Morgan Stanley

PRIVATE WEALTH MANAGEMENT

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 the option spread (typically the difference between the per share purchase price and other adjustments and the exercise price) if options are cashed out as a result of the sale. The option spread will be subject to payroll taxes and applicable with holding.
- 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 converted to purchase stock of the new company as a result of the transaction. purchase stock of the new company as a result of the transaction. If not converted, they may be cashed out, resulting in ordinary income tax on the option spread, in addition to payroll taxes.
- 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. Review your award agreement to determine whether an IPO impacts your options, restricted stock or restricted stock units. The availability of a public market following the IPO provides more liquidity, which may make exercising your options and selling the underlying shares more feasible. However, you may be subject to a lock-up agreement. You will recognize ordinary income on the option spread upon exercise with respect to nonqualified stock options and disqualified incentive stock options and will be subject to payroll taxes and applicable withholding.

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 federal lifetime gift and estate tax exemption ($12.6 million per person and $24.12 million for a married couple in 2022). In most cases, the value of your business will have a lower value, for transfer tax purposes, before the sale than it will after the sale. This is because the interest in a closely held business interest cannot be converted into cash as easily as an interest in a public company. The value of your business, which must be determined by a professional appraiser, will likely be discounted to reflect lack of marketability, and, in the case of a minority or non-voting interest, 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 order to keep the amount recognized as ordinary income 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 these strategies presume that the stock value will appreciate, and they involve risks if the stock price decreases. Consult your tax advisor for more information.

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:

- **ANNUAL EXCLUSION GIFTS.** You can make simple gifts to your children, or to a trust for their benefit, by giving them privately held stock worth up to the annual exclusion amount ($16,000 per person or $32,000 per married couple in 2022) in advance of a liquidity event.
  - Example: You gift $15,000 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.
- **GIFT TAX EXEMPTION AMOUNT.** In addition to the annual exclusion amount, you may gift assets worth up to your federal gift tax exemption amount during their life without incurring federal gift tax.
  - Example: In addition to gifting the $16,000 annual exclusion gift noted above, you gift $12.2 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 $21 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 approximately $12.2 million worth of your company's shares in 2022, you sell them to a trust at the current (discounted) fair market value (as appraised). In return, you get a promissory note, in the principal amount of $12.2 million, and it must bear interest at a rate the IRS will not deem to be a gift. (In July 2022, the minimum interest rate for a nine-year note was 2.99%). As in the example above, when the business is sold, the trust will receive $21 million. The sale proceeds in excess of the outstanding note balance can be held in trust or be distributed to your child free of federal gift tax. This strategy can be enhanced by selling the asset to a trust of which you, as donor, are treated as the owner for federal income tax purposes. (Many refer to this as a "sale to an intentionally defective grantor trust.") In that event, there would be no capital gain recognized upon the sale to the trust, interest payments from the trust would not be taxable income to you, 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 appropriate 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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