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**Creative Use of Stock Options Within A
Grantor Retained Annuity Trust (GRAT)**

Dear Client:

Following up on our recent conversation, this letter summarizes that option strategy within a Grantor Retained Annuity Trust (GRAT) that I mentioned. While the contents of this letter were originally prepared in May 2004 when the §7520 hurdle rate that is necessary for the GRAT to be successful was 3.8% (6.0% in June 2006), nonetheless, the strategy of using options within GRATs is still a relevant and viable tool in today's financial and estate planning universes.

Please note that I have made at least four (4) assumptions/stipulations in this letter: (a) that the option spread is never unwound; (b) that the strategy is done only once during the GRAT's term; (c) that whenever I say that the price of the stock has increased, I am usually contemplating that price immediately before the spread expires; and (d) I do not consider the possibility that the price of the underlying stock decreases (because the spread discussed below is costless, a decrease in the stock price is largely irrelevant when deciding whether to use a spread inside of a GRAT).

Suppose that you transferred 100 shares of Microsoft (closing price on May 21, 2004 was \$25.89) to a GRAT with your children being the remaindermen of the GRAT. If the price of Microsoft goes up to \$27.25, the GRAT produces a 5.2% return $((\$27.25 - \$25.89)/(\$25.89))$, which surpasses the §7520 hurdle rate that is necessary for the GRAT to be successful (3.8% in May 2004). However, what if on the same date that we transferred the shares into the GRAT, we also did the following:

1. Sold two (2) January '05 calls with a strike price of \$27.50, costing \$1.25 per share (closing price on May 21, 2004); and
2. Used the proceeds from the sale, to buy one (1) January '05 call with a strike price of \$25.00, costing \$2.55 per share (closing price on May 21, 2004).

What we have done is create a costless option spread inside of a GRAT. But how has this helped us? Recall that when the price of Microsoft went up to \$27.25 and no options were in place, the GRAT yielded a gain of \$1.36 $(\$27.25 - \$25.89)$. By using a spread, and assuming the same price of \$27.25, we have more than doubled our return without any additional cost. Here's how, \$1.36 from the stock owned $(\$27.25 - \$25.89)$, + \$2.25 from the \$25 call we bought $(\$27.25 - \$25.00)$ — a total of \$3.61.

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Once the price of Microsoft exceeds the strike price of the two (2) options sold (\$27.50), the return on the GRAT will be maximized at \$4.11 ((+\$1.61 from the stock owned (\$27.50 - \$25.89), +\$2.50 from the \$25.00 call we bought (\$27.50 - \$25.00)). With the price of Microsoft somewhere between \$27.50 and \$30.00, the costless spread still produces a better result than without it. For example, if the price of Microsoft is \$29.50, the GRAT with the spread produced its maximum return of \$4.11, but without the spread, the GRAT would have yielded a gain of only \$3.61 (\$29.50 - \$25.89).

Not until the trading price of Microsoft exceeds \$30.00 do you reach the point where it would have been better not using this type of spread. For example, if the price of Microsoft is \$31.00, a GRAT without the spread would produce a return of \$5.11 (\$31.00 - \$25.89), as opposed to the maximum of \$4.11 it produces when this spread is used.

By doing this costless spread, you have (a) potentially “super-charged” what is left for the remaindermen of the GRAT when the underlying stock trades between certain prices; and (b) depending on the §7520 hurdle rate that month, the spread might be the difference between your GRAT being a winner instead of a loser. Admittedly, if there is a surge in the stock’s price, you would have been better off not using the spread. While this trade-off might not be suitable for everyone, a spread inside of a GRAT should be considered as a potentially viable financial tool when contemplating the use of GRATs.

Please call me to discuss any questions or comments. I look forward to hearing from you.

Very truly yours,

STRAUSS & MALK LLP

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