Morgan Stanley

PRIVATE WEALTH MANAGEMENT

ESTATE PLANNING STRATEGIES

Pre-Liquidity Event Planning Overview

Wealth and Estate Planning Strategists
Family Office Resources

Liquidity events, such as an initial public offering or a merger or acquisition, may provide income tax and transfer tax planning opportunities. Liquidity events also magnify the need to put in place or update certain essential estate planning documents.

Overview

It is important to consider and implement income tax and wealth transfer strategies prior to a potential liquidity or sale event. From an income tax perspective, an executive must consider whether to exercise options and the cost and tax consequences. Charitable planning should be considered before a deal has been struck if income tax minimization or deferral is an objective. From a wealth transfer perspective, the main issue is valuation. The goal is to transfer interests in the business at the lowest value possible, by considering if the benefit of marketability discounts for minority interests in a closely held business would be available. The closer one is to a transaction, the greater the valuation may be. Therefore, advance planning is critical.

In addition to strategic tax planning, a liquidity event often raises greater issues for the business owner. He or she is often faced with some fundamental questions for the first-time regarding family goals and priorities, investment decisions, wealth preservation and stewardship as well as philanthropy.

Income Tax Planning

Pre-liquidity income tax planning generally involves minimizing and/or deferring the income tax due with respect to the transaction.

Gifts to Charity

A gift of low basis stock (or other entity interests) to charity in advance of a taxable sale of a business may provide the donor an income tax deduction for the year of the gift. Further, there will be no gain to the donor or the charity upon a future sale of the interest given to charity, assuming the charity is tax-exempt.

One important issue arises if the gift to charity is made shortly before the liquidity event. If the deal had been consummated prior to the donation, the IRS may take the position that the income must be reported as the donor's taxable income despite the last-minute gift to charity. In a published ruling, the IRS indicated that income will be imputed back to the donor if at the time of the gift the donor was legally bound or could be compelled to sell the shares.[1] Accordingly, prior to a donation, whenever sale negotiations begin, the donor should discuss the assignment of income issue with a tax advisor.

A gift of appreciated closely held stock or interest in an entity to a public charity will generally generate an income tax deduction for the donor equal to the fair market value of the stock or interest, reduced by any imbedded ordinary income or short-term capital gain. On the other hand, the deduction for a gift of an appreciated closely held interest in an entity to a private foundation will be limited to its cost basis. When the interest is sold by the charity there should be no capital gains tax consequences to the charity.

Certain operating businesses will generate income while held by the charity prior to the sale. If the business is not related to the charity's purposes, that income can be deemed unrelated business taxable income ("UBTI") to the charity. Generally, income from an operating business that is UBTI is subject to tax at the corporate income tax rate (if the charity is organized as a corporation) or the estate and trust income tax rate (if the charity is organized as a trust). However, dividends and other forms of passive income are generally not considered as UBTI. Any interest in an S corporation owned by a charity is considered an interest in an unrelated trade or business, of which the income of the S corporation, and the income from the sale of S corporation stock may be taxed to the charity. The client should speak with his or her tax advisor to determine the specific application of these rules to their particular circumstances.

Charitable Remainder Trust

A Charitable Remainder Trust ("CRT") may be used to defer income taxes, benefiting both the donor and the charity. A CRT is a trust in which the donor transfers assets to an irrevocable trust and the donor or another individual retains an annuity interest in the trust for a term of years, not exceeding 20, or for the life of one or more non-charitable beneficiaries. Upon the expiration of the retained annuity interest terms, any remaining assets in the CRT are distributed to the charitable beneficiary.

A CRT is a tax-exempt entity for U.S. federal income tax purposes. Therefore, there is no immediate tax to the trust at the time of liquidity events pertaining to assets held in the CRT. The annual annuity paid to the non-charitable recipient carries out the trust's taxable income (including built in gain from the sale). As a result, the capital gains generated from the sale of an appreciated asset held in a CRT is spread out over the CRT's term.

A CRT also can be used after a liquidity event in lieu of or in conjunction with other hedging techniques, which can be used to defer taxes or manage the risk of a concentrated equity position. Business owners must be careful about a plan to transfer closely held business interests to a CRT, as a separate excise tax applies to UBTI within a CRT. The tax on UBTI earned by a CRT is imposed at a 100% rate.

Stock Options

With respect to stock options, in general, upon the exercise of a non-qualified stock option (NQSO), the difference between the then fair market value and the exercise or strike price (the spread) is taxed as compensation for federal income tax purposes.[2] Future appreciation, if any, is treated as a federal capital gain and taxed at a preferential rate if the stock is held for more than one year at the time of sale. Thus, the benefit of exercising the NQSO in advance of a liquidity event is the potential for a reduced federal tax on the future appreciation, if any. On the other hand, the cost of exercising the option is the risk of investing capital for an uncertain federal tax benefit.

Upon the exercise of an incentive stock option (ISO), the spread is not taxed as compensation upon exercise, but is generally treated as an adjustment item for alternative minimum tax (AMT) purposes. After exercising the ISO, if the stock is not sold more than one year from the exercise date and two years from the date the option was granted, all appreciation over the strike price will be taxed at the long-term capital gains rate when the stock is sold.

Some or all of any AMT paid may be available as a federal tax credit in the year the stock is sold. The exercise of an ISO prior to a liquidity event (i.e., when the spread is lower) can minimize or eliminate AMT exposure and it starts the individual's holding period. Exercising early in the calendar year can also give the option holder more flexibility in terms of making a disqualifying disposition by year end and/or having the liquidity to pay any AMT by the individual federal tax return filing deadline (usually April 15 of the year after exercise).[3] Like NQSOs, the cost of exercising the option is the risk of investing capital for an uncertain tax benefit. [4]

Other complex tax and economic issues relating to ISO and NQSO should be explored with the individual's tax and other advisors.

Transfer Tax Planning

Separate from the income tax, the US also taxes gifts of property made during an individual's life and/or at death (the federal gift tax and estate tax).

All US taxpayers have an exemption from the federal gift and estate tax, currently $10 million, adjusted for inflation ($13.99 million in 2025).[5] Also excluded from the federal gift tax are gifts of up to $19,000 per year (in 2025), per recipient (the annual exclusion). Note also that gifts and bequests to a US citizen spouse and to qualified charities are not subject to federal estate and gift tax.

The maximum tax rate on any transfer in excess of an individual's available exemptions and exclusions is 40% at the federal level. Some states also impose an estate or inheritance tax in addition to the federal estate tax. Currently, Connecticut is the only state that has a gift tax.

Estate Planning Process

Individuals expecting to have an estate in excess of the amounts that can be passed free of federal gift and estate tax often consider making lifetime gifts because these gifts remove the asset and any future income and appreciation from the donor's estate.

A lifetime gift potentially can minimize the overall transfer tax since all income and appreciation from the date of the gift will pass to the donee federal gift and estate tax free. Moreover, if the asset has a current low value, but has significant appreciation potential, an early gift can result in substantial transfer tax savings.

Certain gifting techniques (like a Grantor Retained Annuity Trust or a sale to a grantor trust) allow the donor to retain the current value and transfer the appreciation. These techniques may be appropriate if the donor has used all of his or her exemption or is apprehensive about giving away "too much."[6] Because these strategies usually involve zero or nominal taxable gifts, these types of gifts also can be used where the donor wants to preserve the federal transfer tax exemption for later use.

The impact of a gifting plan often is greatest in advance of a liquidity event when a gift tax valuation may reflect a fraction of the ultimate value at liquidity.[7] Integral to the implementation of any such gifting plan is an appropriate appraisal of the value of the assets transferred. Uncertainty about the asset's ultimate valuation, preoccupation with the liquidity transaction or other distractions may cause an individual to wait until after a liquidity event to focus on planning. However, given the valuation issues and need for advance income tax planning, early planning is optimal.

Other Issues

Under Internal Revenue Code ("IRC") sections 280G and 4999, federal excise taxes may apply to "golden parachute payments," including payments that relate to stock options, that arise in connection with a change in control.

In addition, IRC section 409A, which was enacted to address certain perceived tax-timing abuse with respect to non-qualified deferred compensation arrangements, may apply to stock options. If an option is subject to section 409A and does not comply with section 409A, the amount deferred generally will be treated as taxable income at vest (rather than at exercise) and will be subject to an additional 20% federal tax and potentially other penalties.

NQSOs are generally subject to IRC section 409A if they have a strike price below the fair market value of the stock at grant. IRC section 409A sets out specific requirements for the determination of fair market value. Though ISOs are exempt from IRC section 409A, strict valuation rules applicable to ISOs can nevertheless result in ISOs being treated as NQSOs if the ISO is granted below fair market value. *Clients should consult their tax advisors on the application (or non-application) of IRC section 409A.*

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[1] Palmer v. Commissioner, 62 T.C. 684 (1974); Rev. Rul. 78-197.
[2] State income tax treatment may vary. Please consult your tax advisor.
[3] i.e., by selling and having met the 2/1-year rule before the AMT is due.
[4] For example, gifting shares acquired by ISO exercise before the 2/1-year rule is met is generally a "disqualifying disposition" converting the ISO to an NQSO. Consult your tax advisor.
[5] Under current law, the increase of the federal gift and estate tax exemption amount from $5 million to $10 million, effective 1/1/18, will sunset on December 31, 2025, at which time the federal gift and estate exemption amount will revert to $5 million, adjusted for inflation.
[6] The risk of over-gifting can be mitigated if the governing instruments are drafted properly.
[7] The same rationale applies to the generation-skipping transfer tax (an additional layer of tax imposed on transfers above an exempt amount to individuals two or more generations younger than the transferor).

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