Executive decisions

Use goals-based wealth management to prepare for life's stages

With regard to executives, planning in the context of a company's lifecycle is all about timing. Deciding on **which** planning techniques to use and **when** to use them depends on the company's status in terms of financing, capital structure, product development and long-term strategic plan.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

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Many client meetings focus on how the portfolio did against one or more benchmarks rather than how much progress the client is making towards meeting the intended goals.

Wealth management can be a complex undertaking. Clients today have a large universe of investment and planning options that can generate a bewildering array of questions: Should I invest in stocks or bonds? How much risk do I need to take in order to achieve my goals? How do my current assets match up against my future liabilities? Corporate executives in particular may face an extra layer of complexity and uncertainty because of their concentrated, and sometimes illiquid, holdings of company stock and options. Although owning significant equity in a single company can generate significant wealth, such ownership also creates high volatility and gives rise to a wide range of tax planning issues.

These kinds of questions have been addressed by building a single investment portfolio based on the client's risk tolerance and overall projected cash flow needs. With this approach, however, it is sometimes difficult for a client to understand how specific investment decisions relate to his/her desired outcomes because there is no direct and explicit link between the structure of the portfolio and the client's unique goals. As a result, clients may find it hard to stick with the investment strategy during difficult markets because they are unsure of why they own specific investments. Many client meetings focus on how the portfolio did against one or more benchmarks rather than how much progress the client is making towards meeting the intended goals.

The UBS wealth management framework

To help make the most out of planning opportunities, UBS has developed a wealth management framework that can be used to help track progress towards key goals.[1] This framework harnesses our natural tendency to use "mental accounting" and divides a client's assets into three dynamic and adaptive portfolios: a liquidity portfolio, a longevity portfolio and a legacy portfolio.

- The **liquidity portfolio** is designed to meet the client's near-term (2 – 5 years) cash flow needs (general living expenses, upcoming tuition payments, capital calls) and is typically funded with conservative investments like cash and short-term bonds.

- The **longevity portfolio** is constructed to provide financial support for long-term goals (education, retirement) across the client's life expectancy. This portfolio is hedged for risk and is generally based on a balanced or growth asset allocation. The size of the longevity portfolio is based on projected future expenses including general living expenses, education costs, medical costs, routine charitable gifts, weddings, vacations, etc.

- The **legacy portfolio** is composed of assets not needed for the liquidity and longevity portfolios. The legacy portfolio has the longest time horizon, so it usually holds equities, including illiquid investments such as private equity. The legacy portfolio is available to fund strategic gifts to family and charity.

Planning within the goals-based wealth management framework

In many cases, people think about the three L's (liquidity, longevity and legacy) in terms of asset allocation, which makes sense because each particular pool

of capital has its own distinct timeframe and risk profile. However, each pool should also be viewed across the entire planning spectrum, including risk management, income tax planning, charitable planning and estate planning.

There are a number of ways that planning interacts with the goals-based wealth management framework, some of which are highlighted in the following chart. Italicized items are described in further detail in the sections that follow.

	Liquidity	Longevity	Legacy
Investment Planning	– Cash and short-term fixed income – Provide funding for capital calls	– Diversified portfolio tied to risk tolerance and spending goals	– Illiquid investments – Long time horizon – Risk profile of beneficiaries
Estate Planning	– Fund revocable trust to avoid probate – Efficient post-death management structures	– Fund revocable trust to avoid probate – Efficient post-death management structures	– *Annual exclusion gifts* – *Spousal Lifetime Access Trusts (SLATs)* – *Grantor Retained Annuity Trust (GRATs)* – Sales to Grantor Trusts (SGTs) – Estate tax liquidity strategies, including Irrevocable Life Insurance Trusts (ILITs) – Efficient post-death management structures
Income Tax Planning	– Optimal mix of taxable and tax-free bonds based on marginal income tax rate – Cash contributions to charity	– Asset location – Retirement plan contributions – Tax-efficient investments in taxable accounts – Capital loss harvesting – *Tax-efficient stock option exercise strategies* – *Qualified Small Business Stock (QSBS)* – *Incomplete Non-Grantor (ING) Trusts* – Charitable Remainder Trusts	– Grantor trusts – Roth IRA conversions – Contributions of qualified appreciated property to charity (pre-liquidity and/or post-liquidity)
Charitable Planning	– Cash contributions to charity	– Routine gifts of appreciated property to charity – Charitable Remainder Trusts	– Donor Advised Funds – Private Foundations – Charitable Lead Trusts
Risk Management	– Supplemental insurance/umbrella policy – Long term care insurance	– Term life insurance to provide financial security – Supplemental insurance/umbrella policy – Long term care insurance	– Cash value life insurance to provide estate tax liquidity and a family financial legacy

Building the liquidity and longevity portfolios can be one of the most significant challenges for executives of non-public companies who have not had a liquidity event in the past.

Overview of key strategies for executives
While some of the ideas in the chart are well-known and simple (e.g., "cash contributions to charity"), others require more explanation, especially as they pertain to executives of public and private companies. Once we have defined the strategies at a high level, we will illustrate these concepts by using a case study.

Techniques for Building the Liquidity and Longevity Portfolios
Building the liquidity and longevity portfolios can be one of the most significant challenges for executives of non-public companies who have not had a liquidity event in the past. Before an initial liquidity event, an executive's balance sheet is typically dominated by the value of the company, and liquid assets to meet every day expenses may be scarce. The obvious way to create such liquidity is to sell company stock once that opportunity becomes available, but it's important to conduct such sales in the most tax-efficient way possible, which will allow the executive to build the liquidity and longevity portfolios faster.

Tax-Efficient Stock Option Exercise Strategies[2]
Executives are frequently granted the option to buy shares in their companies at the then-current share price (the strike price). If the value of the company rises, then those options can become very valuable. In terms of taxation, a grant of stock options is not generally a taxable event, but the **exercise of those options** can have significant income tax consequences. Accordingly, it is important to exercise stock options in a tax-efficient manner.

Most options are nonqualified stock options (NQSOs) which means that the spread between the strike price and the price at the time of exercise is ordinary earned income subject to regular income and payroll taxes. Other options, however, are characterized as incentive stock options (ISOs) ISOs do not give rise to income when they are exercised, but the spread between the strike price and the price at the time of exercise is considered to be income for purposes of the alternative minimum tax (AMT). The AMT is a special tax that is designed to ensure that high income earners (and even some not-so-high income earners) pay income taxes at a minimum rate even if they have a lot of income tax deductions and other "preference items" that reduce their regular income tax liability. As a result, exercising ISOs can lead to the executive owing additional taxes even though exercising ISOs does not create regular taxable income.

A common goal (but certainly not the only goal) of a tax-efficient option exercise strategy is to exercise ISOs without triggering the AMT. There are two main ways to achieve this goal. In both cases, it is important to work closely with a CPA to determine the optimal exercise strategy based on the executive's unique circumstances.

If the executive is not already paying AMT, then the strategy is for the executive to exercise as many ISOs as possible without triggering the AMT.

Many executives, however, are already paying AMT even without exercising ISOs. The AMT does not allow deductions for state income taxes and real estate taxes, so executives who take large deductions for those items for regular income tax purposes frequently find themselves exposed to the AMT. For executives in that situation, the goal is to look for ways to generate additional regular income because a higher level of regular income tends to create "space" to exercise ISOs without incurring additional AMT. A common way to do this is for the executive to exercise NQSOs, which creates regular income. Additionally, converting a traditional IRA into a Roth IRA can boost regular income and create space to exercise ISOs without triggering the AMT.[3]

Qualified Small Business Stock[4]

On September 28, 2015, it became possible to sell qualified small business stock (QSBS) and exclude up to $10 million of gain from federal income taxation. The QSBS rules are complex, but here are the **key requirements** to take advantage of the gain exclusion:[5]

- The corporation is a domestic C corporation that operates an active business and uses at least 80% of its assets in the active conduct of a qualified trade or business.
- The shareholder acquired the stock at original issue (i.e., directly from the corporation) or via gift or bequest from someone who acquired the stock at original issue. Such shareholders typically include founders, executives and venture capital/private equity investors.
- The gross assets of the company, as measured at the time the stock was acquired, did not exceed $50 million.
- The stock was acquired on or after September 28, 2010. If the stock was acquired before September 28, 2010, then only a partial exclusion (50% or 75%) of the first $10 million of gain is available and the partial exclusion is subject to the AMT, which significantly reduces (but does not eliminate) the tax benefit of QSBS treatment.
- The stock has been held for at least five years.
- The business is not based on providing professional services (health, law or financial services), is not based on banking, insurance, leasing or investing, is not involved in farming, mineral extraction or hospitality and is not a REIT, mutual fund or other similar type company. Most companies that focus on technology, manufacturing, construction, retailing, etc. are eligible for QSBS treatment provided that all of the other requirements are met.

If the company is nearing a sale, there is not a lot of planning to be done with regard to QSBS in that the stock either qualifies or it does not. One possible exception is that if the executive is very close to the five year holding period, then he/she may want to consider delaying the closing until the holding period test is satisfied.

The real planning opportunities occur when the company is formed and/or when the executive joins the company.

With regard to forming the company, consider that only stock in C corporations can qualify for QSBS treatment. Many new companies are created as S corporations in order to avoid a corporate-level income tax and to take advantage of losses in the early years, but it may be worthwhile to consider C corporation status right from the start in order to get the five

year holding period started, especially if the company is not projected to have significant taxable income during that time.

When an executive joins a company and QSBS treatment is a future possibility, outright grants of vested stock can be extremely valuable because the five year holding period immediately starts running. In terms of restricted stock, negotiating an accelerated vesting schedule could pay off significantly in the future in terms of meeting the five year holding requirement. On a related note, an executive might wish to consider exercising stock options sooner rather than later in order to get the five year holding period started.

Incomplete Non-Grantor Trusts[6]

A typical successful executive owns a considerable amount of stock with a very low tax basis. The downside is that selling the stock (once a liquidity event occurs) triggers a significant capital gain (at least to the extent QSBS treatment is unavailable). The top federal rate on capital gains is 20.0% plus a 3.8% net investment income tax for a total rate of 23.8%. If the executive lives in a state that taxes capital gains,[7] that income tax burden can increase substantially.

One way to avoid state capital gains taxes is to change residency to a non-taxing state before recognizing the gain, but that is likely not a feasible alternative for most people. Another approach is to use an incomplete non-grantor trust to accomplish the same goal. In short, this strategy involves the following steps:

- The executive creates an irrevocable trust in a state that does not tax trust income, such as Delaware, Nevada or New Hampshire. The trust is structured to be its own separate taxpayer for federal and state purposes (i.e., a non-grantor trust).
- The executive appoints a trustee that is based in the state. This can be an individual, but is most often a trust company.
- The executive transfers the stock to a limited liability company (LLC) that the executive controls and then transfers the LLC member interests to the trust well in advance of a sale. The executive reserves the right to direct how the trust distributes at the executive's death, so the transfer is not considered to be a completed gift and will not use up any of the executive's lifetime gift tax exemption. Accordingly, the trust will be fully includible in the executive's estate for estate tax purposes.
- The executive, as the controlling manager of the LLC, decides to sell the stock at some point in the future. The gain flows through the LLC to the trust. The trust pays federal tax at a maximum rate of 23.8% (as described above), but no state tax is due because the trust is a tax resident of the non-taxing state rather than the executive's state.
- The executive can receive distributions from the trust at the discretion of a Distribution Committee composed of other trust beneficiaries who are usually members of the executive's family.

Whether this tactic is effective depends on how the executive's state of residence taxes trusts. Some states have trust income tax laws that reach any irrevocable trust created by a resident, even if the trust is governed by another state's laws and even if the trustee is not a resident of the taxing state.

In those states, this strategy will not be effective.[8] It is absolutely critical to review this approach carefully with a well-qualified tax accountant or attorney because every state's trust income tax laws are different in both the text of the laws and how the state's taxing authority applies those laws.

Techniques for Protecting the Legacy Portfolio from Estate Taxes

By definition, the legacy portfolio is not required to meet the executive's liquidity or longevity goals. Accordingly, the legacy portfolio is likely to grow over time. If the executive simply lets the longevity portfolio accrue on his/her balance sheet, then those assets will be subject to estate tax at the death of the survivor of the executive and the executive's spouse. A married couple can currently shelter $10.9 million (adjusted for inflation going forward) from the federal estate tax, but assets in excess of that amount are subject to the federal estate tax at a flat 40% rate. If the executive's home state assesses its own estate or inheritance tax,[9] the marginal combined rate can climb to 50%. For most executives, a primary estate planning goal is to minimize estate taxes by making lifetime gifts of the legacy portfolio.

Annual Exclusion Gifts

In addition to a $5.45 million individual lifetime exemption from federal gift and estate taxes, each individual can give anyone $14,000 per year without using up any of the donor's $5.45 million lifetime gift/estate tax exemption.[10] A married couple can combine their annual exclusions to give anyone $28,000 per year. As noted above, estate taxes can be as high as 50%, so a simple annual gift of $14,000 can save $7,000 of estate taxes immediately, plus 50% of any future growth. Over time, a series of annual gifts to a number of beneficiaries can save significant estate taxes. In most cases, the beneficiaries are the executive's children (or a trust for the children's benefit), but it can also make sense for an executive to make gifts to his/her parents (sometimes called "upgifting") if the parents have a modest net worth. The parents have the same lifetime exemptions from the gift and estate tax as the executive, so boosting their net worth can allow them to use their exemptions to shelter the gifts (and future growth) from tax at their deaths and create a trust for the benefit of the executive and his/her descendants that will not be included in the executive's estate.

In many cases, these gifts take the form of cash, but such gifts can be made using any kind of property. In the case of an executive of a private company, it can be advantageous to make gifts using company stock and/or options. The company stock is the asset most likely to have the highest future growth and making gifts of it will not adversely impact the executive's liquidity portfolio. Before making such gifts, a number of possible issues need to be nailed down: is the stock vested, is the stock transferrable, is it appropriate for family members to own the stock, etc.

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Spousal Lifetime Access Trusts (SLATs)

In most cases, making annual exclusion gifts alone is not enough to meet an executive's goal of minimizing estate taxes. Using some or all of the $5.45 million lifetime gift tax exemption to move significant amounts of company stock into an irrevocable trust while the value of the stock is still low can result in massive estate tax savings by shifting large amounts of growth outside of the transfer tax system. [11]

An irrevocable trust is a trust that cannot be changed or revoked by the grantor. Provided that the grantor does not have too much control over the trust, it is possible for the irrevocable trust to avoid inclusion in the grantor's estate. In addition, the trust can avoid inclusion in the beneficiaries' estates as well. If the property contributed to the irrevocable trust grows in value, then the grantor will save 40% – 50% of the post-gift appreciation in estate taxes.

If the executive is absolutely sure that his/her longevity portfolio is sufficient, then it's an easy decision for him/her to make large gifts to an irrevocable trust, but it's not always possible to have a high degree of certainty that the longevity portfolio will meet all future living expenses, especially if the executive is young and future income and expense projections have a lot of variability. In those cases, the executive can opt to include his/her spouse as a beneficiary of the irrevocable trust, thereby giving the spouse access to the trust for his/her lifetime (hence the term "spousal lifetime access trust"). If it turns out that the executive and his/her spouse need to boost the longevity portfolio, then the trustee of the SLAT can make a distribution to the beneficiary-spouse and then the spouse can contribute that distribution to the longevity portfolio. Any distributions will be includible in the estate of the survivor of the executive and the spouse, but all of the property that remains in the trust should avoid estate taxation at both deaths.

One drawback to this approach is that the executive loses the ability to boost his/her longevity portfolio via distributions from the SLAT if the executive ceases to be married to the beneficiary-spouse as a result of death or divorce. This risk can be hedged by buying life insurance on the life of the beneficiary-spouse and/or by the beneficiary-spouse creating a similar (but not identical) trust for the benefit of the executive-spouse.[12]

Grantor Retained Annuity Trusts (GRATs)

If the executive does not want to make a significant gift to the SLAT, use any of his/her lifetime gift tax exemption to fund the SLAT or has already used up the exemption and does not want to pay gift taxes, then a grantor retained annuity trust (GRAT) may be an effective way to transfer wealth into the SLAT.[13]

A GRAT is a short-term (usually 2 – 5 years) irrevocable trust that pays the grantor an annuity that has a present value equal to whatever the grantor contributes to the GRAT. For example, if the grantor funds a 3-year GRAT with $1,000,000, it is easy to structure the annuity so that its present value equals $1,000,000. Since the grantor funded the GRAT with $1,000,000 and took back an annuity worth $1,000,000, then, under the tax rules, the grantor has made a gift worth $0. If the property in the GRAT produces a total return in excess of the rate used to calculate the present value of the annuity (which is based on federal bond yields and is 1.8% for GRATs funded in May 2016),[14] then there will be money left in the GRAT when the term ends, and that leftover money can flow to a trust for the benefit of the grantor's spouse and children (such as the SLAT discussed above) without using any lifetime gift tax exemption or any annual exclusions. If the property in the GRAT fails to produce a total return in excess of that rate, then the GRAT will pay the

annuity to the grantor for as long as it can and then it will "bust" and nothing will be distributed from the GRAT at the end of the term. In short, the GRAT is a "heads I win, tails I don't lose" (except for any cost and time expended to establish the trust) opportunity.

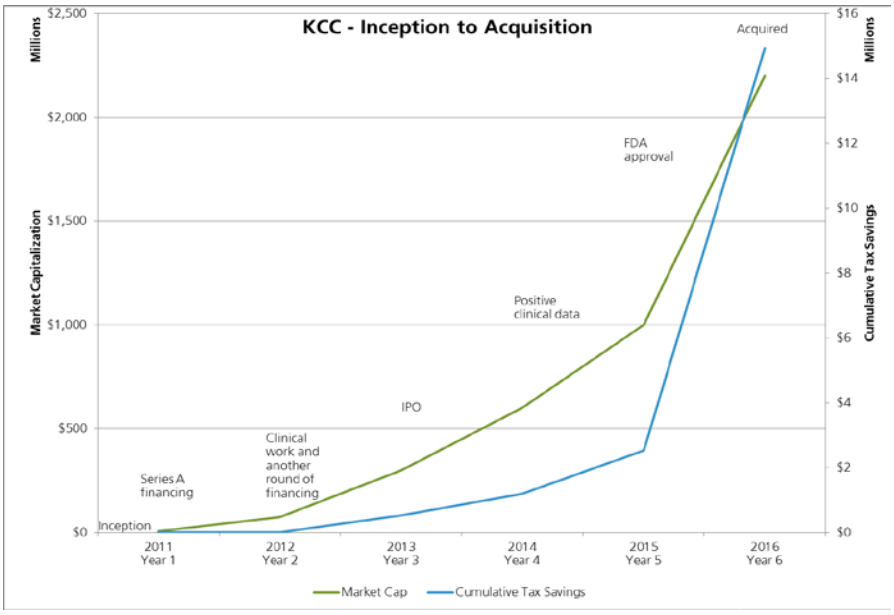
Case study: using a goals-based wealth management framework to plan for life stages

The concepts discussed above can be complex and confusing. In order to help provide a better understanding, consider the following hypothetical illustration that centers on a biotechnology executive with a successful start-up company. Although the illustration is specific to the biotechnology field, the planning concepts have broad applicability to executives in many different types of companies.

Background
Ed Smith (50) is married to Beth Smith (45) and they have two children: Bob (15) and Mike (12). Ed has a Ph.D. in Biochemistry and has spent 20 years at a large pharmaceutical company, with the last 10 years working in high level, senior positions. Ed joined the Kibosh Cancer Corporation (KCC), a biotech startup company, in October 2010 as its founding CEO after completing a short stint as Entrepreneur-in-Residence at a well-known life sciences venture capital fund. Upon joining KCC, Ed received 7% of the company in the form of founder shares. Ed's target annual cash compensation is $500,000 (salary and bonus). Beth is a corporate attorney who decided to take a hiatus from practicing until the boys are both in college.

The Smith family lives in a state that has a flat 5% income tax rate and no state estate tax.

Overview of Outcomes Illustrated



	2011 (Year 1)	2012 (Year 2)	2013 (Year 3)	2014 (Year 4)	2015 (Year 5)	2016 (Year 6)
Liquidity	– Set target for next five years of expenses	– Provide cash for ISO exercise	– Add some cash from higher salary/bonus	– Fully funded by exercising NQSOs and selling the resulting stock	– Fully funded	– Fully funded
Longevity	– Build financial plan and set target funding amount	– Exercise 40k ISOs and hold resulting stock – Roth conversion	– Exercise 40k ISOs and hold resulting stock – Roth conversion	– Exercise 40k ISOs and hold resulting stock – Exercise 175k NQSOs and sell resulting stock	– Exercise 40k ISOs and hold resulting stock – Exercise 125k NQSOs and sell resulting stock – Fund ING (150k shares)	– Fully funded – Income tax savings realized from ISOs, QSBS, ING and DAF: $6.6 million
Legacy	– Create basic documents	– Fund SLAT (100k shares) – Upgift to parents (6k shares)	– Fund GRAT (100k shares)		– Fund donor advised fund (DAF) (20k shares)	– GRAT sends residue to SLAT – Estate tax savings from SLAT, upgift and GRAT: $8.3 million

2011 (Year 1)

KCC completes a successful Series A round of financing. As part of that round, Ed receives an option grant composed of nonqualified stock options (NQSOs) and incentive stock options (ISOs), scheduled to vest over the next four years (25% vest after the first year (known as a "one year cliff") and then the rest vests monthly over the subsequent three years). KCC gives Ed additional options in order to keep his ownership percentage at 7% (a practice known as "topping off"). At the end of the year, KCC's per share value is approximately $2.50.[15]

Liquidity

– Ed works with his UBS Financial Advisor to map out his projected living expenses over the next three years, including cash needed for exercising options, and holds that amount in cash and short-term bonds.

Longevity

– The Smiths work with their Financial Advisor to build a cash-flow plan based on their long-term financial goals (college education for the boys, annual gifts to charity, retirement, etc.). The plan is based on a diversified portfolio designed to meet those goals while making an efficient trade-off between risk and return.

– The Smith's current pool of diversified assets is less than the amount required to secure their financial future (also known as "core capital"). The Smiths and their Financial Advisor agree to fill that gap by contributing to retirement plans and by liquidating a portion of Ed's KCC options and stock once the company has a liquidity event.

Legacy

– Ed and Beth work with their estate planning attorney to create a core estate plan consisting of health proxies, durable powers of attorney, wills (appointing guardians for the boys) and revocable trusts that will help their family minimize probate expenses and protect the boys' future inheritance from creditors.

2012 (Year 2)

After having done some clinical work, KCC taps existing investors and crossover funds to complete another round of financing in preparation for an IPO in 2013. As was the practice in the previous year, the company tops off Ed with additional options to keep his ownership stake at 7%. Because of the limitations pertaining to ISO grants, all of these options are NQSOs. The options vest over four years with a one year cliff and then monthly thereafter. At the end of the year, KCC's per share value was approximately $4.[16]

Liquidity

– Ed uses some of the liquidity pool to exercise 40,000 vested ISOs and holds the resulting stock.

Longevity

– Exercising the vested ISOs converts any future gains into long-term capital gains if the resulting stock is held for at least one year from the date of exercise and two years from the date the option was granted. In addition, if the one year and two year tests are met, the spread between the strike price and the value of the stock at the time of exercise will also be treated as long-term capital gain income when the resulting stock is sold.[17]

– Ed works with his UBS Financial Advisor and his accountant to coordinate the ISO exercise with his overall income tax situation in order to avoid the alternative minimum tax (AMT). In order to create some space for the ISO spread to avoid triggering AMT, Ed converts a portion of his traditional IRA to a Roth IRA, which creates regular income and also creates a Roth IRA, which can distribute to Ed, Beth and the kids in the future free of income tax while avoiding required minimum distributions until after the death of the survivor of Ed and Beth.

– Based on Ed's confidence in KCC's prospects, he and his Financial Advisor estimate that Ed and Beth are likely to have surplus capital in the foreseeable future that can be directed to the legacy portfolio.

Legacy

– Ed is optimistic about the IPO next year and thinks the stock will IPO well above its current value. Based on Ed's projections, his Financial Advisor estimates that he and Beth could have a net worth in excess of their combined lifetime estate tax exemption ($10.24 million in 2012).

– Ed creates a spousal lifetime access trust (SLAT) for Beth and the boys and funds it with 100,000 of his founder shares worth $400,000. The SLAT is structured so that gifts to it qualify for the annual exclusion, so $39,000 qualifies for the annual exclusion (3 beneficiaries times $13,000 (the amount of the annual exclusion in 2012), and the gift uses $361,000 of Ed's lifetime gift tax exemption). Ed also gifts 6,000 shares of KCC stock (worth $24,000) to his parents, using a portion of his and Beth's combined annual gift tax exclusions to cover the gift.

2013 (Year 3)

KCC raises $100 million through an IPO. The deal prices at $16 per share, giving the company a post-IPO valuation of $300 million. During the year, especially after the lock-up period ends, the stock experiences significant volatility. Ed's ownership (including stock and options) drops to 4.7% as a result of dilution. The value of Ed's KCC interests is approximately $10.8 million (after factoring out option exercise expenses) and the family's overall net worth is $15.0 million.

Liquidity

– Ed's cash compensation increases to $1 million now that he is the CEO of a publicly traded company, which allows him to augment the liquidity portfolio despite exercising more ISOs and paying income taxes arising from the previous year's Roth conversion.

Longevity

– Ed exercises 40,000 more vested ISOs. In order to avoid triggering the AMT, Ed converts the rest of his traditional IRA to a Roth IRA.

Legacy

– After the 6-month lock-up on his KCC holdings expires, Ed contributes 100,000 founder shares to a grantor retained annuity trust (GRAT). The GRAT is designed to run for three years with an annuity (payable to Ed) that increases by 20% per year (sometimes called a "backloaded GRAT"). Any property left in the GRAT at the end of the three year period will pour over to the SLAT without using any of Ed's annual exclusions or lifetime gift tax exemption.
– The SLAT has stock worth $1.6 million, and Ed's parents have stock worth $96,000. Combined, the gifts have saved about $534,000 of estate tax so far, assuming a federal estate tax of 40%.

Balance Sheet at End of 2013 (Year 3) (KCC at $16)

	Family	Parents	SLAT	GRAT
Cash & investments	2,200,000	–	–	–
Traditional IRA	500,000	–	–	–
Roth IRA	200,000	–	–	–
KCC 401(k)	100,000	–	–	–
Primary home	2,000,000	–	–	–
Founder shares (375k)	2,704,000	96,000	1,600,000	1,600,000
ISO shares (80k)	1,280,000	–	–	–
ISOs (80k, $2.50 strike) – unvested	1,080,000	–	–	–
NQSOs (45k, $2.50 strike) – vested	607,500	–	–	–
NQSOs (45k, $2.50 strike) – unvested	607,500	–	–	–
NQSOs (62.5k, $4.00 strike) – vested	750,000	–	–	–
NQSOs (187.5, $4.00 strike) – unvested	2,250,000	–	–	–
Total	**14,279,000**	**96,000**	**1,600,000**	**1,600,000**

2014 (Year 4)

KCC announces positive clinical data and the stock rises to $32, creating a market capitalization of $600 million. Ed is granted $2,000,000 of restricted stock units that vest over four years with a one year cliff and then vest monthly thereafter.

Liquidity

– The liquidity portfolio has been diminished by income tax payments and money used to exercise ISOs. Ed exercises NQSOs (see below) and sells the resulting stock in accordance with a 10b5-1 plan.[18] He uses some of the proceeds to replenish the liquidity portfolio, and the rest of the proceeds go into the longevity portfolio.

Longevity

– Ed and Beth are now in a position to add significant assets to their longevity portfolio by diversifying out of some of their KCC holdings. Ed exercises 175,000 of vested NQSOs and sells the resulting shares immediately, netting $5.16 million on a pre-tax basis after the shares are sold, all of which is treated as compensation income.

– The large spike in compensation income gives Ed ample space to exercise 40,000 vested ISOs without triggering the AMT. The proceeds from the NQSOs provide the funds needed for the ISO exercise.

Legacy
– The SLAT has stock worth $3.2 million, and Ed's parents have stock worth $192,000. Combined, the gifts have saved about $1.2 million of estate tax so far, assuming a federal estate tax of 40%.
– After being in existence for one year, the GRAT has a balance of $2.75 million with two years left in the term.

2015 (Year 5)
One of KCC's drugs is approved by the FDA and stock moves up to $53, boosting the market capitalization to $1 billion. Ed is granted $3,000,000 of restricted stock units that vest over four years with a one year cliff and then vest monthly thereafter.

Liquidity
– Exercising vested NQSOs (see below) and selling the resulting stock in accordance with a 10b5-1 plan has created enough liquidity for the Smiths to keep their liquidity portfolio at the target level, even as their expenses rise as a result of college education expenses.

Longevity
– Ed exercises another 40,000 vested ISOs in anticipation of selling KCC shares in the near future.
– The Smiths continue to build their longevity portfolio by exercising 125,000 vested NQSOs and selling the resulting stock. After the 2015 infusion, they ask their Financial Advisor to update the financial plan, which now illustrates that they have hit their target for the longevity portfolio. The Smiths then decide to direct all remaining KCC holdings to the legacy portfolio.
– With an eye toward selling KCC stock that he has held for many years, Ed creates an incomplete non-grantor (ING) trust in Delaware. He places 150,000 KCC shares held for more than one year into the ING trust. This transaction does not count as a gift nor does it remove the stock from Ed's estate because Ed has retained sufficient control over the ING. Ed's state of residence taxes capital gains at 5%, but the ING will not be subject to the tax laws of Ed's state because the trustee (which is a Delaware trust company) is not a resident of Ed's state.

Legacy
– Ed and Beth create a type of charitable vehicle called a donor advised fund (DAF) and contribute 20,000 KCC shares to it, which the DAF immediately sells. The contribution creates a charitable income tax deduction of $1,060,000. The Smiths have a marginal federal income tax rate of 39.6%, so that income tax deduction will net them about $420,000 of income tax savings. Unfortunately, their state does not allow deductions for gifts to charity. Nevertheless, Ed and Beth will be able to leave the money in the DAF with potential for growth over time, and/or distribute it out to other charities whenever they wish.
– The SLAT has stock worth $5.3 million, and Ed's parents have stock worth $318,000. Combined, the gifts have saved about $2.1 million of estate tax so far, assuming a federal estate tax of 40%.

– After being in existence for two years, the GRAT has a balance of $3.99 million with one year left in the term.

2016 (Year 6)
KCC is acquired by another company for $117 per share in an all-cash deal worth $2.2 billion in early 2016.

Liquidity
– The Smiths' liquidity portfolio is fully funded.

Longevity
– The Smiths have fully funded their longevity portfolio.
– Ed's founder shares, which are sold to the acquiring company, qualify for the Qualified Small Business Stock (QSBS) capital gain exclusion. As a result, Ed can exclude $10 million of capital gain for federal income tax purposes. Assuming a federal capital gain tax rate of 23.8% (including the net investment income tax), that's a tax savings of $2,380,000. Unfortunately, Ed's state does not follow the federal government's lead on QSBS gain exclusion.
– The 150,000 KCC shares in the ING will escape state income taxation. The shares sell for $17.55 million, all of which is long-term capital gain which avoids the 5% state income tax, thereby creating a tax savings of $877,500.
– Over the last few years, Ed has exercised 160,000 ISOs without paying any extra AMT. The shares arising from the ISO exercises sell for $18.72 million, and just about all of that, other than the modest exercise cost, which is excluded from this example, is long-term capital gain which triggers a $4.4 million federal tax (23.8% rate). Had Ed simply held the ISOs until KCC was acquired, the proceeds would have been treated as regular compensation income since Ed would not have held the resulting shares for a year, and the federal tax would have been $7.4 million (39.6% rate). By working closely with his Financial Advisor and his accountant to exercise his stock options in a tax efficient manner, Ed ends up saving $3.0 million in federal income taxes.

Legacy
– The SLAT has stock worth $11.7 million, and Ed's parents have stock worth $702,000. Combined, the gifts have saved about $4.8 million of estate tax so far, assuming a federal estate tax of 40%. As the SLAT continues to increase in value in the future, the estate tax savings will also continue to grow.
– The GRAT terminated at the end of 2016 with a final balance of $8.7 million, which equals an estate tax savings of $3.48 million, plus future growth. The $8.7 million in the GRAT poured over to the SLAT, upping the SLAT's value to $20.4 million. The trustee of the SLAT (which Ed can hire and fire at will) can use those funds to invest in Ed's next company, and all of the growth will be sheltered from estate tax at Ed and Beth's level and as well at their sons' level.
– The DAF was unaffected by the sale of KCC since it sold the KCC stock immediately, so it still has a balance of $1.06 million that Ed and Beth can use in furtherance of their charitable goals.

Balance Sheet at End of 2016 (Year 6) (immediately before acquisition closes, KCC at $117)

	Family	ING	Parents	SLAT & GRAT	DAF	Total
Cash & investments	10,000,000	–	–	–	–	10,000,000
Traditional IRA	–	–	–	–	–	–
Roth IRA	700,000	–	–	–	–	700,000
KCC 401(k)	300,000	–	–	–	–	300,000
Primary home	2,200,000	–	–	–	–	2,200,000
Founder shares (375k)	2,883,000	17,550,000	702,000	20,400,000	1,060,000	42,595,000
ISO shares (160k)	18,720,000	–	–	–	–	18,720,000
RSU shares (119,104) – vested	13,935,168	–	–	–	–	13,935,168
NQSOs (40k, $4.00 strike) – vested	4,520,000	–	–	–	–	4,520,000
Total	53,258,168	17,550,000	702,000	20,400,000	1,060,000	92,970,168

Conclusion

With regard to executives, planning in the context of a company's lifecycle is all about timing. Deciding on **which** planning techniques to use and **when** to use them depends on the company's status in terms of financing, capital structure, product development and long-term strategic plan.

Overall, combining the goals-based framework with a comprehensive financial plan can generate significant benefits for clients. By dividing assets into the three buckets of liquidity, longevity and legacy, clients can gain a better understanding of where they stand in relation to their goals and, in conjunction with their UBS Financial Advisor, attorney, accountant and other advisors, apply an array of tax savings strategies designed to achieve those goals and maximize intergenerational family wealth.

- Terence Condren, *Senior Wealth Strategist*
- Brian S. Schimpf, *Associate Wealth Strategist*

The **Advanced Planning Group** of UBS provides comprehensive planning, advice, and education to ultra high net worth individuals and families. The team consists of professionals with advanced degrees, extensive planning experience, and various areas of expertise. Through our publications, the Advanced Planning Group features the intellectual capital of UBS in wealth planning, estate tax, and philanthropy and evaluates how changes in the legislative and tax landscape might impact our clients' planning.

[1] "Goals-based wealth management," *Your Wealth & Life* (February 17, 2015).

[2] For a detailed discussion of employee stock options, see "Ins and Outs of Stock Options and Equity Compensation," UBS Whitepaper (February 2016).

[3] For a detailed discussion of Roth conversions, see "Roth conversion: Is the potential for more tomorrow worth the pain of taxes today?" Trust & Estate Insights (March 2014).

[4] For a detailed discussion of qualified small business stock, see "The benefits of qualified small business stock," Trust & Estate Insights (November 2013).

[5] I.R.C. §1202.

[6] For a detailed discussion of incomplete non-grantor trusts, see "DING Trusts: A strategy to save on state income taxes when living in a high income tax state," Trust & Estate Insights (May 2014). Note that the IRS recently approved this technique with regard to its federal tax effects. See Private Letter Ruling 20164007 (April 1, 2016).

[7] As of 2015, the following states do not tax capital gains: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. The other states tax capital gains at rates ranging from 13.3% (California) to 3.2% (North Dakota). http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-tax-rates-united-states.

[8] For many years, this strategy was effective for New York residents. In fact, it was so effective that New York changed its trust income tax laws in 2014 to block this strategy.

[9] The following states assess either an estate tax, an inheritance tax or both: Connecticut, Delaware, District of Columbia (not technically a state, of course), Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska (assessed by the counties), New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington. Tennessee repealed its inheritance tax as of January 1, 2016. See http://media.mcguirewoods.com/publications/State-Death-Tax-Chart.pdf.

[10] For more information see Wealth Planning Insights (November 2011).

[11] For a detailed explanation see "Using irrevocable grantor trusts to transfer wealth," Advanced Planning Insights (April 2015).

[12] If the trust created by the spouse is too similar to the trust created by the executive, then the IRS could claim that the trusts are reciprocal and seek to include the trusts in the estates of the executive and the spouse. A skilled estate planning attorney can minimize that risk with careful planning.

[13] For a detailed explanation of GRATs see "Maximize your gifts and minimize your taxes with a grantor retained annuity trust (GRAT)," Advanced Planning Group (December 2013).

[14] Rev. Rul. 2016-11. https://www.irs.gov/pub/irs-drop/rr-16-11.pdf.

[15] The share price is based on the 409(A) valuation, which is used to set strike prices for options granted to employees. For purposes of this illustration, we will assume that the gift tax value of KCC shares equals the 409(A) valuation. In reality, a qualified appraiser with gift tax valuation experience should be consulted to determine the value of non-public company shares before a gift of those shares is made.

[16] The share price is based on the 409(A) valuation.

[17] I.R.C. §422.

[18] A 10b5-1 plan is a pre-arranged plan to sell stock. Executives and other insiders of publicly-traded companies use 10b5-1 plans to provide an affirmative defense against allegations of insider trading.

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