Morgan Stanley

PRIVATE WEALTH MANAGEMENT

PRE-LIQUIDITY

Pre-Liquidity Event Planning Overview

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

Wealth and Estate Planning Strategists
Family Office Resources

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 also must occur 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, with the benefit of marketability discounts for minority interests in a closely held business. 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 often is faced with 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 generally provides 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 is that of the donor and must be reported as taxable income despite the last minute gift to charity. The IRS's official position is that the 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] The assignment of income issue should be considered with a tax advisor whenever sale negotiations have begun prior to the donation.

A gift of closely held stock or other entity interest to a public charity will generally generate an income tax deduction for the donor equal to the fair market value of the interest, reduced by any imbedded ordinary income or short term capital gain. The deduction for a gift of an appreciated closely held entity interest to a private foundation will be limited to 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 charity prior to the sale. If the business is not related to the charity's purposes, it is deemed unrelated business income ("UBI"). The tax consequences of UBI to the charity will depend upon the structure of the business entity. Generally, income from an operating business that is UBI is subject to a separate unrelated business income tax ("UBIT") equal to the corporate income tax rate. If the unrelated business is held in a C corporation that is not controlled by the charity, dividends generally will be passive income not subject to UBIT, while flow through funds from an S corporation generally trigger UBIT. Additionally, the sale of S corporation stock of an unrelated business also may result in UBIT. The client should speak with his or her tax advisor to determine the specific application of these rules to the particular circumstance.

Charitable Remainder Trust

A Charitable Remainder Trust ("CRT") may be used to defer income taxes, benefiting both the donor and 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. Upon the expiration of the term, any remaining assets pass to charity. A CRT is a tax-exempt entity for income tax purposes. Therefore, there is no immediate tax to the trust at the time of the liquidity event. 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 tax 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 UBI within a CRT. The UBIT tax for a CRT is equal to 100% of the UBI.

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 capital gain and taxed at a preferential rate if the stock is held for more than one year at the time of sale. *The benefit of exercise in advance of a liquidity event is, therefore, the potential for a reduced tax on future appreciation, if any. The cost of exercise is the risk of investing capital for an uncertain tax benefit.* Upon exercise of an incentive stock option (ISO), the spread is not taxed as compensation upon exercise, but is treated as an adjustment item for alternative minimum tax (AMT) purposes. After exercise, if the stock is held for the longer of one year from the exercise date and two years from the date the option was granted, all appreciation over the strike price will be considered capital gain when stock is sold. Some or all of any AMT paid may be available as a credit in the year the stock is sold. 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 April 15 of the year after exercise.[3] The cost of exercise, again, is the risk of investing capital for an uncertain tax benefit.* Other complex tax and economic issues relating to ISO and NQSO should be explored with the individual's tax and other advisors.[4]

Transfer Tax Planning

Separate from the income tax, the US also taxes gratuitous transfers of property made during an individual's life and/or at death (the gift tax and estate tax). Currently, all US taxpayers have an exemption from the gift and estate tax, currently $10 million, adjusted for inflation ($11.7 million in 2021).[5] Also excluded from the gift tax are gifts of up to $15,000 per year (in 2021), per recipient (the annual exclusion). Note also that gifts and bequests to a US citizen spouse and to qualified charities are not taxable. The maximum tax rate on any transfer in excess of an individual's available exemptions and exclusions is 40% at the federal level. Many states also impose an estate or inheritance tax in addition to the federal estate tax. Only one state, Connecticut, currently imposes a gift tax on lifetime transfers above a certain threshold.

Estate Planning Process

Individuals expecting to have an estate in excess of the amounts that can be passed free of 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 gift and estate tax free. Moreover, if the asset has a current low value, but significant appreciation potential, an early gift can result in substantial 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 they usually involve zero or nominal taxable gifts, these types of gifts also can be used where the donor wants to preserve the 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

Excise taxes may apply on "golden parachute payments" and stock option valuation issues may arise in connection with a change in control. In addition, Internal Revenue Code section 409A, which was enacted to address certain perceived tax-timing abuse with respect to deferred compensation, includes options. If an option is subject to section 409A, taxes and penalties may apply upon vesting. NQSOs are subject to IRC 409A if they have a strike price below fair market value at grant. IRC 409A sets out specific requirements for the determination of fair market value. Though ISOs ostensibly are exempt from IRC 409A, the strict valuation rules can nevertheless result in ISOs being treated as NQSOs. *Clients must consult their tax advisors on the application (or non-application) of IRC 409A.*

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[1] Palmer v. Commissioner, 62 T.C. 684 (1974).
[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 is generally a "disqualifying disposition" converting the ISO to NQSO. Consult your tax advisor.
[5] Under current law, the increase of the base exemption amount from $5 million to $10 million, effective 1/1/18, will sunset on December 31, 2025, at which time the base exemption amount will revert to $5 million.
[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).