.

Corporate Policies on Hedging and Pledging Stock
Executives are typically restricted from hedging or pledging (margin loan) stock as a precaution against allegations of insider trading. A hedging transaction (put option) would be considered a defensive measure, whereas, a pledging transaction (margin) could be used to purchase additional shares to magnify gains should the stock rise in value.

Sale of Restricted Stock — Rule 144
Rule 144 stock subjects affiliates (typically Section 16 insiders) to restrictions on sale of shares not registered with the SEC. Specific terms of sale include volume limitations, manner of sale and holding period for stock. Please consult corporate counsel for specific rules related to firm policy.

Reporting — Forms 3, 4 and 5
An initial statement of holdings must be filed by directors, officers and beneficial owners who own greater than 10% of company stock as mandated by the Securities and Exchange Act of 1934. The following forms must be filed with the SEC to record beneficial ownership, changes in ownership, purchase /sale and participation in hedge or swap transactions:

- Form 3 – Initial Filing of Beneficial Ownership
- Form 4 – Filing to Disclose Changes in Beneficial Ownership
- Form 5 – Filing Annual Statement of Beneficial Ownership

Conclusion— The Intellectual Paradox

The orchestration of a pre-liquidity strategy takes deft coordination amongst a team of specialized advisors to walk a parallel path through the IPO or acquisition of your company.

In this very specific realm, where founders and insiders are both highly educated and extremely proficient, we refer to the Intellectual Paradox wherein "the more you know, the more you realize you don't know." In a period where time and execution wait for no one, the opportunity cost of an ad-hoc strategy versus a coordinated strategy may never be more extreme. The professional who recognizes this Intellectual Paradox and has the foresight to put the right players and pieces in place early will maximize their outcome from the transaction.

The right team of advisors can help you identify the most appropriate strategies to employ prior to your liquidity event. Once you've crossed the finish line and completed the sale, your financial advisor can then take the lead on implementing and managing a comprehensive plan for preserving and growing your wealth for the long-run.

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors do not provide tax or legal advice. This material was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties that may be imposed on the taxpayer. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this material may not be suitable for all investors. Morgan Stanley Smith Barney recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

© 2015 Morgan Stanley Smith Barney LLC. Member SIPC.

CRC 1191850 CS 7997669 05/15