Liquidity Planning for Entrepreneurs

Strategies for Preserving Wealth Before and After the Transaction

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One of the most important decisions faced by entrepreneurs is how to convert all or part of their investment in a business into a more liquid asset. Whether this liquidity event is in the form of an initial public offering (IPO), a recapitalization or a sale of the business to a financial or strategic buyer, there are a wide variety of factors to be considered.

FROM OPERATORS TO INVESTORS

In addition to deal-related issues to complete the transaction, business owners should begin to plan for the implications of their shift from operators to investors. Areas of focus often include the establishment of broad goals and priorities in investments, family wealth preservation and philanthropy. This analysis is important because the goals for a business owner seeking to maximize investment income, for example, would be different from a seller who is focused on philanthropic initiatives.

Generally speaking, there are three time frames in which to address these issues: pre-liquidity, the liquidity event itself, and post-liquidity.

PRE-LIQUIDITY PLANNING

The different events which occur before a transaction takes place can have a significant impact on the after-tax proceeds available to the selling owners. In an IPO transaction, for example, it is crucial for sellers who hold stock options to be aware of any plan restrictions or option exercise provisions which may be triggered by a change in control.

Sellers in transactions other than IPOs encounter a wide range of other issues, including:

- The tax implications of structuring the transaction as an asset sale or a stock sale;
- Compensation-related issues for continuing or departing employees;
- State income tax ramifications of different structural alternatives.

By addressing these issues well in advance of a transaction, you can create a more tax-efficient structure. Left to the last minute, however, your potential options are significantly limited. Keep in mind that reducing the effective tax rate on a transaction can be just as important as increasing the earnings multiple to be used in the calculation of the selling price.

If you are selling to financial or strategic buyers, be sure to conduct a thorough review of the entity's capital structure in order to maximize your estate planning options. For example, it may be advantageous to transfer assets to trusts for the benefit of children or grandchildren *before* the sale. This planning may enable you to take advantage of opportunities for discounting which may not be available after the transaction. In addition, you should review your family's overall estate plan to confirm whether these plans are still appropriate or whether they need modifications.

In anticipation of the inflow of the sale proceeds, one should also begin formulating an investment policy to create a road map for the investment of these funds. Considerations include both the time frame over which the proceeds will be invested as well as the various legal entities which may be put in place in order to meet estate and gift planning objectives.

DURING THE LIQUIDITY EVENT

While a liquidity event may often be structured as a receipt of cash, there are instances where securities of the buyer are used as payment either in a taxable or tax-deferred transaction. In these cases, it may be prudent to enter into any number of potential hedging transactions. Appropriate hedging can reduce or eliminate the downside risk inherent in holding buyer securities or continuing to hold a concentrated position in a newly-public entity.

Equity Collars

One of the most commonly used techniques is a "collar." In this instrument, one establishes a range of values for the buyer's stock, thereby reducing the range of prices for the newly acquired securities. The collar is created by the sale of a call option and the purchase a put option. In some cases, the collar will be structured as a single instrument.

Depending on the relative prices of the options, the collar can be structured to be "cost-free." In other words, the cost of the put option purchased is funded by the option premium received on the sale of the call option. For tax purposes, the width of the collar's range is important in order to avoid a "constructive sale" of the stock which would trigger any inherent gain in the position. Constructive sales tax treatment may apply to transactions that both reduce the risk of loss and the opportunity for gain. The range of values that is generally adopted as an acceptable rule of thumb has been 20 percent of the stock price at the time the position is established.

Forward Contracts

Another alternative for hedging your exposure to guard against valuation declines on buyer's stock is a variable pre-paid forward contract (VPF). A VPF contract generally calls for an advance of funds to the stock holder with a variable number of shares required to be delivered at the end of the contract term. The advantage of this instrument is that a portion of the market value of the stock subject to the contract is available to be received in cash and therefore available to be reinvested in a diversified portfolio. As with the collar described above, there are income tax issues which need to be addressed. The goal is to avoid constructive sale treatment which would make the inherent gain in the stock position taxable upon the establishment of the contract.

Exchange Funds

Many sellers consider the use of exchange funds to hedge the risk of holding a concentrated position. In this structure, a limited partnership or LLC, comprised of holders of a number of different securities, combine their holdings in order to create a more diversified portfolio. If structured correctly, none of the holders realize a gain on the contribution of their securities to the partnership or LLC. A potential disadvantage of these structures is the limited ability of any one investor to control the composition of the portfolio created.

There are a number of other financial instruments which may be used by business owners selling their companies. The common theme running through all these alternatives is that business owners can potentially mitigate the economic risks of holding concentrated positions and defer their inherent gains for tax purposes. In any event, the income tax considerations of a transaction must be thoroughly evaluated prior to entering into the transaction in order to avoid potential pitfalls.

> "Plan for the future, because that is where you are going to spend the rest of your life."
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> — Mark Twain

LIQUIDITY PLANNING STRATEGIES #1

There are a number of planning strategies available to families before and after a liquidity event. As with any financial plan, it is important to consider diversification in order to maximize your flexibility and to reduce your overall risk should any of these approaches be challenged by the IRS. We have outlined several effective tools below. What is common to all these techniques is that they are designed to shift future appreciation away from the senior generation. They also take advantage of various discounting and time-value concepts to reduce the amount of currently taxable wealth.

BASIC GIFT PLANNING STRATEGIES

Annual Gifts

Each individual has the ability to utilize two exclusions from the combined estate and gift taxation regime. First, annual gifts of $12,000 per year per beneficiary are free from gift tax. This annual exclusion does not carry over from year to year, so it is important to take advantage of the exclusion each year.

In order to qualify for the annual exclusion, gifts must be available for the beneficiary's use in the current year. When children or grandchildren are potential beneficiaries, there are a number of different trust structures which are available to meet the current gift requirements, yet delay the ultimate receipt of the "trust corpus" or principal until a point in time which the donor feels is appropriate.

Estate Tax Exclusion

In addition to the annual gifting allowance, each person has a credit ("applicable exemption amount") permitting transfers of $1,000,000 during life or $2,000,000 at death without tax. Use of the gift tax credit (above the annual exclusion) reduces the estate tax credit dollar for dollar. Estate transfers and gifts above these exemption limits are taxed at 45% (from 2007 to 2009). (See chart below.) Also keep in mind that the appreciation of an asset after it is transferred is not taxed in the donor's estate. Accordingly, it is a good strategy to utilize the lifetime exemption prior to death in order to shift that appreciation to the next generation.

Estate Tax Exemption and Tax Rates 2006-2011

Year	Maximum Estate Tax Credit	Marginal Tax Rate
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	Repealed	N/A
2011	Reinstated at 2002 level ($1 million)	50%

LIQUIDITY PLANNING STRATEGIES #2

If you have significant wealth to transfer, a $12,000 per beneficiary per year gifting program plus utilization of the applicable tax credits may not be enough to meet your needs. More elaborate estate planning may be necessary. Especially when a liquidity event such as an IPO, merger or sale is on the horizon.

There are a number of tax efficient strategies that can be used to overcome these limitations. Each of the structures described meet different family objectives, and they can all be used in combination with each other.

GRANTOR RETAINED ANNUITY TRUST (GRAT)

Purpose:

- GRATs are irrevocable trusts which pay the grantor fixed annuity payments for a fixed number of years while transferring most of any appreciation of the GRAT assets to the beneficiaries

Advantages:

- Transfers appreciation of pre-event stock from the grantor's estate
- Substantial reduction in gift tax
- Transactions between the grantor and the trust are ignored for income tax purposes
- At the end of the annuity term, the remaining assets within the GRAT are transferred to the beneficiaries, free of gift or estate tax

FAMILY LIMITED PARTNERSHIP (FLP)

Purpose:

- The Family Limited Partnership (FLP) is an investment vehicle which provides control and gifting efficiency, arising from discounted appraisal values

Advantages:

- The senior generation can maintain control of the FLP by retaining 1% general partnership interest, and transferring the remaining 99% limited partnership interests to the next generation, at substantial discounts from the underlying asset value
- The family can maintain a centralized investment vehicle, improving the efficiency of managing investments
- Younger generations can be taught investment management as they mature
- Family assets are protected from creditors
- There may be estate and gift tax valuation discounts

LIQUIDITY PLANNING STRATEGIES #3

INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

Purpose:

- IDGTs seek the tax-free transfer of appreciation in pre-liquid stock by purchasing the stock with interest-bearing promissory notes

Advantages:

- Greater leverage than a GRAT
- Removes property and appreciation from grantor's estate
- Substantial reduction in gift tax
- Transfer of wealth continues throughout the life of the IDGT as the grantor pays the trust's income tax
- Transferred assets do not revert to grantor upon the grantor's death

CHARITABLE REMAINDER TRUST (CRT) (GENERALLY POST LIQUIDITY)

Purpose:

- The CRT allows a donor to diversify highly appreciated investments, defer taxes, receive an income tax deduction in the year of formation, and receive an inflation-protected annual payment for life while benefiting a charity at death

Advantages:

- "Tax free" sale of appreciated position and diversification within the CRT
- Current income tax deduction for a portion (usually 10%) of the value transferred to the CRT
- Diversified portfolio allows the asset base to grow with inflation
- Distributions are a fixed percentage of the CRT assets

Disadvantages:

- Remaining assets at death go to the charity instead of the family
- Portfolio could suffer losses thereby reducing distributions

POST-LIQUIDITY ACTIVITIES

One of the first issues to be addressed after the receipt of proceeds is the implementation of the seller's investment policy. Typically there's a diversification of assets over a period of time in order to utilize dollar cost averaging. Depending on the aggregate investment involved, the number of asset classes and the number of money managers to be employed, the funding of specific mandates may be spread over several months to a year.

At this time, it may also be appropriate to begin your philanthropic planning. There is a broad range of potential charitable vehicles available to meet your family's short and long-term charitable goals, including:

- Direct contributions to public charities;
- Various forms of charitable trusts;
- Creation of private foundations;
- The use of established vehicles such as donor-advised funds.

Ongoing Monitoring

Just as your business required time and effort to run smoothly, so will the continued maintenance of your investment and tax structures, and your estate and philanthropic plans. For example, you will need to review your estate and gift plans as your financial assets and family structures change. Your evolving personal priorities may lead to a review of your philanthropic plans. This maintenance is an ongoing process and requires at least an annual review.

AS WE HAVE SEEN, there are a number of opportunities and instruments for entrepreneurs who want to convert their stake in a business into a more liquid asset. However, the most important step is taking the time to explore your options well in advance of the actual liquidity event.

By utilizing these tools to minimize taxes (including income, estate and gift taxes) and to maximize the after-tax proceeds, you can preserve the benefits gained in the transaction for the financial security and comfort of family members for many generations to come.

For the benefits of these strategies and whether or not they apply to your specific situation, please speak with your Harris myCFO™ client service director.

Jim Raaf, Managing Director, Harris N.A., supervises the delivery of comprehensive family office solutions to individuals and families of substantial wealth. He has more than 25 years of experience in tax and financial services, and planning for closely held businesses, asset management and high-net-worth family services.

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