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Capital Market Exits: Planning for Restricted and Control Securities

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Capital Market Exits: Planning for Restricted and Control Securities

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I. Pre-Transition Event

A sale of the company's stock to the public in a registered offering, or an acquisition of the company for cash or the publicly traded stock of an acquiring company provide shareholders attractive wealth transfer planning opportunities. In such case the value of closely held stock can be expected to rise as a result of the liquidity event: when stock becomes marketable following the IPO, or when shares become entitled to a proportionate share of the "enterprise" value of a company upon the company's sale. Similarly, at some point in time following an IPO, stock that was restricted in the hands of insiders will rise in value as a result of the lapse of such restrictions. Wealth transfer planning strategies implemented in a timely fashion in anticipation of such events can produce significant transfer tax and, in the case of charitable transfers, income tax savings.

A. Gifts

Gifts of company stock prior to a liquidity event, even if made at a stock value much higher than would have applied in the case of an earlier "cheap stock" gift, has the attraction of definitively "freezing" value as of the date of the gift and unconditionally shifts all post-gift appreciation to the gift recipient. In the case of a taxable gift, the effective rate of tax payable will also be reduced as a consequence of the "tax exclusive" method by which gift tax is calculated, assuming that the donor lives for three years following the date of the gift so as to avoid inclusion of the gift tax paid in his/her estate for estate tax calculation purposes.

As in the case of early stage gifting, the effectiveness of non-freeze pre-IPO or pre-acquisition gifting can be enhanced through the use of a family limited partnership, while also accomplishing other family objectives such as consolidation of management of family wealth and continued family control. If Company stock is contributed to a FLP prior to the liquidity event and gifts are made in the form of limited partnership interest, the gifting is leveraged as a consequence of discounts available in connection with the valuation of a limited partnership interest. However, as noted earlier, care should be taken to ensure that the loss of QSBS status of the Company stock which results from the contribution of such stock to a FLP does not occur inadvertently. Similarly, gifts made to defective grantor trusts offer the additional attractions of possible future

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gift leveraging through the donor's payment of income tax attributable to the gifted stock, greatly enhanced QSBS rollover planning flexibility and the opportunity for additional gift-leveraging through installment sale techniques.

B. Freeze Strategies

Not surprisingly, however, clients are seldom enamored with the prospect of actually paying gift tax, particularly during an era in which call for the repeal of "death taxes" have increasingly become part of the political debate. Thus, planning in the pre-IPO and pre-acquisition setting often involves the use of "freeze" planning techniques designed to leverage the effectiveness of the limited available federal gift tax annual exclusions and the applicable credit exemption equivalent, and to minimize any gift tax liability actually incurred. A grantor retained annuity trust (a "GRAT"), an installment sale to a defective grantor trust and a partnership freeze each have attractive planning attributes in this setting. Each requires that the post-transfer compound rate of return of the asset transferred exceed the particular discount rate used to value the gift made employing the freeze technique. Those rates differ for each technique, as do other planning considerations.

1. **Grantor Retained Annuity Trust.** A GRAT is a trust under the terms of which the donor retains the right to receive annual fixed payments (the "annuity") from the trust for some period of time, after which any remaining trust property is distributed to (or continues to be held in trust for the benefit of) whomever the trust instrument specifies (the "remainder beneficiary") Because the donor retains the right to receive the annuity payments, the value of the gift to the remainder beneficiary is not the full value of the property placed in trust, but rather the value of that property less the present discounted value of the donor's retained right to receive the prescribed annuity payments. The Section 7520 rate is used to calculate the present value of those payments. It assumes, in effect, that the GRAT's total compound investment return will equal the rate used to make the present value calculation. Therefore, if a GRAT's investment return exceeds that rate, the excess return will pass to the trust remainder beneficiary free of additional transfer tax.

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2. **Installment Sale to a Defective Grantor Trust.** An installment sale of Company stock, or of a limited partnership interest in a FLP holding such stock, can also be an effective pre-IPO or pre-acquisition wealth transfer technique. In this case, the note must provide that interest will be paid at the appropriate applicable federal rate given the term of the note. Since the Section 7520 rate used to value even a short-term GRAT remainder is equal to 120% of the mid-term AFR, an installment sale is superior to a GRAT from a discount rate perspective. As in the case of a GRAT, because of defective grantor trust status, appreciated assets may be used to fund note payments without income tax consequences, and interest payments to the seller will not give rise to seller interest income (or an interest deduction for the trust payor).

3. **Freeze Partnership.** In many cases a freeze partnership structured to comply with the requirements of Section 2701 of the Code will be an attractive pre-IPO or pre-acquisition planning vehicle. As in the case of an installment sale for a note with deferred principal payment, a freeze partnership permits a slower payout from the freeze entity that a short term GRAT since the underlying capital allocable to the frozen interest remains invested in the partnership. Thus, the duration of the freeze can be extended without either the risk of estate inclusion (which characterizes a GRAT), or the risk of possible gain recognition at the seller's death (as a result of termination of grantor trust status in the case of an installment sale to a defective grantor trust). Like an installment sale, and unlike a GRAT, a freeze partnership can also be used in connection with GST planning. The freeze partnership has the additional advantage that preferred extending the time when all assets can remain in the freeze entity (for example, while restrictions lapse and the asset value rises). Like the GRAT or installment sale to a defective grantor trust, the freeze partnership may also distribute appreciated assets in kind without gain recognition.

II. Post-Transition Event: Diversification Strategies Based Upon Hedging Transactions

A. Overview

The hedging and monetizing strategies (other than exchange funds and charitable remainder trusts) detailed in this presentation involve private transactions which often encompass the purchase or sale of customized equity options. In contrast, the options that most investors are familiar with are listed on an exchange ("listed options"), such as the Chicago Board of Options Exchange (CBOE) or the American Stock Exchange (AMEX), and generally have predetermined strike prices, maturities, exercise styles and settlement methods. Over-the-counter ("OTC") equity options are private agreements negotiated directly with financial institutions that can be customized to meet an investor's needs and objectives. As a result, the flexibility of privately negotiated structures relative to exchange-traded products is important in the areas of maturities, stock

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prices, size, settlement and exercise methods, with particular attention to:

	Exchange Traded	OTC
Settlement	<u>Physical</u> — physical delivery of the underlying asset	<u>Physical</u> ; or <u>Cash Settlement</u> — payment of cash in the amount by which the option is in-the-money
Exercise Method	<u>American</u> — exercisable by owner at any time prior to the expiration date	<u>American</u> ; or <u>European</u> — exercisable by owner only on the expiration date

Note: The Taxpayer Relief Act of 1997 effectively eliminated strategies such as short against the box, which essentially eliminated exposure to the underlying stock. Transactions entered into after June 8, 1997, which "substantially eliminate risk of loss and opportunity for gain" trigger constructive sale treatment and result in tax on the embedded gain.

B. Six basic diversification strategies remain:

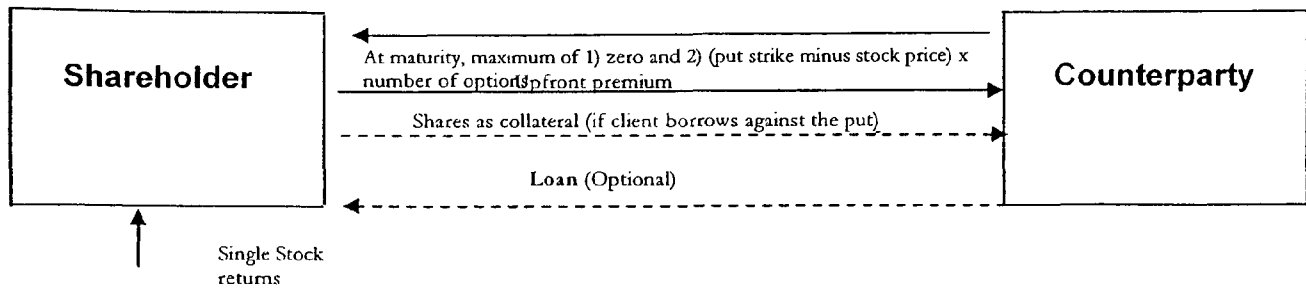
1. Put options
2. Covered Calls
3. Collars
4. Advance forward contracts
5. Exchange Funds
6. Charitable Remainder Trusts

The first three are hedging transactions and involve limiting the risk associated with holding a single stock through the use of derivatives. Diversification is achieved by borrowing against the hedged position.

C. Put Options

Buying a put option gives the shareholder the right, but not the obligation, to effectively sell his or her shares to the counterparty at some predetermined price (the strike price) at some future date (the maturity date). Buying puts protects the shareholder in the event that the value of the underlying shares falls below the strike price on the option.

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The shareholder (put buyer) would pay the counterparty (put seller) an upfront premium, based on the strike and term of the put. The counterparty, in return, would agree to pay, at the maturity of the option, the difference between the strike price on the option and the value of the underlying shares. If the value of the underlying shares were greater than the strike price at maturity, the shareholder would lose the entire premium paid for the option.

1. **Tax treatment of puts.** For *cash settled* puts, if the option expires unexercised, the premium paid for the put is a capital loss. If the put was used to hedge a long position in the underlying stock, straddle rules apply and the loss (which would be long term if the shares have been held for more than one year) cannot be deducted for tax purposes until the underlying shares are sold. If the put is exercised, the cash received (the put strike less the market price of the underlying stock) net of the premium paid for the put is a short term capital gain and is taxable immediately.

If the shareholder borrows against the put (and the proceeds of the loan are used for investment purposes), interest expense is deductible on a current basis to the extent dividends are received on the underlying shares; interest expense in excess of dividends received is added to the tax basis of the shares.

2. **Borrowing against the put.** If the shareholder wants to borrow against put, the use of loan proceeds will determine the level of collateral required. If he or she intends to use the proceeds to purchase margin stock (i.e. publicly traded equities), Regulation U of the Board of Governors of the Federal Reserve Board, pursuant to the Securities Exchange Act of 1934, requires an initial collateral value of 2:1. To help reach that level of collateral, the lender can use the securities purchased by the loan proceeds as additional collateral for the loan. The proceeds of each successive loan can be borrowed against in a similar manner (i.e., stocks worth 10 covered by an at the money put supports a borrowing of 5, the stock purchased for 5 supports a farther borrowing of 2.5 and so on).

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If the proceeds of the loan are not used to purchase margin stock, Regulation U would not apply, and a lender would generally lend about 90% of the hedged value of the shares (i.e., 90% of the put strike). The loan would typically be priced at a spread over LIBOR.

3. **Diversification.** Often the loan proceeds are used to invest in a diversified portfolio. Thus the put allows an amount equal to roughly 90% of the put strike price less the cost of the put to be diversified.

The cost of a put can be reduced by using a "put spread." This provides a defined level of downside protection while reducing the upfront premium. The investor buys a put at one price and sells a put at a lower price. This effectively caps the maximum payout, which reduces the premium. For example, the investor might buy a put at 100 (the current value) and sell a put at 70. If the price at maturity is between 70 and 100, the investor receives an amount equal to 100 less the stock price. If the price is less than 70, he receives 30 (100-70). If the price is greater than 100, he receives nothing.

D. Selling Covered Calls

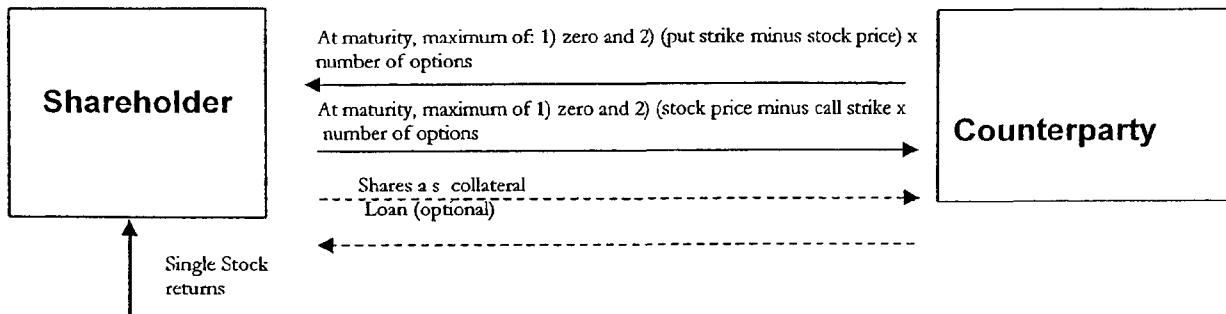
1. A different strategy involves selling a call on the underlying stock. The idea is that the amount received for the call can be reinvested in other assets, thus enhancing the return of the underlying stock and providing a limited amount of downside protection (i.e., the premium received effectively protects the investor against a decline in price equal to the premium).
2. At maturity, the investor (call seller) or must pay the counterparty (call buyer) the difference between the market value of the stock and the call strike. The investor's goal is to set the strike price just high enough so that he does not think the option will be exercised yet he realizes the largest possible premium (the higher the strike price, the lower the premium received). The break even price is equal to the strike price plus premium received by the investor. However, the investor does run the risk of having the stock called away.

E. Collars

1. **Cashless Collar.** A cashless collar effectively consists of buying a put and selling a call with matching maturities. Like the put, it provides protection against a decline in the stock price below some pre-determined level. However, it also reduces or eliminates paying an upfront premium for that protection by selling some of the upside in the underlying stock. This structure essentially locks in the value of the stock to a price range (or "collar") that is defined by the strikes on the put and the call. The

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shareholder would indicate the level of downside protection required (e.g., a put option with a strike 10% below the current stock price) and, for a cashless transaction, the strike on the call would be set to generate a premium that exactly offsets the premium paid for the put. It must be emphasized that a cashless collar is not costless. The cost is built into the spread.



2. On the maturity date, one of three things will happen:

- a. If the stock price at maturity is between the two strike prices, no payment will be due by either party and the collar will expire worthless;
- b. If the stock price is below the strike on the put, the shareholder will receive a cash payment from the counterparty equal to the difference between the put strike price and the stock price multiplied by the number of the shares on which the collar is written; or
- c. If the stock price is above the strike on the call, the shareholder will be obligated to make a payment to the counterparty equal to the difference between the stock price and the call strike price multiplied by the number of shares.

Since the counterparty has credit exposure if the stock price is above the all strike at maturity, it will require collateral to secure the transaction.

3. Tax treatment of cashless collar

The following chart depicts the potential tax treatment of an over-the-counter cash settled collar where the shareholder is long the stock and the shares being hedged have been held for more than one year. It should be noted that there is a

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considerable amount of uncertainty with regard to tax treatment. The appropriate treatment will depend on whether the transaction is viewed as a single financial contract or two separate contracts. If viewed as a single financial contract, any gain or loss would likely be capital (although it is possible the gain or loss is ordinary). In addition, if the shareholder borrows against the collar, straddle rules apply to defer any interest paid on the loan in excess of the dividend income received on the hedged shares.

	<u>Single Financial Contract</u>	<u>Two Separate Option Contracts</u>
Put exercised and call expires	Probably a capital gain; possible to ensure that gain is capital by selling contract	Gain on put, net premium paid, is short term capital gain; premium from call is short term capital gain
Call exercised and put expires	Probably a capital loss; if loss is treated as ordinary it is subject to 2% misc. itemized deduction; possible to ensure that loss by selling contract prior to maturity; straddle rules apply to defer losses	Amount deemed paid for put is long term capital loss; excess of cash paid on call over premium deemed received is a capital is capital loss (which would be long term if straddle rules apply); straddle rules apply to defer losses and may apply to defer loss on call
Both put and call expire	No tax event	Premium deemed received from call is short term capital gain; premium deemed paid for put is long term capital loss; straddle rules apply to defer losses

4. **Borrowing against the collar.** If the shareholder wants to borrow against the hedged position, the use of loan proceeds will determine the level of collateral required. If the shareholder intends to use the proceeds to purchase margin stock (i.e. publicly traded equities), Regulation U requires an initial collateral value of 2:1. To help reach that level of collateral, the lender can use the securities purchased by the loan proceeds as additional collateral for the loan. In this way, the total borrowing approach the value of the collateral stock, as defined above.

If the proceeds of the loan are not used to purchase margin stock, Regulation U would not apply, and the lender would generally lend about 90% of the hedged value of the shares (i.e. 90% of the put strike). The loan would typically be priced at a spread over LIBOR.

5. **Constructive sale considerations.** In June 1997, the Taxpayer Relief Act changed the tax rules governing certain hedges of appreciated equity positions. The Act categorizes as a "constructive sale" any transaction which substantially eliminates both risk of loss and opportunity for gain (e.g., an equity swap or short against the box). Transactions which preserve significant upside potential or downside risk for the holder (i.e., puts and properly constructed collars) should not constitute constructive sales.

To help clarify the constructive sale legislation, the Conference Committee asked the Treasury to issue regulations that would provide standards for when collar transactions would result in constructive sales. The Committee stated that it

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expects that these guidelines will be applied on a prospective basis except in cases that are clearly abusive. These regulations have not yet appeared. While it is difficult to determine what may be considered abusive, it is generally believed that the legislative

history of this provision indicates that a collar would not be considered a constructive sale unless it eliminated substantially all of the taxpayer's risk of loss and opportunity for gain with respect to the appreciated equity position. As a conservative "safe harbor," collars are typically structured so there is at least a 15% to 20% probability that the stock price at maturity is between the two strikes.

6. **Unwinding Collars.** A shareholder may want to "unwind" a collar before maturity if the stock has declined substantially and the shareholder thinks it was bottomed-out. For example, if he executes a 2-year \$90/\$130 collar when the share price is \$100 and one year later the price has dropped to \$70, he may want to cash out. The shareholder may then want to execute another collar at the new price, although if he truly believes the price will go no lower, that might not be prudent. Alternatively, if the shareholder has become bullish on the stock he may want to get out of the collar. For example, if the \$100 share subject to the \$90/\$130 collar has run up to \$135 with 12 months left to maturity, he may want to buy back the call option for, say, \$11 (the \$5 intrinsic value plus the time value of the 12 months before maturity). If the price at maturity turns out to be more than \$141 (\$130 call strike plus \$11 unwind cost), unwinding will have been the way to go; if not, he should have held on to the collar (with the benefit of hindsight).
7. **Put Spread, Call Spread Collars.** As described above with respect to put spreads, collars can be structured using spreads. In addition to the put spread, the investor would sell a call option at a strike above the current value and buy a call at a still higher price. In that way the shareholder would receive appreciation up to the lower strike, give up the appreciation between the two strikes and receive the appreciation above the higher strike. Thus, the investor can create a call spread set to generate a premium to offset the put spread, while achieving a substantial amount of downside protection and retaining a lot of the upside.
8. **Advantages and Risks of Collars**
 - a. Advantages
 - (1) The investor has limited downside protection on the position from the high put strike price down to the low put strike price
 - (2) The investor participates in appreciation on the position up to the call strike price
 - (3) The investor retains ownership and voting rights on the position

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- (4) Regular common cash dividends are generally retained by the Investor
- (5) The costless put spread collar permits the investor to participate in more upside than the standard costless collar
- (6) If the investor executes a costless put spread collar, no upfront option premium is paid
- (7) The investor has flexibility in determining the minimum and maximum value range of the position
- (8) Cash settlement of the OTC costless put spread collar also defers a sale of the position

b. Risks

- (1) Unlike a standard costless collar, the downside protection is capped in a put spread collar. the investor is only protected between the high put strike price and the low put strike price
- (2) The investor does not participate in any upside appreciation on the position above the call strike price
- (3) The investor will also be exposed to the price difference between the current market price and the high put strike price (as with a standard costless collar)
- (4) The seller of the collar must be able to borrow and sell short shares of the position in order to offer the transaction
- (5) Generally, an investor will only be able to collar 5 times average daily trading volume

F. Prepaid Forward Contracts

1. A prepaid forward contract locks in a minimum price for the stock, which is paid upfront, and allows the seller the opportunity to participate in some portion of the potential upside in the stock. At maturity, the shareholder simply delivers some or all of the shares hedged, depending on the stock price, or cash of equivalent value. In the interim, the shareholder continues to receive any dividends paid on the stock and retains the voting rights associated with the hedged shares. The shareholder defers any capital gains tax liability which may arise from the sale of the stock for the term of the trade.

<i>Final Stock Price</i>	<i>Amount Owed</i>
Final Stock price < hedged value	Market Value of shares
Hedged value < final stock price < upside limit	Hedged value of shares
Final stock price > upside limit	Hedged value of the shares plus the appreciation above the upside limit

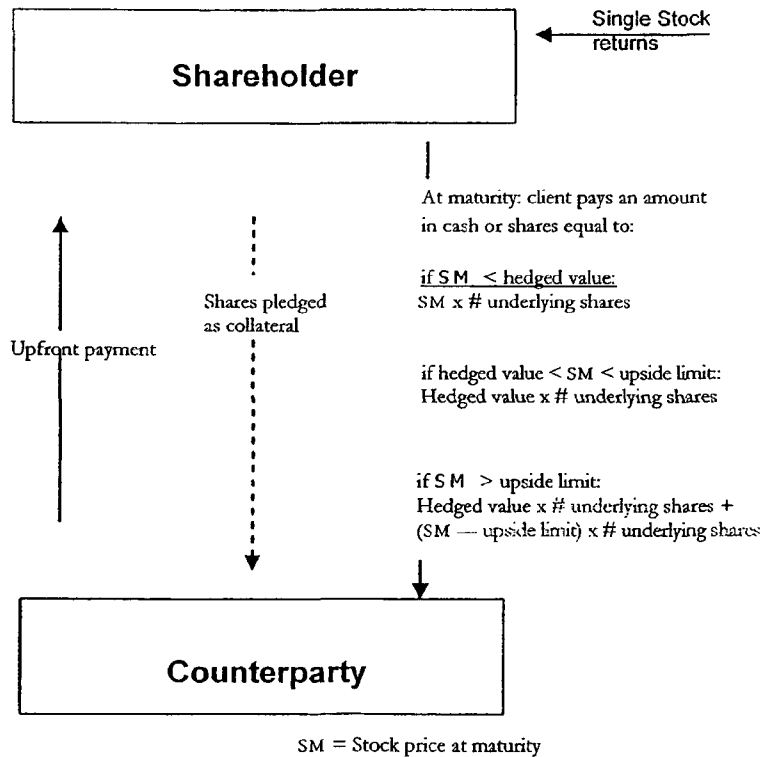
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2. **Potential Tax Treatment**

As previously mentioned, in June 1997, the Taxpayer Relief Act changed the tax rules governing certain hedges of appreciated equity positions. The Act categorizes as a "constructive sale" any transaction which substantially eliminates both risk of loss and opportunity for gain (e.g., an equity swap or short against the box). Transactions which preserve significant upside potential or downside risk for the holder (i.e., puts and properly constructed collars) should not constitute constructive sales.

A prepaid forward contract like the one described, which preserves significant upside potential in the stock, should not trigger a capital gain on the underlying shares when the transaction is entered into. Instead, the transaction would only give rise to a taxable event when the shareholder closes out the transaction by delivering the shares. The shareholder would have long term capital gain (assuming the shares are held for longer than 12 months at inception) at that time equal to the excess of (i) the proceeds received at the inception of the transaction over (ii) the tax basis of the shares delivered to close out the transaction.

Advance Forward Contract



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If the transaction is cash-settled, the shareholder would recognize a short term capital gain or loss equal to the difference between the amount received upfront and the cash owed at maturity. A loss would likely be considered a straddle for tax purposes and, if so, would be deductible only when the underlying shares are sold.

G. Comparison of Collar with Loan and Prepaid Forward Contract

1. The primary deciding factor is whether the shareholder wants the loan at the time of the transaction or may want to pay the loan off prior to maturity. The prepaid forward contract effectively requires the loan to be made and to remain outstanding because the amount of cash received at the outset reflects the implicit payment of interest over the term. With a collar, the loan may be taken and paid off as needed.
2. If the loan is to be used for investment purposes, the collar is more attractive because interest may be deducted on a current basis up to the amount of dividends received on the shares. With the prepaid forward contract, interest is paid in the form of a discount on the proceeds received up-front and is not deductible.

III. Exchange Funds

- A. Exchange funds are private funds, usually limited partnerships or LLCs, to which an investor contributes a single stock in return for an interest in the fund. Under current tax law, investors may redeem their units after seven years for a pro-rata share of the underlying securities without incurring capital gains tax. They do, however, receive the same basis in those securities as they had in the stocks originally contributed.
- B. The contribution of securities in exchange for units in the fund does not trigger a capital gains tax and does not require a section 144 filing for a holder of control or restricted stock. A form 4 filing to report a change in beneficial ownership, however, would be required of an insider. In addition, a contribution to the fund in exchange for units is considered a sale for purposes of section 16. Accordingly, a purchase within six months of the exchange could trigger the short-swing profit rules. Also, insiders cannot enter the fund during blackout periods.
- C. As noted above, redemption after the seventh anniversary of the closing results in the investor receiving a pro-rata share of the underlying securities without any income tax consequences. Prior to seven years, but after two years, an investor may redeem his units in return for an amount equal to the lesser of the fair market value of the contributed securities and the net asset value of the investor's units in the fund at the time of the redemption. If the redemption is accomplished by the distribution of the securities the investor contributed, there is no taxable event. If, however, cash or other securities are distributed, gain is recognized in an amount

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equal to the least of (i) the excess of the fair market value of the distributed securities over the adjusted basis of the investors units immediately before the distribution reduced by the money received in the distribution, (ii) the excess of the fair market value of the contributed securities over the adjusted basis of those securities when they were contributed, or (iii) the excess of the fair market value of the contributed securities over the adjusted basis of those securities at the time of the distribution. Prior to two years after the closing, the same tax rules apply, but generally the investor can only request, not demand, a redemption.

- D. Under Section 721 of the Code, no gain or loss is recognized upon a contribution to the fund in exchange for an interest therein so long as the fund would not be treated as an investment company (within the meaning of section 351) if it were a corporation. In order to avoid classification as an investment company, not more than 80% of the assets can be marketable "stock or securities" held for investment. Generally, the non-marketable portion of the funds assets consist of real estate, most often preferred equity interests in operating partnerships (or LLCs) affiliated with REITs. These qualify as something other than stocks or securities under section 351 (e). The non-marketable securities typically are purchased with borrowed funds. The manager must not have the intent to reduce the non-marketable portion of the fund below 20%, but after the closing that portion may be reduced.
- E. A downside to exchange funds is their illiquid nature; a seven-year commitment. Although the units can be borrowed against, usually up to about 35% of their value, this strategy is not designed to produce cash flow.
- F. A by-product of the exchange fund's inherent illiquidity is that it may offer estate planning advantages. Some discount could be taken with respect to any transfer of units because full redemption might not be possible until the end of seven years. In addition, several recent funds have offered an estate freeze feature, pursuant to which the investor accepts a longer lock-up, generally around 15 years, and divides his or her shares into common and preferred units. Besides the discount available because of the restrictions on getting out of the fund, the fact that the fund consists of unrelated investors allows a freeze to be structured that is not subject to Chapter 14 of the Code. Thus, the investor can accomplish an estate freeze by keeping preferred units carrying a fixed cumulative, but not compounded, dividend and giving away common units representing all appreciation over and above that fixed rate.

IV. Charitable Remainder Trusts

- A. The benefits of a charitable remainder trust ("CRT") as a diversification strategy are well known and will not be repeated in any detail in this outline. Basically, because the trust is a tax-exempt entity, the contributed assets (often a single, highly appreciated stock) can be sold without any immediate tax consequences. Instead, the gain is realized (after any ordinary income) by the non-charitable

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beneficiaries only as paid out in the form of annuity or unitrust payments. The benefits of this deferral can be enhanced by using a net income charitable remainder unitrust, either with a make-up provision ("NIMCRUT") or without ("NICRUT").

- B. The opportunities offered by CRTs were broadened recently by the publication of final regulations approving the use of "FLIP" unitrusts. FLIP trusts are trusts that are NIMCRUTs or NICRUTs to a certain point and then "FLIP" into regular unitrust status. This allows the deferral of an income-only trust to be combined with the certainty of a normal unitrust. Although FLIP unitrusts were never mentioned in the Code or regulations, people started using them years ago, often as retirement fund substitutes. In proposed regulations in May of 1997, the IRS required that a FLIP trust be composed of at least 90% unmarketable assets and that the FLIP be triggered only by the sale of those assets. The final regulations dropped the unmarketable asset requirement and provide that the FLIP must be triggered on a specific date or by an event the occurrence of which is not within the control of the trustee or any other person. Thus, for example, the attainment of a certain age, the sale of unmarketable assets, the birth of a child, and (interestingly) marriage or divorce are acceptable triggering events. A decision by a trustee or financial advisor or request from a beneficiary is not. If the trust is a NIMCRUT, no make-up may be made after the conversion date. The determination of when to use a NIMCRUT/NICRUT and when to use a FLIP trust depends upon the goals of the grantor. Generally, the FLIP trust is appropriate when the aim is a steady income stream after a certain date (for example, a retirement fund, as mentioned above). A NIMCRUT/NICRUT provides greater flexibility and potential tax deferral.
- C. Historically, CRTs structured as non-affiliates (i.e., with independent trustees) have been used to achieve diversification with tax deferral and, perhaps just as important to executives, no filing requirements other than a Form 4 or Form 5 showing the initial donative transfer to the trust.
1. In March 1999, the SEC published a Telephone Interpretation (Division of Corporation Finance Manual of Publicly Available Telephone Interpretations Supplement – March 1999, Rule 144, 15 Rule 144 (a) (1) (2). telephone interpretations are a less formal set of interpretations than "no action" letters) taking the position that when the grantor/beneficiary of the CRT is an affiliate, the trust shall be deemed an affiliate, even if there is an independent trustee.
 2. If the trust can qualify as a non-affiliate and if the shares have been owned and fully paid for by the grantor for at least 2 years, under Rule 144(k) of the Securities Act of 1933. There is no Form 144 filing requirement at the time of a sale and no volume limit on sales (although the trust's sales will count against the grantor's volume limit).

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If the trust is considered an affiliate, the same 144 rules applicable to the grantor will apply to the trust.

3. The Telephone Interpretation relies heavily on the idea that the grantor has retained a current income interest in the trust and, therefore, the sale of securities is on his behalf. Thus a NIMCRUT/NICRUT might produce a different result, as no sale would be required and the receipt of income would be dependent upon a decision by the trustee to take the action necessary to produce income.
4. In any event, it is unclear how authoritative the interpretation should be considered. Its holding is contrary to the SECs traditional position and may be a case of a not-too-well thought out response to a question that shouldn't have been asked in the first place.
5. Regardless of the resolution of the Rule 144 issue, a CRT with an independent trustee should be exempt from the short-swing profit rule of Section 16 (b) of the Securities Exchange Act of 1934 because it is a gift (Rule 16b-5). The initial transfer to the trust is reportable on either Form 5 or 6 (Rule 16a-3 (f) (1) (i)); but if the trustee of the CRT is an independent person (i.e., neither the grantor nor a family member living with him), neither the grantor nor a family member has investment control over the trust, and the trust does not own more than 10% of the outstanding shares of the company, transactions by the trust should not be reportable by the grantor and should not trigger the short-swing profit rule (Rule 16a-8).

V. Restrictions and Limitations

- A. Diversification strategies are not inherently subject to security law restrictions and limitations other than those that are part of the structures themselves (e.g., an exchange fund is a private offering for which only qualified purchasers are eligible). As a practical matter, however, a very high percentage of those seeking diversification hold restricted stock or are considered to be "insiders" under the securities laws; often they are shareholders in newly public companies, and are also subject to contractual "lock-up" periods. Accordingly, a brief review of the pertinent restrictions is helpful in understanding when a diversification strategy is appropriate.
 1. **Rule 144.** Rule 144 of the Securities Act of 1933 governs the sale of restricted and control securities. *Restricted Securities* are shares acquired for investment in a nonpublic transaction from the company or from an affiliate of the company. *Control Securities* are securities acquired by an affiliate in any manner, including open market purchases. An affiliate is defined as any person or entity that directly or indirectly controls the management and/or activities of the issuing company. Affiliates usually include a company's senior management,

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directors, and beneficial owners of more than 10% of the company's stock (this is a factual determination, hence, a 10% shareholder who is not in control may not be considered an affiliate). The following apply to sales of restricted stocks:

- a. Anyone (affiliate or non-affiliate) who sells restricted stock must wait one year after they have paid for the stock in full before selling ("holding period"). In an IPO situation, sellers must wait until at least 90 days after the company's IPO (usually extended to 180 days contractually). There are limits on the number of shares that can be sold in any three month period ("volume limits") equal to the greater of 1% of the class of securities outstanding and the average weekly reported trading volume during the four preceding weeks. These limits apply until the shareholder has not been an affiliate for three months, and has held the shares for at least two years. The "manner of sale" restriction prohibits the selling broker from soliciting buyers other than brokers who expressed interest within the last 60 days and customers who expressed unsolicited interest within the last 10 days. A Form 144 must be sent to the SEC no later than the day of the trade. All of these restrictions, except the holding period, also apply to control stock.
2. **Hedging Rule 144 stock.** Generally, restricted stock should not be hedged until at least 30 days after the private placement in which it is received. In practice, the contractual lock-up probably restricts hedging for a longer period. The industry consensus is that it is not necessary to file a Form 144 for a cash-settled hedging transaction. There is no rule that specifically requires affiliates or non-affiliates to follow the "volume limits" when hedging, but many advisors believe those limits apply implicitly. Affiliates' hedging trades will eventually become known through filings under Section 16 of the Securities Exchange Act of 1934 and hedging trades by affiliates or non-affiliates may become known through Section 13 (d) filings.
3. **Section 13(d).** Section 13(d) of the Securities Exchange Act of 1934 applies to all beneficial owners of more than 5% of a class of publicly traded voting equity and requires that an investor file an initial report of ownership with the SEC after the 5% threshold is crossed and subsequent amendments when more than 1% of the class is bought, sold, or pledged. Pre-IPO holdings can often be reported on Schedule 13G, rather than the more detailed Schedule 13D. Schedule 13G has two additional advantages over Schedule 13D: it usually only needs to be filed annually and amendments can often be handled in the annual filings rather than within 48 hours, as Scheduled 13D requires. However, if the owner's level of ownership changes by more than 2% of the outstanding shares of the class in any 12-month period, the owner will have to file

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reports on Schedule 13D. Buying put options and selling call options are generally considered a "sale" of shares whenever the options are exercisable within 60 days and must be reported promptly at that time by a seller who file Schedule 13D if "material" (a transaction that include 1% or more of a class of public equity is considered "material"). Whether the option is exercised or not should also be promptly reported by the seller, if material.

4. **Contractual lockup.** Separate and different from Rule 144, in an IPO situation the company and/or the underwriter may ask the shareholder to sign an agreement that prohibits selling, and sometimes hedging, the stock for a period of time that can be as short as 90 days or as long as one or two years (180 days is typical). If one has the ability to influence the language used in your specific agreement, language should be drafted that does not unduly limit the ability to hedge the shares.
5. **Section 16 (and insider trading rules).** If the shareholder will be an insider or an affiliate of a newly public company, the shares he or she owns are subject to the complicated Section 16 "short swing profit" rules, which are meant to discourage insider trading and require insiders to give up any profits on purchases and sales that are made within 6 months of each other. These rules can apply to transactions before an IPO (e.g., if shares are purchased 3 months before IPO and sold 2 months after).

The insider is liable not only for his or her own trades, but also for trades made by any person or entity deemed to be the same "person" as the insider. Examples of this include a family member who shares the insider's residence and a trust for which the insider acts as trustee and in which the insider has a "pecuniary interest."

Since most hedging strategies are reportable as a "sale" under Section 16 (requiring that a Form 4 be filed within 10 business days of the start of the month following the hedging transaction; note that a variety of news services such as Bloomberg monitor these filings and may report the transaction as a sale) at inception, an insider will always need to consider whether he or she has made any purchases in the 6 months before the hedging trade or anticipates making any purchases in the 6 months after the inception of the trade.

In addition, it is likely that insiders would need to report a "purchase" of the shares at maturity of a hedging trade. Accordingly, a hedge should be structured with a term greater than six months. There should also be other assets available to satisfy any obligation at maturity since the individual would have to wait six months after the maturity of the hedging transaction before selling shares in order to avoid short swing profit issues.

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Finally, if the shareholder is considered an insider or affiliate, the counterparty will need to confirm that the company does not have any prohibitions against the proposed transaction under the general insider trading rule (Rule 10b-5), or otherwise. The transaction will also need to be executed during a "window period."

6. **Market Constraints.** The ability to offer most hedging strategies will depend a great deal on the market characteristics of the underlying stock.

For example, puts, collars, and advance forward contracts are over-the-counter (OTC) strategies where the counterparty hedges its risk associated with the transaction dynamically. Initially, some portion of the shares to be hedged are borrowed and sold short in the market. Then, as the probability of the options being exercised at maturity changes over time, the counterparty will either buy back some of the shares or sell short additional shares.

Therefore, the counterparty must be comfortable that there are sufficient shares to borrow and that the shares will not be called away during the term of the transaction. It also needs to be comfortable that the daily average trading volume in the stock is great enough to allow it to trade without putting undue pressure on the stock price. One other important consideration is the volatility of the stock since it is a key component in pricing the hedging transaction.

All of these factors, the depth of the stock lending market, the liquidity of the stock, and the stock's volatility are difficult to judge until the stock has been trading for some period of time. Realistically, these constraints may limit the ability to obtain hedging strategies for several months following an IPO.

7. **Proxy Hedges.** When faced with the various restrictions mentioned above, many investors investigate some sort of "proxy hedge" to lower the risk in their concentrated stock position. The basic idea is that if you can find an index, a basket of other stocks, or perhaps another single stock that "looks" like your stock, you may be able to hedge using this proxy to lessen the economic exposure associated with holding the single stock until you can execute a hedge using the shares in that company. Typically, this situation arises when a company goes public. While it is possible to structure a proxy hedge, it is extremely difficult to be confident in the amount of true protection that a proxy hedge will ultimately provide.

The volatility of holding a single stock can be broken down into its component parts: general market risk, industry risk, and company specific risk. The best a proxy hedge can do is reduce the risk of holding a single stock to its company specific risk. For most single stock, company specific

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risk represents over two thirds of the risk of holding the stock and, for a newly public company, may represent an even greater portion of the risk.

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William & Mary Tax Conference

November 19, 2004

Wealth Transfer and Investment Planning for Restricted and Control Securities

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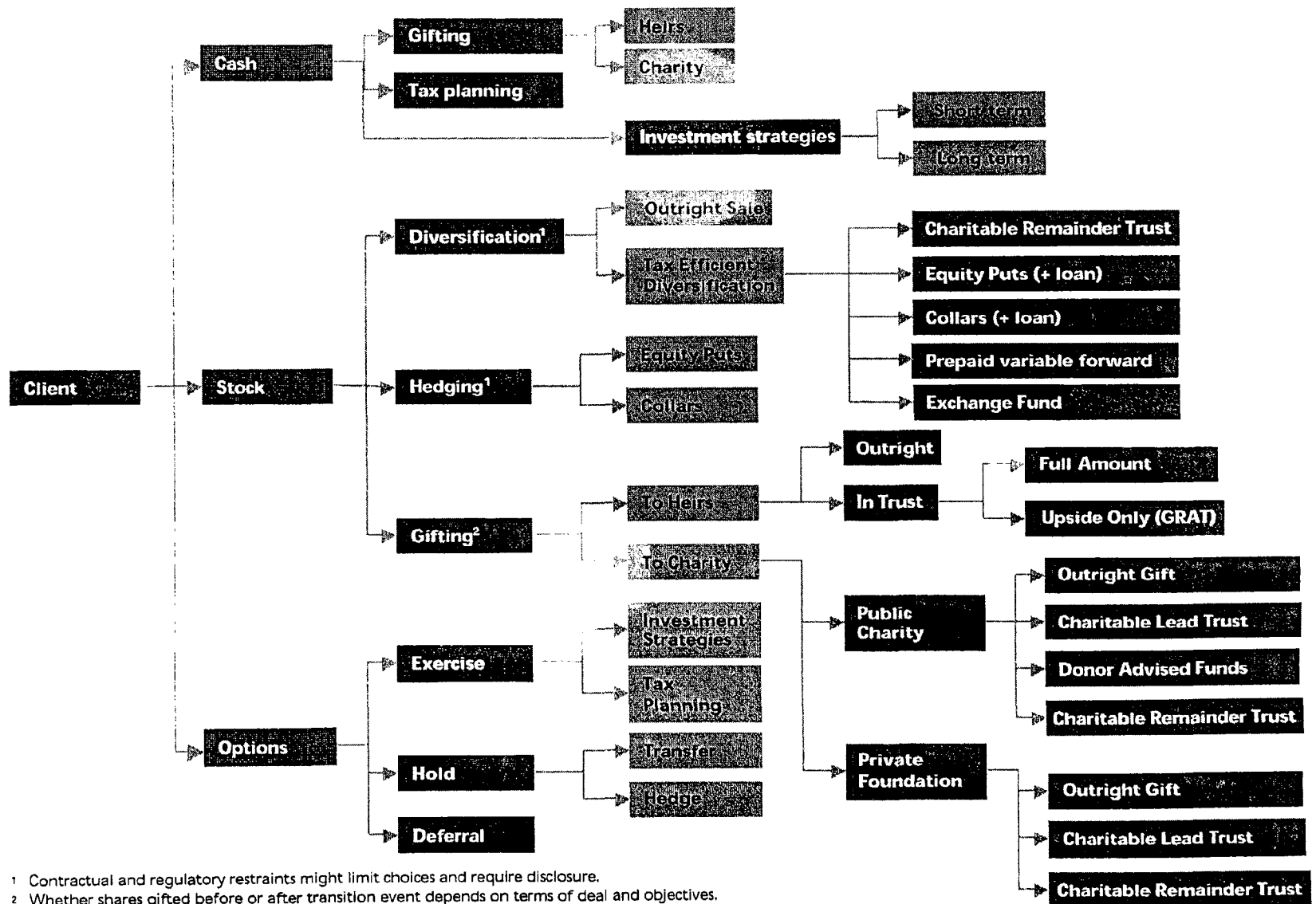
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Agenda

- I. Decision tree for corporate insiders
- II. Overview of rules and regulations pertaining to restricted stock
- III. Pure diversification strategies
 - Outright sales
 - 10b5-1 plans
 - CRTs
 - Exchange funds
- IV. Hedging and monetization strategies
 - OTC put option
 - Collar & loan
 - Prepaid variable forward
- V. Wealth transfer strategies
 - Taxable gift
 - Estate freeze - exchange fund
 - Sale to IDGT
 - GRAT
- VI. Planning for post-death & administration
 - Fiduciary selection
 - Drafting considerations

Corporate insiders face many wealth management decisions



1 Contractual and regulatory restraints might limit choices and require disclosure.
 2 Whether shares gifted before or after transition event depends on terms of deal and objectives.

To understand the securities law framework, it is useful to keep in mind the following definitions

Restricted Securities

- Shares not acquired in a public offering or in the public market. These securities are unregistered, and widely known as "legend stock" because they often bear a legend on the certificate stating that they are subject to selling restrictions. They are sometimes referred to as "letter stock" if issued in private transactions where the purchaser has provided an investment representation letter [Rule 144(a)(3)]

Affiliate

- An affiliate (often called a "control person") is any person or entity that directly or indirectly controls the management and/or activities of the issuing company. Affiliates usually include a company's senior management, directors, and certain large shareholders. A company's legal counsel usually determines whether a control relationship exists [Rule 144(a)(1)]

Control Securities

- Control securities are securities acquired by an affiliate in any manner, including open market purchases.

Insider

- An insider is any person with access to material, nonpublic information. This term extends trading rules beyond the affiliates mentioned above to include the families and close associates of affiliates. While all affiliates are considered to be insiders as well, all insiders are not necessarily affiliates.

Securities law framework

1933 Act "The Securities Act"

- Rule 144: Imposes conditions both on sales of unregistered stock by anyone and sales of any stock by an affiliate
- Rule 145: Imposes conditions on the sale of acquiror securities received in connection with certain types of corporate reorganization such as a merger, consolidation or reorganization by affiliates of target

1934 Act "The Securities Exchange Act"

- Section 13: Imposes reporting requirements on shareholders with more than 5% of a class of voting publicly traded stock
- Section 16: Imposes reporting requirements and potential short swing profit liabilities on senior officers, directors and shareholders with more than 10% of a class of voting publicly traded stock
- Rule 10b-5, Rule 10b5-1: Prohibit insider trading on material non-public information, but offer an affirmative defense

State Securities Laws

Rule 144 [17 C.F.R. § 230.144]

- 1-year fully-paid holding requirement for restricted securities, including while "private" (i.e., pre-IPO). (Does not apply to control stock)
- Company must be public and have satisfied SEC reporting requirements for 90 days before a Rule 144 sale
- Volume limits (during any 3 months, greater of 1% of outstanding shares or average weekly trading volume of previous 4 weeks)
- Aggregation rules
- Manner of sale restrictions
- Current day reporting -- Form 144 filing with SEC on or before date of sale indicating number and market value of shares to be sold
- Rule 144(k) - restricted stock, not held by an affiliate now or in the last 3 months, which has been owned for two years can be sold without volume restrictions

Section 13(d) reporting [15 U.S.C. § 78m(d); 17 C.F.R. § 240.13d]

- Greater than 5% shareholders of a class of voting publicly traded stock
- Upon acquisition (10 days), file Schedule 13D/G
- Schedule 13G can be filed by “passive holders” of <20%
- When holding changes by 1%, amend Schedule 13D for most; 13G filers can generally wait until year end

Section 16(a)-(c)[15 U.S.C. § 78p(a)-(b); 17 C.F.R. § 240.16]

- Form 4 two-day reporting for senior officers, directors and >10% shareholders for most changes
- Form 5 annual filing for other changes
- Short-swing profits recapture (six-month matching)
- No "naked" short sales

Rule 10b-5 and Rule 10b5-1 [17 C.F.R. § 240.10b5-1]

- "Awareness" + trade = liability
- Affirmative defenses (October 2000): contract, instruction or plan
- Rule 10b5-1 plans may allow sales outside trading windows, reduce litigation risk and have less market impact

Pure Diversification Strategies

- Outright sales
- 10b5-1 plans
- CRTs
- Exchange funds

Outright sales

- Investor may decide to sell shares outright to eliminate exposure to the stock
- Rule 144 holding periods apply to restricted securities. Volume limitations and manner of sale apply for both control and restricted stock
- Section 13(d) and (g) reporting requirements apply to shareholders with more than 5%
- Section 16(a) reporting and (b) profit-forfeiture rule may apply
- Rule 10b-5 and Rule 10b5-1 apply
- Company restrictions may apply
- Underwriter lock-ups may apply

Rule 10b5-1 addresses challenges associated with Rule 144 requirements by offering flexibility in restricted stock sales

- October 2000 rule reflects SEC's long-held broad "awareness" standards prohibiting insider trades on the basis of material nonpublic information if he/she is aware of the information at the time trade is made
- But also establishes new "affirmative defense" – no liability if, before becoming aware of the material nonpublic information, insider:
 - entered into a binding **contract** to buy or sell, or
 - gave **instructions** to another person to buy or sell for the insider's account, **or**
 - adopted a written **plan** for selling securities
- The contract, instructions, or plan must meet certain additional requirements

10b5-1 Selling Program enables insiders to take advantage of this expanded flexibility

How this works

- Transfer all or a portion of company stock into brokerage account with a qualified financial institution
- Develop, perhaps with dedicated "10b5-1 Team," a phased, pre-planned sales program to be executed at either market or specified prices in accordance with Rule 144
- Contract generally remains in effect until the earlier of: specified shares are sold, or one year from effective date of contract

Benefits

- **Flexibility:** selling in tranches allows for market adjustments and meets cash flow needs
- **Protection:** a dedicated team may provide additional distance between insider and 10b5-1 contract, reducing appearance of impropriety
- **Efficiency:** a dedicated team may execute and monitor entire process, including Form 144 compliance

10b5-1 Program: issues to consider

- Rule 10b5-1 only provides an affirmative defense against 10b-5 liability. All the following still apply, and may limit sales or affect their timing:
 - Rule 144
 - Section 13
 - Section 16 matching and reporting
 - state laws
- Enter into a plan only when insider is not aware of material nonpublic information
- Corporation must acknowledge the selling program by signing the sales plan
- Corporation should review its insider trading policy
 - a trading program will probably need relief from the blackout period policy
 - corporation may want to amend its policies accordingly
- The insider has the burden to prove compliance with the rule
- Company restrictions may apply

Charitable Remainder Trust (CRT): some of the considerations when funding with restricted stock

Tax structure

- "Straight" CRTs pose issues because of potential delay in consummating sale
- Consider structuring CRT with "flip" provisions or NimCRUT

Rule 144 imposes constraints and considerations:

- Upon donation of restricted securities to the CRT, the CRT can include (or "tack") the donor's holding period for Rule 144 purposes [Rule 144(d)(3)(vi)]
- No sale of restricted securities by CRT within one year of donor's acquisition date. [Rule 144(d)(1)] If CRT's holding period (after tacking) is more than one year but less than two years, CRT sales subject to volume limitations. [Rule 144(e)(1)-(2)] If CRT's holding period (after tacking) is more than two years, Rule 144(k) applies (no volume limits) unless CRT is an affiliate or CRT stock is attributed to an affiliate [Rule 144(e)(2);(k)]
- If securities donated by affiliate are the only asset in CRT, and income interest is held by affiliate or family member who shares affiliate's residence, then CRT will be deemed same "person" as the affiliate and will itself be an affiliate.

Section 13 issues:

- Report initial gift to CRT if donor owns more than 5% on Schedule 13D/G [Rule 13d-2(a)-(b)]
- If the CRT holds more than 5%, it must file its own disclosure reports under Section 13 [Rule 13d-1(a)]

Charitable Remainder Trust (CRT): some of the considerations when funding with restricted stock (cont.)

- If the donor or a relative in donor's household acts as trustee, then donor must continue to report sales by the CRT even if CRT holds less than 5% of the class of publicly traded voting stock [Rule 13d-3(c)]
- If there is an independent trustee and CRT holds less than 5%, generally there should be no Section 13 reporting required after the initial transfer unless the donor or a beneficiary holds or shares voting or investment control

Section 16 issues:

- The donation of restricted securities will be subject to reporting on Form 5 with earlier reporting on Form 4 permitted [Rule 16a-3(f)(1)(i); (g)(1)]
- If the trustee of the CRT is independent, then generally transactions by the CRT should not be reportable by the donor, the trustee or any beneficiary unless the donor or a beneficiary has or shares voting power or investment control [Rule 16a-8(a)(2)]
- Trust transactions may be reportable if the donor, a beneficiary or a trustee (or a member of the trustee's immediate family) has a pecuniary interest [Rule 16a-8(a)(2)]
- The donation of the securities to the CRT should be exempt from the short-swing profit forfeiture provisions of Section 16(b), so long as the donation is a *bona fide* gift [Rule 16b-5(a)]
- The CRT itself may have Section 16 reporting requirements if the trustee is an affiliate or if the trust holds more than 10% [Rule 16a-8(a)(1)]

Charitable Remainder Trust (CRT): some of the considerations when funding with restricted stock (cont.)

- Sale of control securities must be aggregated with the donor's sales and generally will be subject to the donor's volume limits for at least 1 year [Rule 144(e)(2)]
- Most CRT sales of restricted securities are *not* made under Rule 144(k). Restricted securities held for at least two years by a "person," who is not, and has not been within the preceding three months, an "affiliate" of the issuer may be sold to the public without restriction.
 - But, because the donor (or a relative living in the same household) usually retains greater than 10% interest, the donor is generally treated as the same "person" as the CRT, and sales by the CRT count against the donor's volume limit [Rule 144(a)(2)]
 - If the grantor is not an "affiliate," the CRT may or may not be viewed as an affiliate itself, depending on facts and circumstances.
- Rules 10b-5 and 10b5-1 apply at sale
- Company restrictions may apply to contribution and sale
- For IRS purposes, if the remainderman is a private foundation and the donor plans to claim an income tax deduction treating the donated stock as "qualified appreciated stock," the donor should limit securities donated to CRT to amount not exceeding volume limitations of Rule 144
 - donor should agree in writing (through a side agreement) not to sell securities that, when aggregated with securities likely to be sold by the CRT, could cause total number sold to exceed Rule 144 volume limitations

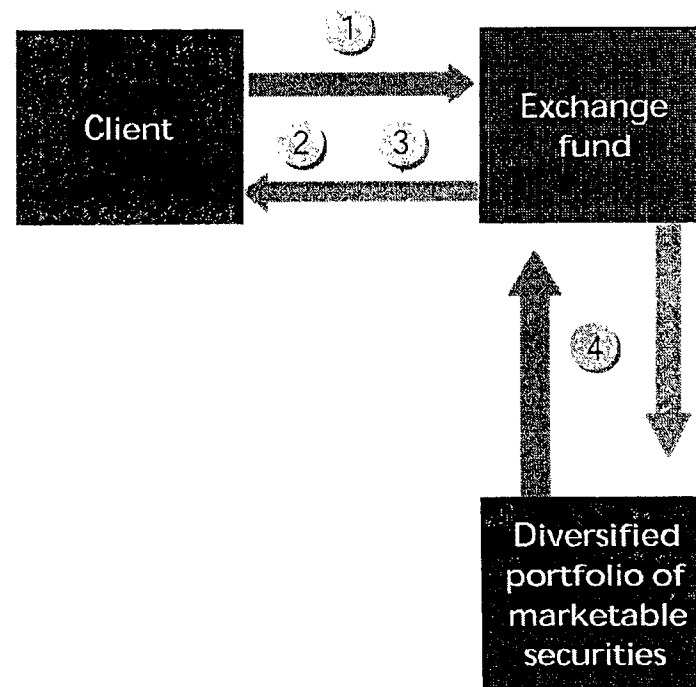
An exchange fund provides another diversification technique

- 1 Investor contributes large holding of stock, typically with low basis. No capital gains tax incurred upon transfer of securities to the fund
- 2 In exchange, investor receives pro rata units of ownership in the exchange fund

During the life of the fund, it is anticipated that the investor may receive annual income distribution to cover tax liabilities

The investment is essentially illiquid for the term of the fund (currently at least seven years) subject to certain redemption requirements
- 3 Manager selects and manages portfolio
- 4 After seven years, investors may redeem their units for a diversified pro rata share of remaining securities in the fund

Under current law, no capital gains tax is incurred upon redemption from the fund, only upon subsequent sale

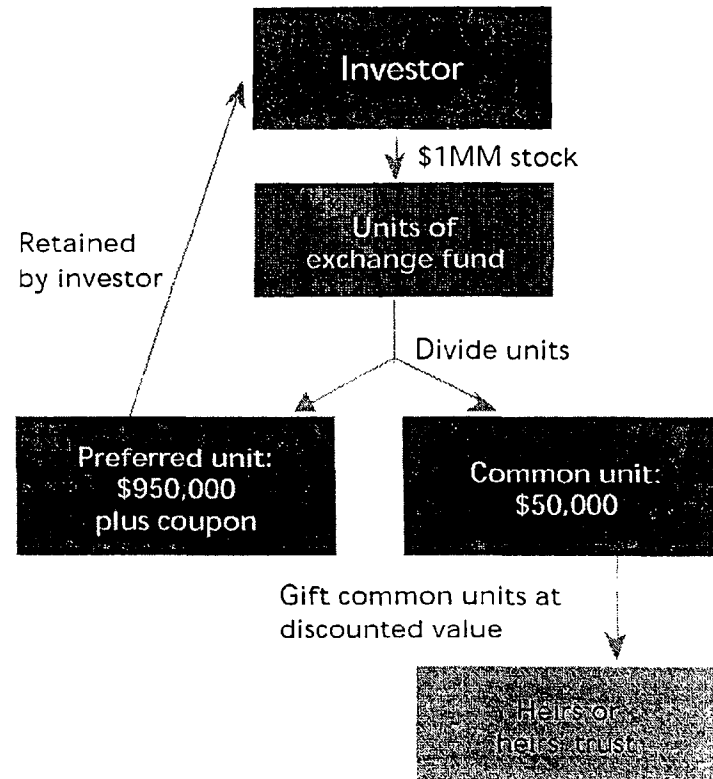


An exchange fund: special considerations when funding with restricted or control stock

- No Rule 144 filing required on contribution
- Section 13 reporting applies
- Section 16(a) reporting applies
- Section 16(b) short-swing profits forfeiture potentially applies; consequently, client should make his investment decision to contribute to the exchange fund when he is in an open trading window, and should not enter into any purchase or purchase equivalent within six months before or after contributing stock to the fund (which, for Section 16(b) purposes, is treated as a sale equivalent)
- Rules 10b-5 and 10b5-1 apply
- Company restrictions may apply

The estate freeze enables exchange fund investors to transfer anticipated appreciation to heirs

- Investor contributes stock to the fund and receives fund units
- At investor's request and with fund manager's approval, units are divided into two distinct units:
 - preferred unit (fixed): 95% initial value plus cumulative, non-compounding coupon
 - common unit (growth): 5% initial value
- Investor gifts common unit which is eligible for valuation discount for gift tax purposes
- If investor divides units, he/she must divide all units, forfeiting all redemption rights until liquidation (15 years)



Hedging and Monetization Strategies

- OTC put options
- Collar + loan
- Prepaid variable forward contracts

OTC put options provide protection against a decline in the value of a single stock

Description

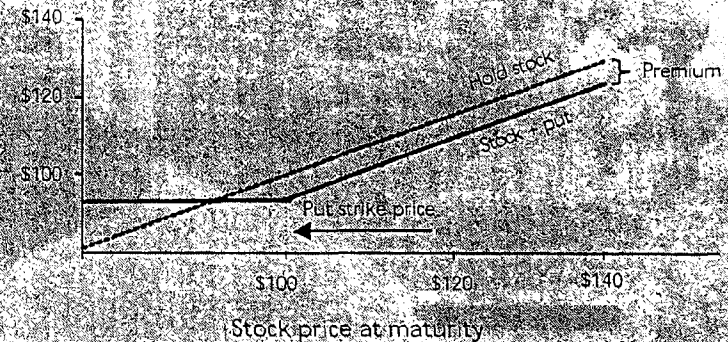
- Long puts provide protection against a decline in the value of a single stock position
- Client purchases, for a premium, the right to sell shares to at a fixed price (the "put strike price") on a specified maturity date
- Client has flexibility in setting put strike price and maturity date
 - put strike price can be set at-the-money to lock in 100% of today's stock value or out-of-the money to reduce cost
- Client retains all upside appreciation, dividends and voting rights
- Client may choose to cash settle the option rather than selling the shares at maturity
 - the client receives the difference between the put strike price over the final share price in cash
- Client can borrow against hedged position to raise liquidity, as needed

Key risks

- Options are a depreciating asset
- If the stock price is at or above the put strike price at maturity, then the client will lose his entire premium

Payout profile (illustrative only)

Effective portfolio value (long stock position combined with put option)



Payment at maturity

Assuming cash settlement:

- **If the stock price at maturity < put strike price,** counterparty will pay the difference between the put strike price and the stock price at maturity
- **If the stock price at maturity \geq put strike price,** the put option expires worthless and the client loses their entire premium

Securities law issues and put options (purchase)

- Purchase not reportable under Rule 144
- Section 13
 - Reportable by Schedule 13D filers [Rule 13d-2]
- Section 16
 - Purchase of put option is reportable as a sale at date of purchase [Rule 16a-3(g)]
 - Purchase of put option is a sale-equivalent for the purpose of 16(b) profit-forfeiture rule [Rule 16a-1(h)]
- Rules 10b-5 and 10b5-1 apply
- Company restrictions may apply

OTC cashless collars provide the same downside protection but eliminate upfront premium by foregoing some potential upside appreciation

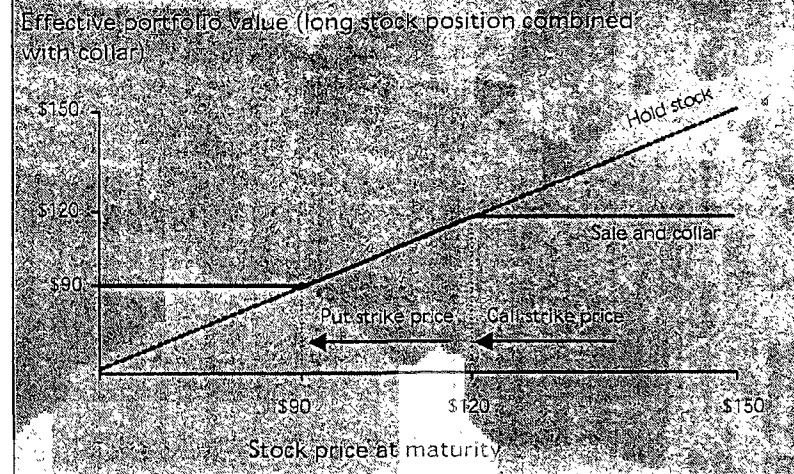
Description

- Provides downside protection but the client forgoes some potential appreciation to eliminate the upfront premium
- Consists of client buying a put and selling a call with same maturity
 - specify level of downside protection needed (e.g., 10%-20% below today's price)
 - strike on call set to generate premium to pay for the put option
- At maturity, payoff of the collar depends on market value of stock
- Client retains all upside appreciation up to the call strike price, dividends, and voting rights
- Shares are pledged as collateral for the collar
- Client can borrow against hedged position to raise liquidity, as needed

Key risks

- The client is capping the potential return on the stock at the call strike price and gives up any stock appreciation above the call strike price
- The collar locks in the amount that can be realized at maturity to a range defined by the put and call strike prices
- Shares are pledged for the duration of the collar

Payout profile (illustrative only)



Payment at maturity

Assuming cash settlement:

- **If stock price at maturity < put strike price:** counterparty pays the difference between the put strike price and the stock price
- **If stock price at maturity > call strike price:** Client pays the difference between the stock price and the call strike price
- **If share price is in between or at the put strike price or the call strike price:** no payments are made by either party and the contract expires worthless

Securities law issues and collars

- Rule 144
 - Should not be reportable at inception
- Section 13
 - Buyer of long put who reports on 13D should amend promptly
- Section 16
 - Reportable under Section 16(a)
 - Deemed sale for 16(b) purposes. Cash settlement of collar considered "purchase." Note: Rule 16c-4 requires person entering into hedge which is treated as a sale to be long as many outright shares as the notional throughout entire term of hedge

Borrowing against a hedged position

- Proceeds can be reinvested in a diversified portfolio or private investments (or consumed)
- Terms can be more attractive than those for traditional secured credit:
 - less collateral required:
 - non-purpose loan:* If a client is not using the proceeds of the loan to purchase or carry margin stock, Regulation U would not apply, and a bank might lend up to 90% of the Put Strike on each share
 - purpose loan:* If the client intends to use the proceeds to carry marginable stock (i.e., publicly traded equities), Regulation U requires an initial collateral value of 2:1
 - downside protection: no requirement to provide additional collateral if stock price falls
 - pricing: Often LIBOR plus a spread; generally below unhedged lending spreads

By combining a hedge and a loan investors can get liquidity and eliminate downside risk

- Generate proceeds to invest in a diversified portfolio
 - upfront
 - or at various times during the life of the hedge
- Eliminate margin calls by hedging downside risk - avoids death spiral
- Retain some upside exposure
- Defer capital gains tax
- Issues to consider
 - advance rate
 - drawdowns
 - interest rate
 - interest deductibility
- Section 16(b) matching is a hazard for insiders

A prepaid variable forward contract (PVFC) is an alternative to borrowing

Description

- A PVF contract allows a client to receive attractive upfront liquidity (typically 80-90% of the stock value) and allows for flexibility in their investment of the proceeds
- Client defers taxes on underlying shares until the maturity of the transaction (assuming delivery of shares at maturity)
- The client protects his/her position below the hedged value and retains all participation in the upside appreciation up to a predetermined upside limit
- Client may retain all dividends and voting rights during the term of the PVFC
- While economically similar to collar plus a loan, no interim cash payments are required

Settlement formula

- At maturity, client pays, in cash or shares, an amount that varies with the stock price:
 - **if stock price at maturity < hedged value**, market value of the shares
 - **if hedged value < stock price at maturity < upside limit**, hedged value of shares
 - **if the stock price at maturity > upside limit**, hedged value of shares plus appreciation above upside limit

Key risks

- Stock appreciation is capped at the upside limit
- Shares are pledged for the duration of the PVFC

Securities law issues and PVFCs for affiliates/insiders

- Rule 144
 - 1 year holding period of Rule 144(d)(1) for restricted securities applies
 - Subject to volume limitations
 - Form 144 must be mailed to SEC no later than trade date
 - Form 144 becomes public record when received by SEC
 - Manner of sale restrictions apply
 - Non-restricted control or 145 stock can be hedged immediately by the counterparty
- Section 13
 - May be reportable at entry if material
 - Reportable if physically settled and material
- Section 16
 - Reportable at entry [Rule 16a-3(g)]
 - Entry likely constitutes a sale-equivalent [Rule 16a-1(h)] and is matchable for Section 16(b) profit-forfeiture rule
 - Physical settlement probably should not constitute a purchase-equivalent
 - Cash settlement less clear for Section 16(b) matching purposes
- Rules 10b-5 and 10b5-1 apply
- Company restrictions may apply

Wealth Transfer Strategies

- **Taxable gifts**
- **Estate freeze - exchange fund**
- **Sale to IDGT**
- **GRAT**

Taxable Gifts: overview

- In the past, taxable gifts were frequently recommended due to tax efficiencies
- Ongoing hope of permanent repeal spurred on by four attempts in the last 17 months by House to permanently repeal
- Soaring Federal and State deficits begin to call into question viability of repeal
- In September 2004 the CBO revised its budget estimates. The new 10-year deficit estimated at \$2.3 trillion (*before* Bush asked for \$87 billion to rebuild Iraq)

Securities law issues for gifts

- Rule 144
 - *Bona fide* gifts do not have to be reported [Rule 144(h)]
 - Donee's holding period tacked with donor's holding period for Rule 144 purposes [Rule 144(d)(3)(v)-(vi)]
 - Donee's sales aggregated with donor's sales for Rule 144 volume limitations for at least one year [Rule 144(e)(3)(iii)]
 - Donee's sales count against donor's volume limit, and vice versa, until the sooner of: (i) one year after the donation, and (ii) the donee's deemed holding period (after tacking) equals two years
- Section 13
 - Gift must be reported by Schedule 13D filers
- Section 16
 - If donor is an insider, gift must be reported on Form 4 or Form 5
 - Gift is not "matchable" for Section 16(b) purposes
 - Subsequent transfers by relatives of the donor living in same household must be reported [Rule 16a-1(a)(2)(A)]
 - Subsequent sale by donee relatives living in same household is matchable for Section 16(b) purposes

Valuation discounts for restricted or control stock

- Value of unvested, restricted or control stock for transfer tax purposes has been a source of some controversy.
 - Blockage discount
 - What is the effect of an employer's restriction (whether continued employment or satisfaction of performance targets) that had not lapsed immediately before the employee's death?
 - Ninth Circuit recognized that restrictions reduce the value for transfer tax purposes even though they may lapse as a result of the employee's death. *Estate of McClatchy v. Commissioner*, 147 F.3d 1089 (9th Cir. 1998)

Estate freeze - exchange fund

- Exchange fund interests usually exempt from registration with SEC (though contribution of restricted or control stock raises SEC issues)
- Retention of preferred interests and gift of common interests freeze value of common interests to donor
- Preferred and common interests not subject to Rule 144, Section 13, Section 16

Securities law issues and sales to intentionally defective grantor trusts

- Rule 144
 - Rule 144 applicable. Subsequent sale by trustee may be aggregated for at least 1 year
- Section 13
 - Applicable
- Section 16
 - Reportable under 16(a). Subsequent sale by IDGT reportable if: (i) trust is an affiliate, (ii) trustee is affiliate and immediate family member has beneficial interest or (iii) beneficiary is affiliate and has voting or investment control
 - 16(b) applies

Securities law issues and GRATs

- Rule 144
 - Initial transfer not reportable
 - GRAT holding period tacked with donor's holding period [Rule 144(d)(3)(vi)]
 - Aggregation
 - Donee's sales count against donor's volume limit, and vice versa, until the sooner of: (i) one year after the donation, and (ii) the donee's deemed holding period (after tacking) equals two years
 - If donor or affiliate is trustee, all sales by GRAT aggregated during annuity period [Rule 144(e)(3)]
 - If remainderman is an affiliate, aggregation rules continue to apply [Rule 144(e)(3)]
 - If trustee of the remainder trust is an affiliate, sale may be aggregated depending on facts and circumstances
 - Payment in-kind of annuity obligation probably should not start new holding period for the donor's 144 purposes
- Section 13
 - If GRAT funded by 13-D filer, initial contribution and payment in-kind of annuity obligation may require amendment of 13-D
 - Any new purchase of stock by GRAT may require amendment to Schedule 13-D
 - Transfer to GRAT remaindermen at termination may require amendment to Schedule 13-D

Securities law issues & GRATs (cont.)

- Section 16
 - May be applicable. Funding of GRAT probably should not be reportable under 16(a) or subject to profit disgorgement under 16(b). [Rule 16a-13] Payment of annuity may be subject to profit disgorgement under 16(b) if there is any kind of control, including control exercised by the grantor over the number of shares used to make the annuity payment.

Kight SEC No-Action letter: payment in-kind to satisfy annuity obligation not reportable under 16. Facts in *Kight* did not present an opportunity to abuse inside information. Grantor did not control investment decisions and did not have power to substitute.

Morales: grantor's substitution of promissory note for stock in GRAT constituted purchase for 16(b) profit disgorgement.
 - If donor exercises a power to substitute assets, section 16(a) reporting and 16(b) profit-forfeiture rules likely apply
 - Distribution at trust termination may be reportable, depending on facts and circumstances

Planning for post-death administration

- **Fiduciary selection**
- **Drafting considerations**

Fiduciary selection

- Selecting an affiliate trustee may require reporting for control stock or perpetuate reporting for restricted stock
- Selecting an affiliate trustee may cause adherence to volume limitations beyond second year and preclude application of Rule 144(k)
- Trustee's holdings and trust holdings may be aggregated for Rule 144 volume limits if considered acting in concert under Rule 144(e)(3)(v)
- Section 13 - Trust stock may be aggregated with trustor's own to determine reporting obligation, depending on facts and circumstances
- Section 16 - Trustee who has (or whose immediate family member has) a pecuniary interest must include trust stock in determining volume limits and sales by the trust will be subject to the reporting and profit-forfeiture rules [Rule 16a-8(a)(2); (b)]
 - Section 16 consequences can be virtually eliminated by use of independent, non-affiliate trustee who has complete control (not shared with the grantor) over the trust's investments
- Consider a special trustee
 - Avoid affiliate status
 - Direct voting
 - Direct pledging, hedging and sale

Drafting considerations

- Waive duty to diversify and authorize retention
- Modify conflict of interest rule
- Allocate decision-making to special trustee
- Provide broad power to sell, borrow and hedge
 - company redemption
 - non-public block sale
 - sale through related entities
 - hedge risk with a put or collar through related entities
 - arrange loans through related entities
 - hedge to support loan through related entities
 - forward sale through related entities
- Authorize to engage tax and securities law experts
- Valuation difficulties for funding marital, charitable, and pecuniary gifts
- Distribution complexity - restricted or control stock may be worth more to one beneficiary than another

Appendix

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Related securities law issues

Rule 10(b)(5)-1 [17 C.F.R. § 240.10b5-1]

- Awareness + trade = liability (October 2000)
- Affirmative defenses: contract, instruction or plan
- Rule 10b5-1 Plans may allow sales outside trading windows, reduce risk and have less market impact

Rule 144 [17 C.F.R. § 230.144]

- One-year holding period (including while "private")
- 90-day "public" company
- Volume limits (during any three months, greater of 1% outstanding or average weekly trading volume for prior four weeks)
- Aggregation rules (side agreements)
- Current day reporting

Section 16(a) & (b) [15 U.S.C. § 78p(a)-(b); 17 C.F.R. § 240.16]

- Form 4 two-day reporting for officers, directors and 10% shareholders
- Form 5 annual filing
- Short-swing profits recapture (six-month matching)
- No "naked" short sales

Section 13(d) reporting [15 U.S.C. § 78m(d); 17 C.F.R. § 240.13d]

- 5% shareholders
- Upon acquisition (10 days), Schedule 13D/G
- When holding changes by 1%, Schedule 13D/G
- Annual filing on Schedule 13G

Summary of strategies to manage a concentrated position

	Defer capital gains	Reduce single stock risk	Create liquidity	Minimize transfer tax	Keep dividends/ voting rights
Hold	x				x
Sell		x	x		
Charitable Remainder Trust	x	x	x		
Hedge					
Buy put	x	x			x
Collar	x	x			x
Monetize					
Secured unhedged loan	x		x		x
Collar + loan	x	x	x		x
PPVFC	x	x	x		x
Personal exchange fund	x	x	x	x	x
Transfer					
Exchange fund w/estate freeze	x	x		x	

Securities law considerations related to restricted or control stock

Type of sale strategy	Rule 144	Section 13(d)	Section 16(a)	Section 16(b)
Outright sale	During any three-month period, sales cannot exceed the greater of 1% of the outstanding shares, or average of prior four weeks trading volume. Shares bought before IPO are privately placed and therefore restricted. Shares owned by affiliates (senior officers, directors, and certain large shareholders) are control shares under 144. No sales or redemptions of affiliate shares may be made until the company has been filing required SEC reports for 90 days (i.e. post-IPO). Restricted securities held at least two years by a person who has not been an affiliate (i.e. at least three months) may be freely sold under Rule 144(b).	Applies to beneficial owners of greater than 5% of a class of publicly traded voting stock. If owner participates in control of company, generally files Schedule 13D; if passive, on Schedule 13G. Changes in ownership equal to 1% of outstanding deemed material. If sale is material, must be reported on Schedule 13D or G. Schedule 13D must be amended promptly (rule of thumb is within 48 hours).	Sale must be reported on Form 4 within two business days following transfers.	Sale is matchable against non-exempt purchase(s) made 6 months before or after sale.
Charitable remainder trust ("CRT")	Transfer to CRT need not comply with Rule 144. In general, CRT can "tack" donor's holding period for Rule 144 purposes. If securities donated by affiliate, and only asset of CRT, and income interest held by affiliate or family member who shares affiliate's residence, then CRT will be deemed same "person" as the affiliate (sales by CRT are deemed to be sales by the affiliate and vice versa) and will itself be an affiliate. If securities donated by affiliate, <u>but</u> conditions above do not apply, the CRT will follow Rule 144 until holding period (after tacking) equals two years.	If donor retains right to vote or dispose of shares after the transfer probably no need to amend Schedule 13G, but probably should amend Schedule 13D in any event. If over 5% of an outstanding voting class of publicly traded securities were beneficially owned by the CRT, the CRT would become subject to the reporting requirements of Section 13(d).	If donor has or shares control over the stock in the CRT, donor will be subject to the reporting requirements of Section 16(a) with respect to transactions in equity securities of the issuer.	Sales by the CRT will be considered sales by donor for 16(b) purposes if donor has to report under 16(a).
Exchange fund	Rule 144 need not be complied with on transfer, but may need to be followed when the fund sells.	Applies. (See Outright Sale)	Applies to transfers reported on Form 4.	Applies to transfer. Should not apply to later sales by the fund.
10b5-1	Rule 144 must be complied with for sales by affiliates and holders of restricted stock.	Applies (See Outright Sale).	Sales must be reported. Form 4 due within 2 business days after notification by the broker as long as within three business days of actual execution where affiliate does not select the date of execution.	Applies (See Outright Sale).

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Securities law considerations related to restricted or control stock (cont.)

Type of hedging strategy	Rule 144	Section 13(d)	Section 16(a)	Section 16(b)
Put option	Not reportable under Rule 144	Holder of long put who reports on 13D should amend promptly	Reportable under 16(a)	A put option is deemed a sale for the purpose of 16(b). Note: Rule 16c-4 requires person entering into hedge which is treated as a sale to be long as many shares as the notional throughout entire hedge.
Collar + loan	If structured properly should not be reportable at inception.	Holder of long put who reports on 13D should amend promptly.	Reportable under Section 16(a).	Deemed a sale for 16(b) purposes. Cash settlement of collar considered "purchase." Note: Rule 16c-4 requires person entering into hedge which is treated as a sale to be long as many shares as the notional throughout entire hedge.
Prepaid Variable Forward (PVF)	Reportable under 144. Morgan believes prepaid forwards for affiliates cannot be entered into for one year after private placement unless prospectus is available. Form 144 must be mailed to SEC no later than trade date. Form 144 becomes public record when received by SEC. Manner of sale restriction prohibits solicitation of buyers other than brokers who expressed interest in last 60 days; customers who expressed unsolicited interest within last 10 days. Non-restricted control or 145 stock can be hedged immediately. Volume limit apply. (See Outright Sale)	Holder of long put who reports on 13D should amend promptly.	Reportable under Section 16(a)	A PVF constitutes a constructive sale for the purpose of 16(b) filings. Note: Rule 16c-4 requires person entering into hedge which is treated as a sale to be long as many shares as the notional throughout entire hedge.

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Securities law considerations related to restricted or control stock (cont.)

Type of transfer strategy	Rule 144	Section 13(d)	Section 16(a)	Section 16(b)
Sale to IDGT	Rule 144 must be complied with for a sale to a IDGT. (See Outright Sale)	Applies (See Outright Sale)	Reportable under 16(a). Subsequent sale by IDGT reportable if: (i) trust is an affiliate; (ii) trustee is affiliate and immediate family member has beneficial interest; and (iii) beneficial affiliate and has voting or investment control.	Applies (See Outright Sale)
GRAT	Transfer to GRAT need not comply with Rule 144. However, if grantor acts as trustee (often the case) then GRAT will be affiliate and subject to 144 volume limitations and holding periods. Payment in-kind of annuity obligation should not start new holding period for 144 purposes.	If GRAT funded by 13D filer, the initial contribution and payment in-kind of annuity obligation may require amendment to Schedule 13D. Transfer to GRAT remaindermen at termination likely requires amendment to Schedule 13D.	Funding of GRAT is probably not reportable under 16(a). If grantor is trustee, trades by the GRAT would then be reportable as trades by the Grantor.	Payment of annuity payment may be subject to profit disgorgement under 16(b) if there is any kind of control, including control exercised by the grantor over the number of shares used to make the annuity payment. <i>Morales v. Quintiles</i> , 25 F. Supp. 2d 369 (S.D.N.Y. 1998), 1998 U.S. Dist. LEXIS 11774; Peter J. Kight, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 946 (October 16, 1997); <i>Dreiling v. Kellett</i> , U.S.D.C., West. Dist. Wash., Case No. C01-1528P, Order on Cross Motions for Summary Judgement (May 14, 2003).

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