

Insights for Entrepreneurs

Part Four: The Public Sale of Privately Held Businesses

Working as part of an integrated advisory team, your Morgan Stanley Private Wealth Advisor can help you make well-informed personal wealth management decisions at every stage of your company's development. Our goal is to provide you with the information, insight and resources needed to help you reach your personal and professional goals. We are here to help you answer the key questions that arise at the intersection of your business strategy and your personal wealth management.

What Considerations Are There in Different Types of Public Sales?

Generally speaking, there are three basic liquidity scenarios: a cash sale, a tax-free stock acquisition (usually by a public company) or an IPO. Each involves different considerations.

- A cash sale will trigger long-term capital gains tax on stock held for the requisite holding period, short-term gain on stock held short term, and ordinary income on option spread if options are cashed out as a result of the sale.
- A tax-free stock acquisition generally results from the exchange of private stock for fully liquid stock in the public company that acquires your privately held firm. There is no tax effect to this transaction until you sell your shares, and your tax basis remains the same. Options may or may not be transferred to the new company as a result of the transaction. If not transferred, they may be cashed out, resulting in ordinary income tax on the options spread.

- An IPO has no immediate tax effect on a long-term stock position you hold in the newly public company. However, several restrictions on sale may be imposed, preventing you from liquidating your position. Options, restricted stock and restricted stock units are typically unaffected by an IPO, but the fact that there is a public market for the stock can make exercise of options easier. The spread on nonqualified stock options, and disqualified incentive stock options, is still deemed ordinary income.

What Tax Planning Measures Should I Consider Ahead of the Sale?

If your goal is to transfer wealth to the next generation, consider implementing your estate-planning measures well ahead of the sale of your business, particularly if you expect the proceeds to exceed your \$5.49 million lifetime gift and estate tax exclusion (roughly \$11 million for a married couple). In most cases, the value of your business will have a lower value, for transfer tax

purposes, than it will after the sale. This is because the value of a closely held business interest is speculative and must be determined by a professional appraisal company. In arriving at the value of a minority interest in your business, the appraiser will likely discount the value to reflect lack of marketability, illiquidity and lack of control. The resulting discounts can enhance estate-planning transfers.

What Are Some of the Most Common Pre-Liquidity Income Tax Strategies?

Income tax strategies typically involve attempting to accumulate a long-term stock position in the company, rather than ordinary income positions such as nonqualified stock options, incentive stock options, restricted stock and restricted stock units. This is because long-term capital gains rates are lower than ordinary income tax rates. This means:

- It is generally better to exercise stock options earlier rather than later in

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- order to keep the tax cost low and start the long-term holding period.
- You may wish to make an 83(b) election upon receipt of restricted stock in order to start the long-term holding period.
- Note that the above risks the loss of both the exercise price and the tax cost if the company is not successful.

What Are Some of the Most Common Gifting and Other Wealth Transfer Techniques?

There are a variety of tools that can be deployed to transfer wealth in a more tax-efficient manner. Here are a few of the more commonly used gifting strategies:

- **OUTRIGHT GIFTS AND ANNUAL EXCLUSION.** You can make simple gifts to your children, or to a trust for their benefit, by giving them privately held stock in advance of a liquidity event.
 - Example: You gift \$14,000 worth of your company’s stock to a trust for your child. One year later, the company goes public, and the stock in the trust is now worth \$42,000.
- **ESTATE TAX EXCLUSION AMOUNT.** In addition to the annual exclusion amount, you may gift assets worth up to the total AEA during their life without incurring gift tax.
 - Example: In addition to gifting the \$14,000 annual exclusion gift noted above, you gift \$5.49 million worth of your stock to your child’s trust. One year later, the company goes public, and the stock in the trust is worth \$15 million.

- **SALES.** The sale of an asset in exchange for a promissory note is a common estate freeze strategy, allowing you to retain the current value of the transferred asset while giving away future appreciation.
 - Example: Instead of gifting \$5.49 million worth of your company’s shares, you sell them to your child at the current discounted fair market value (as appraised). In return, you get a promissory note, in the principal amount of \$5.49 million, and it must bear interest at a rate the IRS will not deem to be a gift. (In June 2017, the rate for a nine-year note was 1.95%). As in the example above, when the business is sold, the child will receive \$15 million. The excess sale proceeds pass to your child free of gift tax. This strategy can be enhanced by selling the asset to a trust which you, as donor, are treated as the income tax owner (many refer to this as a “sale to an income tax (or “defective”) grantor trust”). In that event, there would be no capital gain recognized upon the sale to your child, interest payments from the trust would not be taxable income, and you (not the trust or your child) would be required to pay the capital gains tax upon the sale of the business to the third party. Under this structure, you are able to transfer additional wealth as a result of the valuation and the income tax structure.

- **Additional Estate Freeze Strategies:** A number of trusts, notably Grantor Retained Annuity Trusts (GRATs) and Intentionally Defective Grantor Trusts (IDGTs) are among the commonly used asset freeze strategies. For more on estate freeze strategies, please refer to the Overview of Wealth Planning Structures sheet in this series.

THE INSIGHTS FOR ENTREPRENEURS SERIES COVERS THE FOLLOWING ADDITIONAL TOPICS:

Choosing a Business Structure

Early-Stage Trust and Estate Planning

Overview of Wealth Planning Structures

Family-Owned Business
Succession Strategies

Philanthropic Strategies and Structures

Understanding Equity Compensation

FOR FURTHER INFORMATION

If you wish to discuss which pre-liquidity wealth transfer strategies are best suited to your personal and business goals, please speak to your Private Wealth Advisor. He or she can schedule a meeting with a Morgan Stanley Tax, Trust and Estate specialist.

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