The Importance of Financial Planning Before Selling Your Business.

A Study on Maximizing Personal Wealth When Selling Your Business

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EXECUTIVE SUMMARY

For many owners of privately held companies, selling their business represents the culmination of years of work and offers the Seller(s) financial security for life. Experience has shown, however, that without strategic financial planning prior to the sale, an owner may not realize the highest possible net proceeds. To maximize the proceeds from a Seller's life work, we believe it is critical for a Seller to define their personal objectives, and implement a few key strategies.

The below research study identifies the critical alternatives when selling a business. By integrating potential deal terms, key tax and estate planning strategies as well as establishing the Seller's financial goals, the owner along with Team of Advisors can most effectively extract maximum value from the deal. Even though it is important to personalize strategies to exit your business, research has uncovered some global themes that are discussed in this study.

- **The sale of a business often allows the Seller spending, legacy, and philanthropic goals to be met… but not always, particularly if strategies to meet them are not finalized in the beginning;**
- **Generating the most value from a transaction is not necessarily tied to finding the highest sale price;**
- **It is import to weigh the safety of cash against the tax deferral and greater return potential of a stock transaction;**
- **Evaluate key estate key estate-planning strategies, which often yield maximum benefit if implemented before rather than after the transaction;**
- **Consider various exit or liquidity strategies other than a straight 100% sale.**

1. THE PROBLEM AND THE OPPORTUNITY.

Many owners of closely held businesses have spent a lifetime building their companies, creating a storehouse of value. In some cases, the company was founded by a prior generation, thereby becoming an extension of the family's reputation. When the prospect of sale is explored, it is no surprise that emotions can run high. On the one hand, these sales tend to be seen as the owner's ticket to financial security… the proverbial pot of gold at the end of the rainbow. At the same time, a business owner may worry about losing control over his income and the size of the legacy he would leave behind. **Transferring your business to the next generation of ownership is typically a life-changing event for the owner, requiring profound financial decisions.**

Personal Objectives Should Not Take a Back Seat.

In the high-stakes environment of a sale… evaluating offers, trying to close, overseeing the interests of the company and the employees… business owners feel pressure to focus their efforts on the critical business issues, asking themselves questions like:

a. What is my business really worth?
b. What is the right deal structure?
c. How do I make sure the deal closes?

These are all key questions that must get addressed by the owner and the Seller's ***Transaction Team***. Often it is not until after the sale closes that the owner addresses more personal concerns:

a. Did I get enough to meet my financial objectives?
b. What estate and trust strategies should I consider?
c. How should I invest my financial assets?

But it is crucial to address these questions before the deal… or the owner risks leaving very large sums of money on the table. By bringing the Seller personal financial goals up front, the Seller provides his team of advisors with the information needed to tailor the transaction properly. This is not only a business proposition, but a personal one… complicated by the fact can a probably will take several paths. What may be surprising is that such preparation before the transaction does not have to be onerous; the main thing is for the owner to take those first steps.

Complexity is Manageable.

This study starts with a discussion of setting goals, prioritizing them, and quantifying the likelihood of achieving them. These goals are then considered in an evaluation of deal terms… because some deal structures are better suited than others to meet certain personal objectives, and often can be modified to fit, the owner's needs more closely and with less risk. Further, because business sales offer a great opportunity to shore up one's family or philanthropic legacy, the study highlight the value that different trust strategies can add, particularly when considered prior to, rather than after, the transaction. We conclude by evaluating the financial-planning issues that arise when an owner considers selling less than 100% of his business because he is unwilling to give up control completely or because he is gradually preparing for an inter-generational transfer.

The foundation of much of the study analysis is a proprietary wealth forecasting model that integrates capital-markets behavior (based on history and research-derived projections) with the owner's individual circumstances.

While the size of the transaction is, of course, critical, we focus throughout our study on extracting the maximum benefit for the owner, given the Seller's unique situation, regardless of the deal amount. In our view, this approach not only helps create the best deal for the business owner, it also help make deals happen in the first place.

2. SETTING GOALS

A Seller's goals for his wealth can comprise a long, complicated list. Yet, when reduced to their essentials, there are really only four things people can do with their money:

- spend it;
- give it to the people they care about;
- give it to charity;
- send it to the government in the form of taxes.

Some of these goals will be in competition with other, so a business owner must weigh his priorities; Is a more luxurious lifestyle the priority, or starting a new business? Passing on a large legacy to his heirs, or establishing a charitable foundation? Should he stay involved with the business, for example, or get out... or something somewhere in between? Such decisions will naturally be major drivers of the strategies adopted.

Address Spending First

For most investors, the primary task is to ensure that their lifetime spending needs will be met. And many business owners assume the size of the deal alone will guarantee there will be more than enough. Often, they are right; but not always: They may underestimate their spending needs… especially since former business owners generally find themselves with more free time than they are used to, and a stockpile of assets to draw from.

Even if an owner just wants to maintain spending at his customary rate, his outlays would have to increase with inflation in order to preserve his purchasing power. Long-term, that could have a corrosive effect; At a modest 3% inflation rate, expenditures today would grow by 81% in 20 years. Underestimating the cost of funding their spending needs could cause former business owners to be more aggressive with their other goals than they can actually afford. Proper planning can help ensure that reserves are set aside for all financial needs… spending, family, charity, and so forth. The first step in that planning process is to quantify the amounts needed for each of those buckets.

Consider, for example, an owner who believes he can clear $20 million after taxes from the sale of his business; he's planning based on a 20-year horizon, and he wants to be confident that he will be able to meet his spending needs. Our wealth-forecasting tool can help him by modeling the returns from a variety of assets allocations in 10,000 market scenarios ranging from very good to disastrous. The result is a probability distribution of outcomes that the owner and his team can use as a framework for decision-making.

In ***Chart 2, page 16***, we use the estimates from an analytical model to answer the question, :How much money will the business owner need to reserve from his sale to meet his long-term spending needs (all growing with inflation?") Because meeting that particular goal is critical the Seller wants to have a 95% level of confidence: He doesn't want to have to worry about it. In effect, since he expects his after-tax sale price to be $20 million (in cash), we are asking if that amount is enough to support the Seller's future spending level, and if so, how much will be left over to meet other needs? We consider three different spending levels, and assume that the sale proceeds are invested in a diversified 60/40 stock/bond mix.[1]

The results for this owner vary, depending on the extent of his spending:

- With a $300,000 annual outlay (grown with inflation) and a 60/40 mix, we estimate that the owner would have to "reserve" a minimum of $6.3 million of his sale proceeds to be highly confident he will meet his spending needs. If the owner gets his $20 million price tag, he would have a notable $13.7 million remaining to use for other purposes.

- Even with a $600,000 spending hurdle, in our assessment a 60/40 mix would still leave the owner with over $7.0 million "extra".

- To assure meeting a $900,000 spending requirement (with a 95% level of confidence), however, he would have to reserve virtually all of his sale proceeds. Over the 20-year period in question, assuming all his assets came from his business sale, he would have only $1.0 million left to fund all his other needs. If he exceeded that, he would that he would have to look outside his sale proceeds altogether.

An analysis like this offers dual benefits. It suggests to the Sellers how much they need to set aside as a "life-style fund", as it were. It also provides critical context for what resources remain for other purposes… to establish a trust or family foundation, for example, or to grow their personal assets to a desired amount over time[2]. And as we will see, if such determinations are made before the negotiations begin, the deal terms themselves… including the amount of risk and return potential they bring with them… can be tailored to meet the owner's goals.

The Team Approach

A business owner considering the sale of their business to the next generation of ownership should have a team of professionals on the Deal Team:

a. An Investment Banker
b. A Transaction Attorney
c. A Trust, Estate and Tax Attorney
d. A Wealth Manager

Their know-how and the sophisticated tools they employ are essential in evaluating any transaction. Bernstein's role is one of providing expertise in integrating the intricacies of such planning with investment advice, and facilitating that effort with rigorous quantitative modeling to put the alternatives into the context of a personal financial plan. This approach can make the Team's recommendations more robust and the resulting planning more effective.

3. MATCHING DEAL TERMS TO THE OWNER'S PERSONAL NEEDS

Many deals are straightforward, with the proceeds all coming in cash on the day the deal closes. Some offers include a significant amount of stock in the acquiring company, and in those cases other issues may arise: Will the proceeds be fixed at the time the deal closes, or vary based on the performance of the acquiring company's stock? Will the stock be subject to a lengthy lockup period (during which time selling is prohibited)? A whether stock, cash, or both change hands, contingencies may be added to the deal": Some of the proceeds may be payable in installments over time, for example, or include "earn-outs" based on the company's operating performance.

Such deal-term variants can have material consequences for the owner's future cash flow. So the deal must be evaluated carefully… and from two different perspectives; the value offered for the business, and the impact of the terms on the Seller's personal investment plan. Failure to do so may lead to unnecessary risks or missed opportunities.

Cash or Stock?

An issue often faced by a Seller is how to compare cash versus stock offers, and combination of the two.[3] Not surprisingly, which is more advantageous for a given owner depends on what the Seller is trying to achieve. A cash deal may be preferable for one owner because of the ironclad safety of the payment… even though ultimately the transaction may be of less value. But another owner with substantial outside assets might favor the riskier stock deal for its higher reward potential.

Consider two competing offers… one for all stock, one for all cash. The stock deal is worth $35 million but comes with an 18-month lockup (although one-third of the shares are tradable every six months). The cash deal is worth 10% less, $31.5 million. In both cases, the process, when available, are diversified into a mix of 60% stocks and 40% bonds. Both deals are expected to close in six months. Which offer is superior?

One analysis of the value that can accrue to the owner at the expiration of the lockup period can be seen in ***Chart 3, page 17.***

In the median case (the numbers represented by the dot in the middle of the boxes), we would expect the all-stock deal to best the all-cash deal by $4.0 million after taxes. But it is important to look at the range of scenarios. The bottoms of the boxes and below can be regarded as downside cases: outcomes

that we would expect to sell on 10% of the time. In this case, we estimate a downside of $23.3 million for the cash deal, compared with $20.0 million for the stock deal. Despite the higher initial price of the stock offer, cash is more protective. That is because there is always a chance that the acquirer's stock will fall…perhaps meaningfully… before the deal closes or during the lockup period. And so we are left with a classic trade-off.

Two Owners, Two Offers

But the analysis does not stop here. While there is no single answer as to which deal is better, a clear choice usually emerges when the specific circumstances of an individual Seller are closely examined. Consider the case of two owners of separate manufacturing companies, each receiving two offers: one in cash, the other in stock. See ***Chart 4, page 17***. For this purposes, we will assume that each owner has received the cash and stock offers described above. ($31.5 million in cash, $35 million in stock), and that each is utilizing the services of a full advisory team. At first, the situations of the two owners appear to be very similar; each is the sole owner of their business; they are the same age, and have analogous family situations. They regard 30 years as their investment time horizon, and both plan to sever association with their companies… using $10.0 million to fund a charitable family foundation. The other, “the entrepreneur,” wants to use the same amount to start a new business venture. The philanthropist spends less than the entrepreneur… but has much more in outside assets. These underlying differences trump the similarities; in fact, our analysis suggests that the best choice of deal terms for one (stock for the philanthropist, cash for the entrepreneur) might be a big mistake for the other.

The Philanthropist: Building a Long-Term Legacy

Over the years, the philanthropist has built up a sizable portfolio for himself and his/her family from his/her earnings. With $10 million available to him outside the sale of his/her business, he/she already has more than enough to meet his/her spending needs. In fact, over his/her long 30-year investment horizon, there is a 90% probability that he/she will still have at least $4.0 million left after taxes, exclusive of the proceeds from the sale. Therefore, with a high degree of confidence he/she can use all his/her sale proceeds to fund a charitable family foundation and build a larger legacy for his children. As we will see in the next section, this highlights an opportunity for Seller and his/her advisors to help meet these goals through the use of certain trust vehicles.

What’s more, because he is not depending on the deal proceeds for his family’ needs, he/she is willing to take on some uncertainty in exchange for a higher return potential.[4] And he/she is aware that much of the stock can be diversified in a family foundation’s tax-free environment. With all this information in hand, the advising team recommends going with the stock deal.

The Entrepreneur: Lifestyle Needs Predominate

At first glance, it looks as though the entrepreneur should do the same. The additional value from the stock deal (diversified into 60/40 stocks/bonds) compounds over her 30-year time horizon, offering a median result for her entire portfolio of $53.0 million, versus $36.0 million the entrepreneur had taken cash ***(See Chart 5, page 18)***. On the flip side, if the markets go poorly, the stock deal could potentially leave the entrepreneur with nothing… versus almost $12.0 million from the cash deal.

The entrepreneur's must be prepared for a downside event: The new venture the entrepreneur is interested in carries significant risk, and has relatively few assets besides what is included in the sale of the business. Therefore, the entrepreneur wants to make sure that the proceeds are enough from the current deal to ensure a lifetime spending needs. At $500,000 annually, growing with inflation, those needs are substantial. If the entrepreneur chooses stock over cash, the Seller may fall short of meeting the stated financial goals.

Stocks Deals: Reducing the Uncertainty

We have been assuming so far that these business owners can choose between stock and cash deals. But that is not always the case. What if, for example, the only offer available was for all stock? Would the entrepreneur be required to accept a deal that might not meet the Seller's needs? One of the options is to reduce the planned investment in the new venture, lower spending… or wait for higher offers for Seller's business. (Though of course there is always a danger.) But chances are the Seller would not be forced to take any of those less desirable measures. Deal terms are often flexible, and the Seller and the Seller's advisory team might be able to make adjustments that would likely safeguard the Seller from financial jeopardy.

For example, the entrepreneur's deal team might try to negotiate one of five commonly used strategies designed to cut stock risk either before the deal closes, during the lockup period, or both:

- **"Floor-and-ceiling" on the offer price":** Setting a minimum value that the Seller will receive regardless of the acquiring company's stock price prior to closing (say 85% of the $35.0 million). A maximum value may also be included to reduce the acquirer's risk (say 115% of the $35.0 million). This tactic addresses the risks prior to close, which in this case was assumed to be a six-month period.

- **Fixed dollar value of stock:** Negotiating a fixed price that the owner will receive at the sale. Though the lockup risk remains, the entrepreneur would be assured of receiving $35.0 million in stock at close.

- **Receiving a portion in cash:** Arranging for the acquirer to pay some of the proceeds in cash. The entrepreneur's team might, for instance, negotiate a 20% cash payout. Obviously, this lowers risk… during both the pre-close and lockup periods.

- **Hedging after the sale:** Negotiating the ability to hedge a portion of the acquired stock post-transaction, which can be beneficial since certain hedging vehicles can reduce lockup risk and preserve some upside participation. For example, the owner may be able to establish a collar (simultaneously selling a call and buying a put) or enter a prepaid variable forward contract (similar to a collar but with the added benefit of a large up-front payment to the investor for immediate diversification)[5]

- **Softening the lockup provision**: Receiving shares with a lockup period shorter in duration than the initial offer calls for, or applicable to fewer shares. (for the purposes of our case study, we analyze the effect of reducing the number of shares subject to lockup by 50%.)

<u>Chart 6, page 18</u> presents our analysis of the downside associated with the all-stock deal for the entrepreneur after 30 years. We show those values for the "pure-stock" alternative and each of the five risk-reducing strategies above. Note that each strategy improves the downside result of the all-stock deal. Just by negotiating the "floor-and-ceiling" approach, the team would increase the owner's wealth in a downside scenario to almost $3.0 (from zero. Easing the lockup requirements yields the greatest improvement in this example, since it most materially limits the stock-price risk. Further, though not shown in the char, we would not expect these tactics to substantially reduce growth potential. In fact, with a couple of these strategies… the 20% cash and 50% lockup alternatives… our forecasts are higher than for the all-stock deal in the median case.[6]

On the other hand, none of these strategies will necessarily be easy to negotiate, because they may come with the cost that the Buyer is unwilling to pay. But with the advisory team working together to assess the financial implications of various bargaining chips and to craft an innovative solution, the chances of improving the deal's risk reward profile are measurably greater.[7]

Discussion on Getting Paid in Installments and Earn Outs

If a Seller is willing and able to wait to receive his payout, deal team may be able to boost the ultimate value of the deal. A common strategy is for the buyer to enter into an agreement with the Seller to pay part of the price up front in cash and give the Seller a note payable for the remainder, with interest, over time. In return for his willingness to accept such a deal, the owner can generally realize a higher sales price (and, in addition, usually postpone paying some of the capital-gains tax on the sale proceeds). Indeed, according to the Federal Reserve, this kind of "financing" plays a role in more than half of all business sales.

A second common strategy for deferring payment to the owner is known as an earn out: a contractual arrangement in which a minimum purchase price is set, with the Seller entitled to more if the business reaches certain sales or earning goals within a specified time period. This arrangement may be motivated by disagreement between buyer and Seller about how much the company is worth, or it may be a stipulation by the buyer to ensure the Seller's continued interest in the company's well-being. In that case, an earn-out is generally accompanied by some short of employment or consulting agreement. Although, that may not align with an owner's initial plan, the financial incentive could cause the Seller to reconsider.

There are, of course, no free lunches. Although, getting paid over a period of time… or in line with the company's performance… can add to the deal's value, these arrangements also add risk: The company could miss it's not payments or its financial targets. While the additional risk to the Seller versus a complete, immediate sale can never be expunged, we can place it in a planning context: determining whether the Seller can withstand the risk by measuring how it might affect his highest-priority goals. If the owner is depending on the "extra" earnings to fund critical needs, he is adding vulnerability to his long-term financial plan; whether that is acceptable or not depends on the complete picture of their circumstances and goals. Armed with this type of information, the deal-team may look to renegotiate certain contingencies in an effort to provide added protection for the owner.

4. ORCHESTRATE TRUST STRATEGIES…AT THE MOST OPPORTUNE TIME

Matching the terms of a deal to the owner's goals in just one area where pre-transaction planning can be beneficial. Beyond that, a major liquidity event like the sale of a business creates planning opportunities to build a larger, more tax-efficient legacy and increase philanthropic giving. A variety of trust can create significant additional value if established prior to…. Rather than following… a sale. For the sake of illustration, we will focus on the two most common beneficiaries of trusts: Family and Charity.

Trust for the Benefit of the Family

A host of vehicle is available for passing assets from one generation to another. Many Trusts can make sense at any point, but some hold special appeal if they are a part of a business owner's pre-transaction planning. A grantor-retained annuity trust, or GRAT, is a prime example. (See ***Chart 7, page 19.)***

In a GRAT, an investor (the grantor) contributes assets to a trust and retains a fixed payment each year for the term of the trust, which can be as short as two years. If the grantor survives the term and the investments inside the GRAT perform well enough (success depends on beating an interest rate hurdle tied to Treasury bonds, as defined by the Internal Revenue Code), there will be money left in the trust when the trust when the term ends and all the annuities have been paid out. This value can be passed to the grantor's heirs free of any gift tax. As in all grantor trust, the grantor remains responsible for any income and capital-gains taxes incurred inside the trust.[8] (See ***Chart 8, page 19***)

Timing is Everything

If the GRAT is funded with shares from a closely held business, there is the possibility that substantial additional wealth can be passed to the children. When a minority interest in closely held shares is placed in a GRAT, the shares may be assigned a value that is less than their potential future work because of their inherent lack of marketability at the time. If the owner later decides to sell the business and receives a price higher than that previously assigned value, the beneficiaries (typically the children) reap the benefits of the sale premium free of transfer tax. The right amount contributed to a GRAT can go a long way toward meeting a grantor's legacy goals. And even if the owner decides not to sell the business, or the sale price is lower than anticipated and the GRAT fails price is lower than anticipated and the GRAT fails to pass any assets to the children, the only costs incurred are the legal fees it took to set it up.

To illustrate the value of establishing a GRAT before a sale, consider an owner who anticipates selling

the business at some point in the future. The goals call for transferring substantial assets to his/her children, so her legal team recommends placing a 25% interest in her closely held shares into a GRAT, which we will assume has a term of three years. Because the shares lack liquidity and marketability, his/her advisors value this contribution at $17.5 million, based on a proportional interest of the contributed assets appropriately discounted. How much can the grantor expect to pass to her heirs?

If he/she goes ahead with the sale and receives, say $100 million for the business, the shares in the GRAT are now worth $25 million, so there is an additional $7.5 million available over the original valuation of $17.5 million. Assuming the proceeds from the deal are reinvested in a diversified portfolio of stocks, the pre-established GRAT would provide the entrepreneur's heirs with $8.6 million in the median outcome versus $2.1 million if set up after the deal. Pre-transaction planning for just this one trust would add an estimated $6.3 million in value over waiting till after the sale to implement the GRAT strategy. And significantly should investment results rove to be poor following the sale of the business, our model suggest a 90% chance that the children would receive at least $3.7 million…versus a downside of leaving no legacy through the GRAT had the owner waited until after transaction to set up the trust.[9]

Some Caveats for the Benefit of the Family

A GRAT grantor needs to be very careful in determining how much of his business interest should be placed in the trust. For one thing, the analysis above assumes the owner received $100 million for her business at the time of sale. But market conditions are unpredictable: The sale proceeds might have been disappointing. As potentially disruptive as that situation would have been, an unexpectedly high future value of the business could also mean bad news. The value of the transaction could have soared in an IPO, or a bidding war could have driven up the sale price to levels the owner had not expected. How could this be bad news? Because if too much of the grantor's assets were used to fund the BRAT, the owner would then be transferring more money than anticipated to the kids when potentially being stuck with the entire tax bill from the sale. In some cases, the children may wind up with a larger5 percentage of the after-tax value of the business than the owner.

But we do not mean to underestimate a GRAT's gifting advantages. In the Chart 8 above, had the donor chosen to wait till her death, a wealth transfer would have cost her estate nearly 50% in taxes (assuming she had already used up her Unified Credit)[10] By using a GRAT, we would expect her to effect a large transfer tax-free. The GRAT would materially increase the value of the transaction to her family. In quantifying solutions like these, a wealth manager can help ensure that the business owner has the right vehicle or vehicles in place… whether a GRAT or any other transfer mechanism… with the right amounts in each, so that legacy goals can be met.

Charitable Trusts

Some business owners wish to use a portion of their proceeds to achieve philanthropic objectives in addition to or instead of making gifts to family. This is especially likely if a family legacy is otherwise assured through an already established trust or gifting plan. For those investors, the vehicle of choice may be a charitable remainder trust, or CRT ***(See Chart 9, page 20)***.

In a typical CRT, a donor makes a contribution of low-basis assets (though he can contribute other assets if he wishes) into a tax-deferred trust. In the case of a business owner, the most likely asset would be stock received from the sale of the business, which can be diversified without an immediate tax bill. In return, he receives a charitable tax deduction and annual payouts, which are taxable. The payouts can be either a fixed dollar amount or a fixed percentage of the trust's market value; either way, they are subject to certain limits. At the end of the trust terms, the remaining assets pass to a charity of the donor's choice.[11]

Hence, CRTs offer a means of diversifying a concentrated low-basis stock position while deferring capital-gains taxes generating a regular income stream, and pre-funding a charitable legacy. In addition, the up-front charitable tax deduction can be particularly valuable for investors receiving a large income distribution from the sale of a business (from salary payments due the owner, a large cash earn-out, etc.)[12]

Flip NIMCRUTs": Delayed Payout Allows Asset Buildup

Although most traditional CRTs are used after a business sale is completed, there is a variant that is particularly useful for certain business owners planning before a sale: the so-called "Flip NIMCRUT ("Flip" refers to a change in the CRT payouts when a predetermined event occurs, such as the sale of a business or reaching a certain age: NIM mean net income with makeup; CRUT is a charitable remainder uni-trust). By establishing a Flip NIMCRUT, the owner delays the full annual payout until the flip occurs. It is recommended for investors who do not mind postponing much of the income they receive from the trust. To understand why that is important, consider that if a CRT fails to create the income needed to meet its annual payout requirement, the donor will have to liquidate some of the trust assets. If the CRT owns publicly traded stock that should not pose a problem. But if it owns stock in a privately held business (because it was funded pre-transaction), problems may arise in selling the shares, since they are not freely traded.

Prior to the "flip", however, a Flip NIMCRUT is required to pay out the lesser of the uni-trust percentage or the annual net income generated by its assets, making it a vehicle well suited for illiquid shares (such as equity in a closely held business). Once the triggering event "flips" the trust into fully-paying mode, an annual payment based on a percentage of the assets will be made. The hope is that the assets in the trust will have benefited from tax-deferred growth and will begin to pay a large distribution. The farther off the trigger is, the more time the trust assets will have to grow. For business Sellers with charitable intent who do not need large current trust distributions, this can be an extremely beneficial vehicle.

Use a CRT… or Sell Company Shares?

The downside of a CRT strategy implemented before a sale is that by contributing privately held shares, the donor may get only a very small tax deduction, since the value of the deduction is determined by the cost basis of the shares (as opposed to a CRT funded with publicly traded securities, where the deduction is typically determined by the *market value* of the shares).

Chart 10, page 20 quantifies the personal wealth that would accrue to a business owner under three different scenarios:

- Selling $10.0 million in company shares outright

- Setting up a traditional CRT with $10.0 million in transaction proceeds;

- Establishing a Flip NIMCRUTT with $10.0 in closely held shares before the sale.

In the straight sale, we are assuming that the owner diversifies his proceeds into a 60/40 stock/bond mix. The traditional CRT, we are assuming, is funded with zero-basis unrestricted *publicly traded* stock that the business owner has received from the sale of his business. The CRT then takes advantage of the trust's tax-deferred environment, sells the publicly traded stock, and invests the proceeds in a more heavily stock-weighted 80/20 balance. In the Flip NIMCRUT, the assumption is that $10.0 million of his *company shares* are contributed before the business sale. Once the business is sold, the proceeds are reinvested in the same way as the traditional CRT[13]. We further assume that the owner is 55 and establishes the triggering even as his 65th birthday. For the moment, we are ignoring the value of the assets remaining in the trust for the charity's benefit.

In this case, over a 10-year period personal wealth would be greater *without* setting up a CRT. The reinvested payouts from the traditional CRT…the only funds than accrue to the investor… do not have time to grow enough to match the reinvested proceeds from a straight business sale. And since the Flip NIMCRUT has not yet had its triggering even, it has been paying out only income; it performs worst of all for the owner. Over time, however, the benefits of the trusts build. We expect the post-transaction traditional CRT to accumulate more wealth than a straight sale by year 20 (with a flip NIMCRUT lagging the sale proceeds by only $1 million). Over the full 30-year period, both the Flip NIMCRUT… and the post-transaction CRT have created more personal wealth: The owner has accumulated $54 million by then with the Flip NIMCRUT… some $3.0 million more than from an outright sale. Given a long enough time frame, our analysis indicates that in this case the Flip NIMCRUT comes out on top. See Chart 10.

The bequest to charity is significant a well. At year 30, with post-transaction CRT, we estimate that the charity will have $5.2 million in the median case. With a pre-transaction Flip NIMCRUT, the charity's interest will have grown more than twice as much, to almost $11.0 million

Trade-Offs

Nothing in this analysis is meant to suggest that establishing a Flip NIMCRUT is an open-and-shut case. The value of any CRT to a business owner is contingent on a number of factors, and special considerations apply if the owner is considering a Flip NIMCRUT. In particular, time horizon and near-term cash-flow needs are critical variables.[14] A young entrepreneur with a large current-income stream can view this vehicle as a supplemental retirement plan that pays out later on when he needs it and will be taxable largely at long-term capital-gains rates. On the other hand, a retiree who needs to draw substantially from his assets may find this type of trust unsuitable.

What the analysis does make clear is that a CRT, whether traditional flip, can be a very valuable tool for some business owners… and one that should be considered in advance of a sale, *whether the actual implementation comes before or after.* Quantifying one's spending and charitable goals can indicate which legacy and philanthropic strategies to pursue and how much to allocate to each trust. In the Flip NIMCRUT example in ***Chart 11, page 21***, the deal team estimates that by setting up the trust before the sale, the owner would increase his personal wealth… exclusive of the philanthropic contribution… by

28% versus a straight sale over 30-year period. And the Seller would have the additional satisfaction of donating millions of dollars to charity.

5. ALTERNATIVES TO A 100% SALE

Thus far, we have been assuming that an owner is contemplating a full sale of his business, so we have discussed financial-planning strategies in that context. In fact, it is not uncommon to sell only a portion of a business. The owner may want to continue to work but would like to unlock some of the value in his equity. If the transaction market is especially strong, the Seller may see an opportunity to sell a piece of the business for a great price. He may be considering an investment in another business venture…or ceding some of his current business to his children. In such cases, the owner is not yet willing to sell the whole firm, but is drawn toward divesting a piece of it, whether it is a minority or a majority interest. In all these examples, the critical question for the owner and his team of advisors is: What is the right amount to satisfy the Seller's needs?

Looking for Liquidity

Consider an owner nearing retirement who is seeking to gain some liquidity from his retail business, appraised at $30 million (see ***Chart 12, page 21***). He plans on working five more years, at which time he hopes to begin to pass a controlling interest in the company to his daughter, who will take over the day-to-day operations of the company. He wants to invest in a new home and a real-estate partnership, and fund a comfortable retirement. In addition to his company equity, he has $5.0 million invested in a very conservative stock/bond allocation. It has protected him from the risk inherent in his business, and it is how he intends to invest the sale proceeds. The Seller wonders how little he can pull from the business and still meet his goals.

Factoring in spending, taxes, and inflation, the results for the owner's total wealth are revealing (See ***Chart 13, page 21***). If the owner sold up to 40% of the business we estimate that he could end up with as much as some $16 million or more, but on the downside he could wind up without enough to meet his spending requirements. This owner is cautious by nature and wants a higher level of confidence than this. Our model indicates that to ensure his portfolio would remain in the black with a 90% level of confidence the Seller needs to sell nearly half his stake…a bigger amount than he might have hoped.

The problem is the owner's asset allocation. A very conservative stock/bond mix may have been prudent when so much of his net worth may have been prudent when so much of his net worth was tied to the equity in his business. But once he divests a large portion of his business, the role of his investment portfolio changes… from providing protection again company risk to providing long-term financial security. In that light, the conservative asset allocation is no longer appropriate, as it is unlikely to provide the growth potential he requires. Further, as soon as the owner sells some of his company's

equity, he already reduces his risk; therefore, he should be willing to increase his allocation to stock in a diversified portfolio of liquid assets. If he considers a more balanced mix of stocks and bonds (say, a 60/40 portfolio), our analysis indicates that he can then sell as little as 40% of his shares and still have a 9-in-10 chance of having at least $3.0 million in liquid assets left after 30 years (See ***Chart 14, page 21***).

And that is on the downside; his upside potential is far higher. Armed with this analysis, the deal team might recommend a 40% sale for this owner.

Some Other Strategies

There are numerous routes that an owner and his deal team can pursue when considering a partial sale in light of the owner's goals. In a recapitalization, for example, the company reallocates the equity and debt on its balance sheet. This opens up several possibilities for the owner, including monetizing his equity, diversifying his portfolio, and transferring ownership to the next generation (by withdrawing a significant percentage of the cash value in the business while passing a majority interest on to heirs. Meanwhile, by maintaining some interest in the company; the owner retains the right to benefit from and IPO or the outright sale of the company later on.

Identifying the right balance of debt to equity requires the expertise of investment bankers and other professionals. But there are critical financial-planning implications in recapitalizations as well. Is the owner withdrawing enough cash to cover his liquidity needs… or will he need to tap other sources as well? If he is transferring the business to his heirs, should he think about restricting his gifting or legacy plans? These types of issues are at the nexus of deal structures and personal goals.

For owners concerned about maintaining control in their businesses, or preserving their corporate culture, an employee stock ownership plan may be ideal. About 11,000 U.S. companies have these plans, which allow the owner of a closely held company to sell all or part of his business interest to a plan that distributes ownership to employees through stock in the company.

6. SUMMARY: WHERE THE PERSONAL MEETS THE FINANCIAL

Emotions run high at the prospect of the sale of a business excitement over the possibility of a financial windfall, anxiety over whether the deal is optimal, concern about loss of control over income and legacy. And there can be a huge amount of money at stake. The latest data available suggest that U.S. families have some $5.7 trillion in net worth tied up in private businesses.[15]

For Sellers, these deals necessitate the most important financial decisions they will ever face… in most cases, the determinants of their long-term financial condition. By defining personal goals and using them to lay out a financial plan prior to the sale, business owners are far more likely to have their concerns and objectives met. The following four elements are an important part of the process.

- Tax, legal, investment-banking, and financial-planning experts can each play a critical role in preparing for a transaction. An integrated team is, in our view, imperative for putting in place the most effective strategies.

- With financial goals clearly defined, the advisory team can best weigh the effects of different deal terms on the owner's long-term different deal terms on the owner's long-term wealth. Quantifying the impact of various strategies can supplement the work of the deal team and give comfort to the owner that the deal contemplated is the best for his or her needs. For example, high spending requirements and fewer outside assets map call for more conservative terms for the Seller… more cash, shorter lockups on acquired stock, less contingent compensation, etc. On the other hand, Sellers with substantial additional resources may be able to withstand greater deal risks in order to pursue higher returns; such strategies may entail accepting more stock, longer lockups, and Seller financing.

- The plan may well take advantage of trust vehicles (or other wealth-transfer vehicles) to help achieve the owner's financial goals. Practically speaking, the potential of these vehicles to add millions of dollars in value for the owner and his family is much greater if they are implemented prior to the sale. Identifying one's spending, legacy, and philanthropic needs ensures that the right amounts are allocated to each trust so that all of the owner's goals can be satisfied.

- Given the wide range of personal situation, tax and trust-planning alternatives, tolerance for risk, and deal terms, a quantitative framework for understanding the trade-offs is essential. An analytical model that quantifies the cost and benefits of each choice in a host of market environments… in effect, allowing a business owner to evaluate alternative prior to implementing them… can help owners and their advisors make the best decisions in each unique case. That goes a long way toward providing peace of mind and getting the deal done.

Footnotes:

[1]Unless otherwise noted, diversified stocks throughout this study are comprised of 70%, 25% developed foreign and 5% emerging markets, with the U.S. component 50 /50 growth/value: bonds are intermediate-term diversified municipals.

[2]Certain trust strategies allow for the grantor to retain an interest in the assets within the trust. When that is the case, assets needed for spending may be at least partially funded from the trust… a possibility that should be incorporated into the financial plan.

[3]Throughout this study we are assuming that the stock of the acquiring company is publicly traded, and that it is a large-cap company.

[4]This assumes that over time the philanthropist diversifies the single-stock position he's acquired (whether in his personal portfolio or as part of establishing a trust). Our research indicates that the average single stock's long-term growth rate is likely to lag the market (as represented by the S&P 500); over the 20 years ending in 2003, the shortfall was 2.7 percentage points annualized.

[5]In the case of the entrepreneur, we assume a collar might be established on a $100 stock with a put strike price at $90 and a call strike price a $115. This is an illustration; actual terms vary depending on a host of factors, including the stock's volatility, dividend yield, the prevailing interest rates, and the length of the transaction.

[6]We estimate the median results for the 20% cash and 50% lockup strategies at $53.7 million and %54.2 million, respectively, versus $53.2 million for pure stock.

[7]Structuring the sale of a business is highly complex and usually requires investment-backing, legal, and tax expertise.

[8]The writers of this study are not tax or legal advisor. Consult with professionals in these fields before establishing a trust or making any plans affecting your legacy goals or tax status.

[9]Although a 100% equity allocation for the sale proceeds is used in this case for the purposes of illustration, a grantor may choose a more conservative asset allocation if he has already received a large premium over the contributed value of the shares. By becoming more conservative, he can "lock in" this value for the children without giving up too much of the GRAT's benefits. For example, a 20/80 stock/bond mix would reduce the median value passed on by the GRAT in our example by $1 .0 million over the all-equity allocation, but would raise the downside by $2.0 million.

[10]The top marginal estate tax bracket at this writing is 48%.

[11]All CRTs modeled in this study are based on a 55-year old donor contributing $10 million in zero-basis assets to a lifetime charitable remainder uni-trust (CRUT) with annual payouts. All calculations are permissible payouts and associated with tax deductions according to Sections 7520 and 664 of the Internal Revenue Code of 1986, as amended, and the rules and regulations promulgated thereunder.

[12]For more on earn-outs see "***Discussion on Getting Paid in Installments and Earn Outs"*** earlier in this study.

[13]We assume that no valuation discount has been applied to these shares. Regardless of the asset allocation within the CRT, all distributions from it are invested 60/40 stocks/bonds in a personal, taxable portfolio.

[14]This can be done only with certain types of ownership structures. Consult your legal advisor.

[15]A report by the Federal Reserve in 2004

Exhibit A

Chart 1

Four Places Your Money Can Go

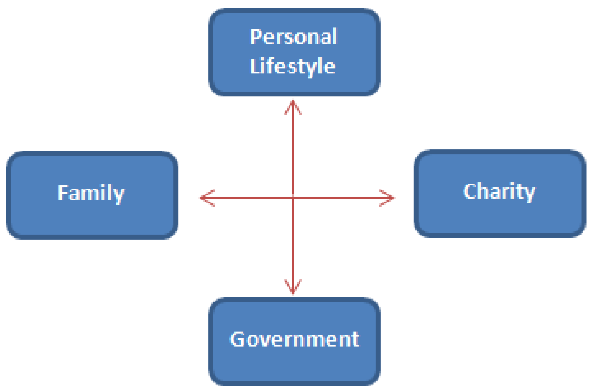
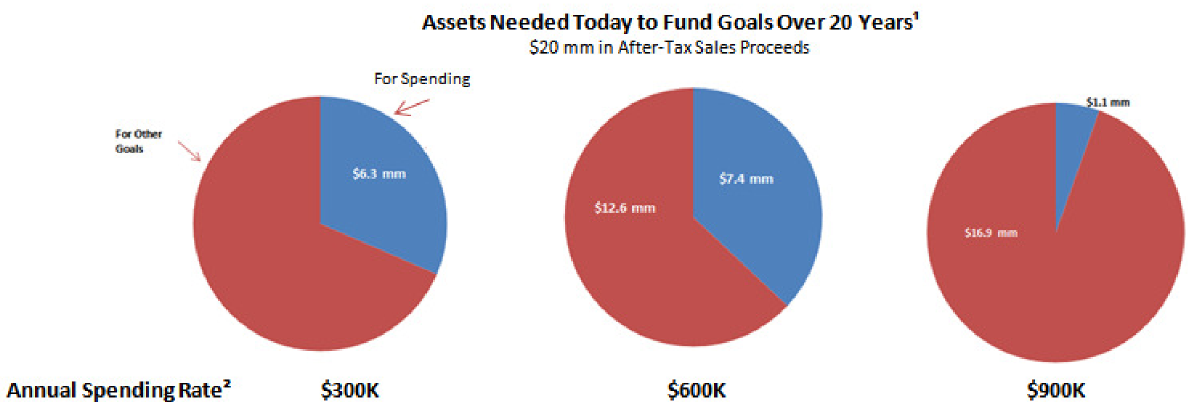


Chart 2

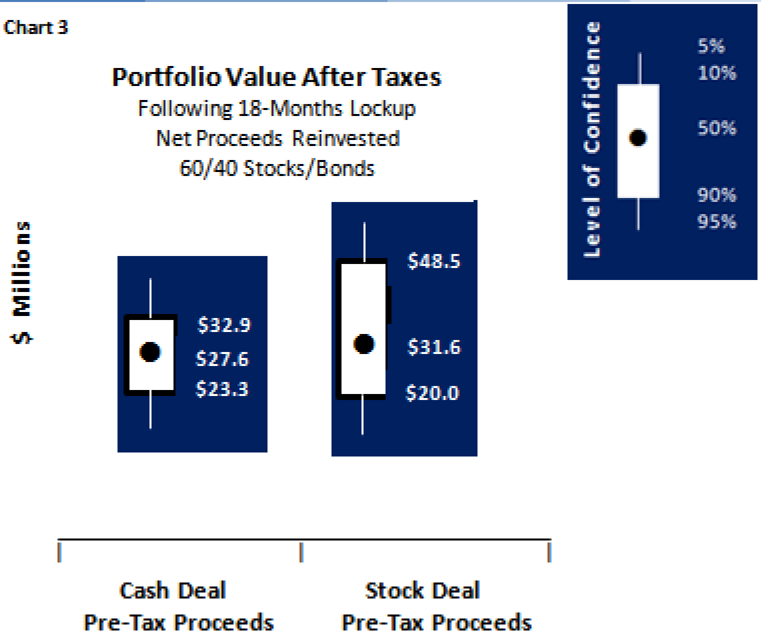


[1]95% Confidence level
[2]Grown with inflation and after taxes
Based on market stimates of the range of returns for the applicable capital markets over the next 20 years. Assumes all proceeds are reinvested in a 60/40 stock/bond split. Data do not represent any past peformance and are not a promise of actual future results. See Notes in Wealth Forecasting Analysis, page 20-22, for further details.

Exhibit A (continued)

Chart 3

Portfolio Value After Taxes
Following 18-Months Lockup
Net Proceeds Reinvested
60/40 Stocks/Bonds



Assumes all proceeds from sale are reinvested in a 60/40 stock/bond mix; proceeds subject to a lockup are diversified into the same 60/40 mix; proceeds subject to a lockup are diversified into the same 60/40 mix once ethe lockup period ends. Based on historical range of returns for the applicable capital markets over the two years. Data does not represent any past performance and are not a promised of actual future results.

Chart 4

Case Study: Different Owners, Different Recommendations
Deal Options: $35.0 Million in Stock or $31.5 Million in Cash

	"The Philanthropist"	"The Entrepreneur"
Age	52	52
Family	Spouse, three grown children	Spouse, two grown children
Liquid Assets (exclusive of business)	$10.0 Million	$1.0 million
Allocation of Liquid Assets	60% Stocks / 40% Bonds	60% Stocks / 40% Bonds
Annual Personal Spending Needs[1]	$350,000	$500,000
Time Horizon	30 Years	30 Years
Critical Goals for Sales Proceeds	$10.0 million to fund family foundation supplement legacy	$10.0 million for new venture; secure family's spending
Team Recommendation	Stock Deal	Cash Deal

[1]Growing with inflation

Exhibit A (continued)

Chart 5

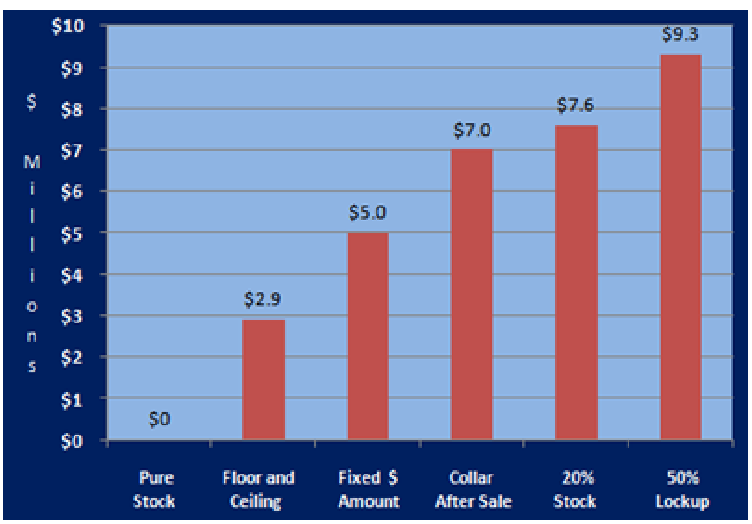
The"Entrepreneur's" Portfolio Value
After Taxes and Spending
Reinvested 60/40 Stocks/Bonds

	Cash Deal	Stock Deal	Difference
	Initial Value $31.5 million	Initial Value $35.0 million	
Median	$36.0 million	$53.2 million	$17.2 million
Downside[1]	$11.2 million	$0.0	Running out of Money

[1]Value at the 90th percentile level of confidence
Assumes all proceeds from sale are reinvested in a 60/40 stocks/bonds mix; proceeds subject to a lockup are diversified into the same 60/40 mix once the4 lockup period ends. Based on market estimates of the range of returns of the applicable capital markets over the next 30 years. Data do not represent any past performance and are not a promise of actual future results.

Chart 6

"The Entrepreneur's" Wealth After Spending and Taxes
Downside Case Year 30[1]



[1]Downside case defined as the value at the 90th percentile level of confidence. Assumes all proceeds from sale are reinvested in a 60/40 stock/bond mix; proceed are subject to a lockup are diversified into the same 60/40 mix once the lockup ends. Values include the investor's entire portfolio, not only the proceeds of Seller's business sale, based on markets estimates of the range of returns of the applicable capital markets over the next 30 years. Data do not represent any past performance and are not a promised of actual future results.

Exhibit A (continued)

Chart 7

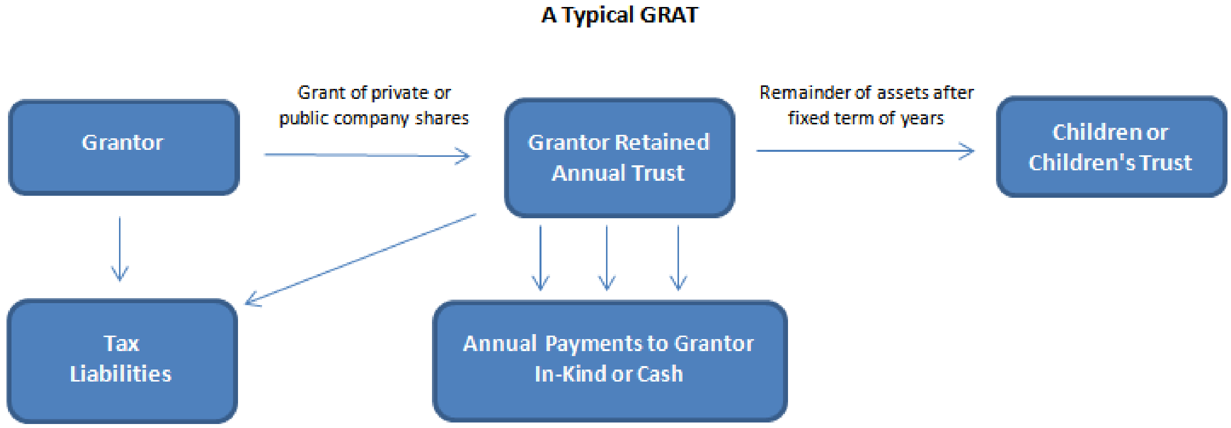
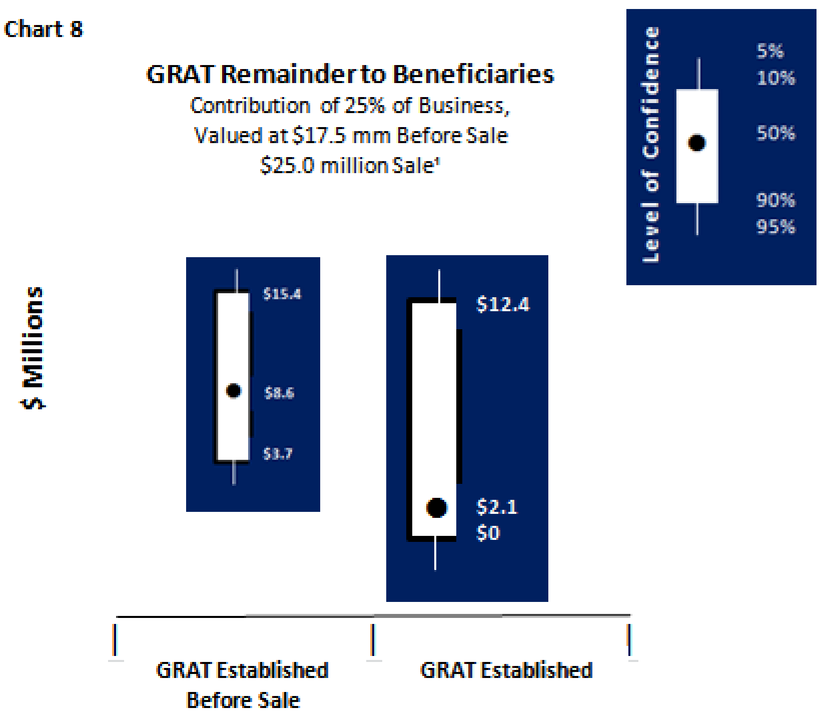


Chart 8



[1]Invested in diversified equities
Based on markets estimates of the range of returns of the applicable capital markets over the next three years. Date do no represent any past performances and are not a promise of actual future results.

Exhibit A (continued)

Chart 9

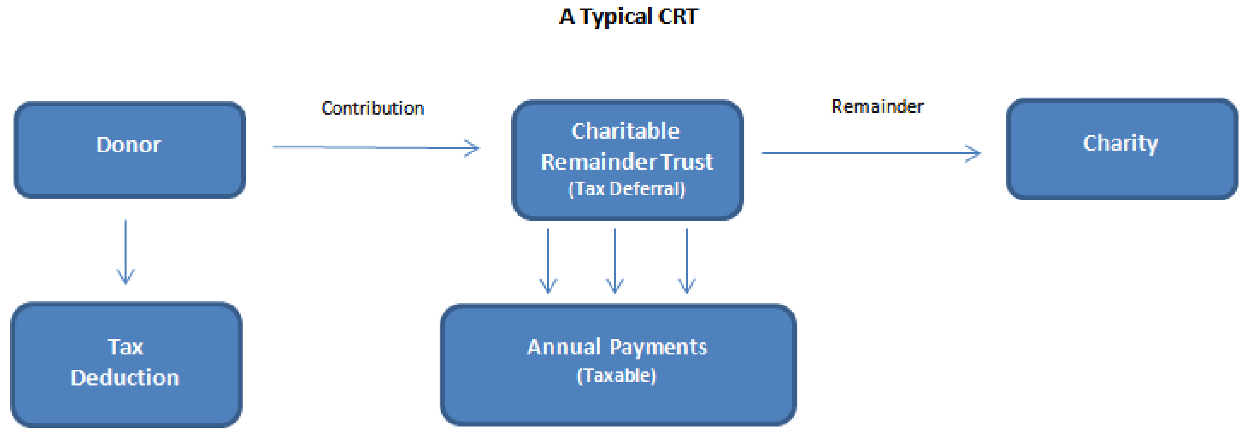
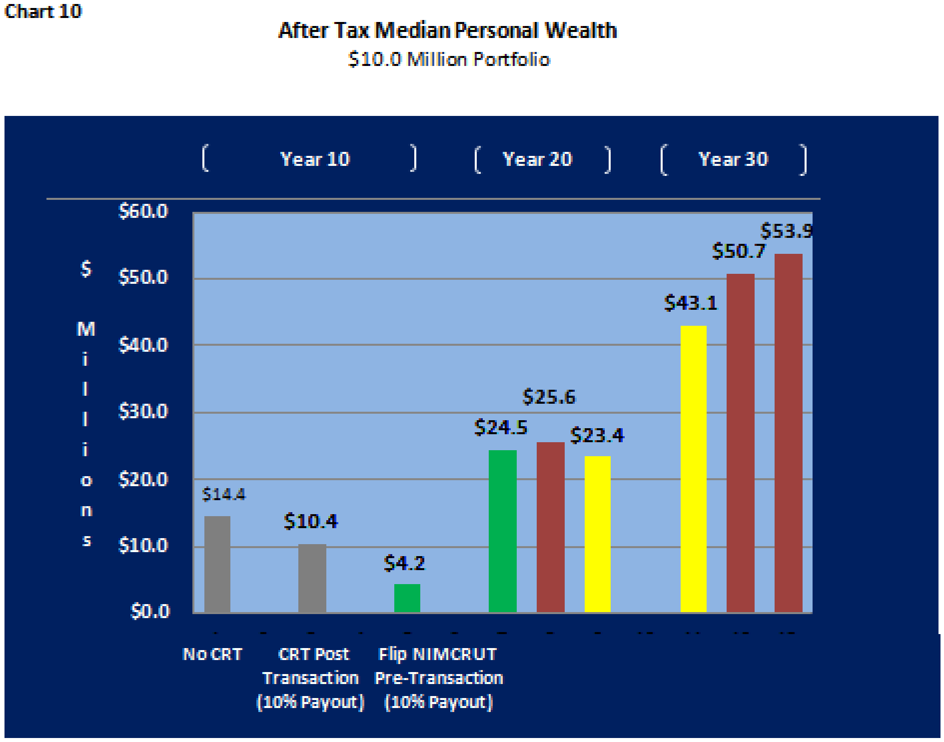


Chart 10

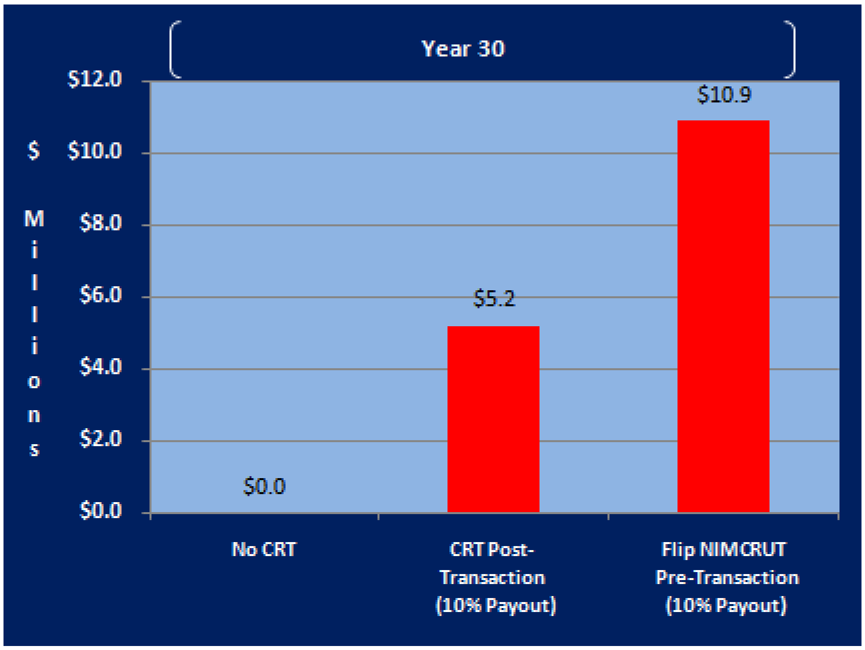


Based on market estimates of the range of returns of the applicable capital markets over the next 30 years. Data do not represent any past performance and are not a promise of actual future results. CRT assets invested 80/20 stocks/bonds.

Exhibit A (continued)

Chart 11

Median Value Received by Charity
$10.0 Million Portfolio



Based on market estimates of the range of returns of the applicable capital markets over the next 30-years. Data do no not represent any past performance and are not a promise of actual future results.

Chart 12

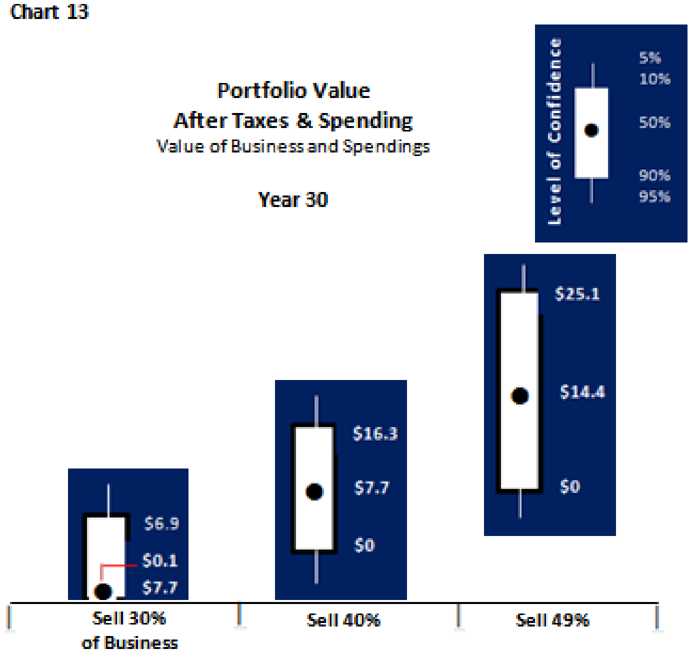
Case Study: How Much of Seller's Business Should be Sold?

Near-Term Spending Plan	$3.0 million for new home & real-estate investment
Long-term Spending Plans	Retire on $500,000 per year[1]
Current Liquid Assets	$5.0 Million
Current Asset Allocation	20/80 Stocks/bonds
Current Salary	$750,000 per year[1]

[1]*Growing with Inflation*

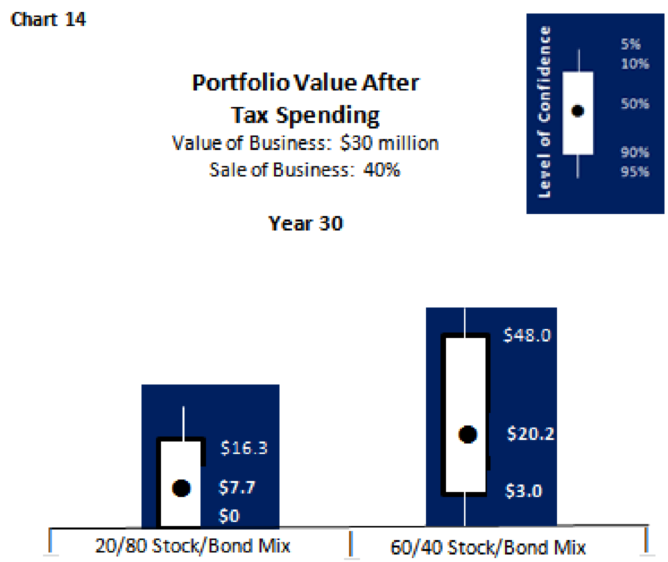
Exhibit A (continued)

Chart 13



Reflects on owner's liquid assets. Assumes remaining interest in business gifted to daughter over time. Based on market estimates of the range of returns of the applicable capital markets over the next 30 years. Data do not represent any past performances and are not a promise of actual future results.

Chart 14



Reflects on owner's liquid assets. Assumes remaining interest in business gifted to daughter over time. Based on market estimates of the range of returns of the applicable capital markets over the next 30 years. Data do not represent any past performances and are not a promise of actual future results.