Pre-IPO Planning

By
Ann Bjerke
Head of Advanced Planning

Advanced Planning Group

Timing is everything. Estate and income tax planning prior to an initial public offering (IPO) will require the time and attention of a business owner but can result in significant tax savings for the family.

Prior to an IPO, business owners may have many tax and wealth transfer opportunities that can result in significant tax savings but that may be lost once the deal is closed. During the deal structuring and negotiation, business owners are often consumed by the transaction details. However, estate and tax planning can be critical to the long-term wealth of the family and does not need to slow down the transaction. The primary goal of pre-IPO planning is to minimize estate taxes by transferring part of the value of the owner's business to family members, trusts, or other entities before the expected "pop" in value. Additionally, business owners may engage in certain income tax planning strategies to minimize capital gains tax on the IPO itself.

Valuation

In most cases, the valuation of a business prior to an IPO is significantly less than the eventual offering price. Because estate and gift taxes are based on the fair market value of assets at the time of transfer, taking advantage of lower valuations allows business owners to shift wealth to family members at a lower, and potentially discounted, cost.

The cornerstone of any pre-IPO planning is the appraisal. Appraisals of closely held business interests often incorporate discounts for lack of marketability, lack of control, and volatility. While the Internal Revenue Service (IRS) may challenge overly aggressive valuations, substantial discounts on the value of interests in privately held operating businesses have often survived challenges by the IRS. However, the moment a share of stock becomes publicly traded, the discounts disappear, so pre-IPO transfers can potentially transfer greater wealth. Moreover, transfers should be completed as far in advance of the IPO as possible because the closer in time to the IPO a transfer occurs, the more likely it is that the IRS can successfully argue that the IPO price is the true measure of fair market value.

Strategies

Numerous strategies to transfer wealth using discounts exist, ranging from a simple outright gift of shares to a complex leveraged structure. Of course, determining which strategy to use requires a thorough understanding of the family's goals and a detailed analysis by the business owner's tax and legal counsel.

Outright gift

A business owner can make outright gifts of shares to family members, thereby shifting the value of those shares (and any future appreciation) out of the business owner's estate for transfer tax purposes.[1] For example, let's assume a business owner transfers $1 million worth of shares of a company to the business owner's children. Several years later, the company is sold, and the shares owned by the children are now

[1] For an individual who is a US person for gift and estate tax purposes, the gift, estate, and generation-skipping transfer (GST) tax exemptions are $12.92 million per person in 2023 (and are indexed for inflation). The exemptions are scheduled to be cut in half after 2025. For the gift, estate, and GST taxes, the current maximum tax rate is 40%.

worth $3 million. As a result of the gift, $2 million in appreciation escapes transfer tax entirely, saving up to $800,000 in transfer taxes for the family (if the $2 million worth of shares were taxed in the business owner's estate at 40%).

Sale

A trust for the benefit of family members can purchase shares from the business owner, with the price supported by an appraisal.[2] Typically, the trust pays for the shares by issuing the owner a promissory note bearing an interest rate based on the rate published monthly by the IRS (which are historically lower than commercial rates). If the sale price is for full fair market value, then there is no gift and thus no gift tax. If the trust's assets appreciate at a rate higher than the interest rate on the note, there will be excess value remaining in the trust after the note is fully paid, and that excess value will escape transfer tax. Typically, the trust is structured as a grantor trust, so the business owner remains liable for the trust's income taxes as if the business owner owned all of the assets of the trust. As a result, the sale to the trust does not generate capital gains tax for the business owner because the business owner is considered as selling the shares to themself. Similarly, the interest payments on the note are not considered taxable income to the business owner. In addition, since the business owner remains liable for the income tax on the trust, the trust assets compound and grow without incurring income tax. Of course, the business owner will have to pay the capital gains tax on the trust's shares when they are sold, even though the business owner won't receive any of the sales proceeds, so the business owner will need to have sufficient other liquid assets for this structure to make sense.

Grantor retained annuity trust

With a grantor retained annuity trust (GRAT), the grantor funds the trust with shares of the closely held business. The trustee of the GRAT distributes an annuity (a fixed amount determined at the outset) to the grantor for a term of years, after which any assets remaining in the trust will pass to the remainder beneficiaries (often the grantor's children or a trust for their benefit). Typically, the GRAT is structured so that the present value of the annuity payments made to the grantor will actuarially equal the fair market value of the property contributed to the GRAT, so that there is little or no transfer tax cost. If the shares in the GRAT appreciate at a rate that exceeds the section 7520 rate in effect at the date of the transfer of those shares to the GRAT, the appreciation in excess of the section 7520 rate generally passes to the remainder beneficiary free of gift tax.[3] GRATs are also grantor trusts for income tax purposes, so the potential for tax-free compounding and the potential for taxable income without liquidity, both noted above, apply to GRATs as well.

[2] If there is no existing trust with assets to purchase the shares, a new trust can be created and seeded with a gift of enough assets to give the trust a reasonable level of equity. The gift to this trust could generate gift taxes. Generally, the grantor will fund the trust by making a gift of assets that represent at least 10% of the purchase price.

[3] The 7520 rate is an interest rate published monthly by the IRS. It is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii).

If the grantor dies during the term of the GRAT, all of the assets of the GRAT are generally includible in the grantor's estate for estate tax purposes, thus negating any tax advantages the GRAT would otherwise provide. GRATs are therefore typically set up with short terms—two or three years—to minimize this mortality risk.

Income tax planning

A business owner may also wish to plan for the income tax impact associated with the eventual sale of shares (often after the IPO). If the business owner is philanthropically inclined, the business owner might consider contributing shares to a public charity (including a donor advised fund), a private foundation, or charitable remainder trust. This may generate an income tax deduction and may provide deferral or avoidance of income tax payable upon the eventual sale of shares (often after the IPO).

Although a business owner might make a charitable contribution before an IPO, it's usually more favorable to do so after the IPO, because the share value may be higher and, in the case of contributions to a private foundation, the tax treatment generally is more favorable. Business owners considering making a charitable donation of stock just prior to an IPO should carefully consider the special rules and limitations associated with making a gift of closely held business interests, along with the potential impact of the assignment of income doctrine, which the IRS has used to tax the donor or transferor upon a subsequent sale of stock by the donee or transferee charity. A recent case vividly illustrates this point. A business owner, who had sought to wait as long as possible before contributing shares to charity, was held liable for the tax on the capital gains on the shares he contributed to charity, because the sale was practically certain to occur when he made the contribution even though the owners hadn't entered into a binding agreement to sell.[4]

A business owner who lives in a state with high income tax rates may wish to consider changing their domicile before the IPO. If that is not feasible, the business owner might consider creating and funding certain types of trusts to defer or possibly eliminate state tax liability upon the sale of shares contributed to the trust, such as an incomplete non-grantor trust (ING). In addition, the business owner may wish to consider exercising incentive stock options or gifting or exercising nonqualified stock options (if they are transferrable).

Conclusion

Estate and income tax planning prior to an IPO will require the time and attention of the business owner but can result in significant tax savings for the family. Contact your UBS Financial Advisor to see if we can assist you with this critical component of pre-transaction planning.

[4] *Estate of Hoensheid v. Commissioner,* T.C. Memo. 2023-34.

About the Advanced Planning Group

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