ADVANCED PLANNING FOR FOUNDERS:
INCOME & ESTATE TAX PLANNING

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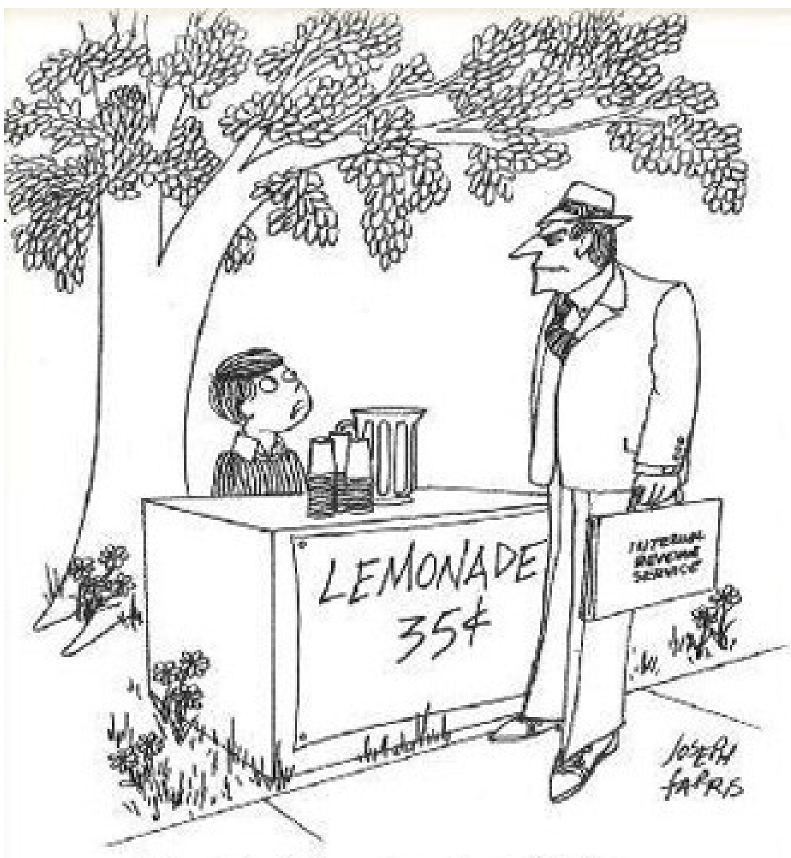
Advising founders and entrepreneurs requires a practiced and diverse skill set. There are a wide range of important considerations in the areas of tax planning that can have a significant impact on ultimate value outcomes. Given their many competing priorities, founders may look to quickly push past early decisions in some of these critical areas.

Tax planning strategies for founders are typically focused on saving both income and estate taxes. Combined with integrated investment strategies, these are powerful tools for founders. Below is a summary of several key concepts that can be selectively employed with experienced advisors to significantly enhance after tax outcomes.



"But I don't have tax returns for the last three years."

Income Tax Planning

Building a business requires tremendous effort, intelligent strategy, and sound execution. If all goes well, successful founders can realize significant value but are also subject to a capital gains income tax that can have a dramatic impact on the net value outcome. Below are two key strategies that can be utilized discretely or in combination to mitigate income tax impact.

Qualified Small Business Stock (QSBS) Exemption:

QSBS rules were enacted in 1993 to encourage investment in small business by considerably decreasing the potential tax liability for founders. If a company's stock is qualified for QSBS, the owner may be exempt from federal tax on the greater of $10mm of otherwise taxable income, or ten times their tax basis.

Saving federal tax on $10mm of cap gain income is a tremendous benefit on its own but there are also opportunities to multiply this benefit by "stacking" QSBS eligible entities. A QSBS multiplier approach allows for each individual owner to receive the same tax exemption. Utilizing trust structures can allow founders to allocate equity across multiple entities to achieve this powerful benefit.

Founders can also use the QSBS election as an incentive to attract investors, as well as recruit and retain talent through equity compensation packages.

There are very specific rules to qualify for the QSBS election. Thoroughly assessing a company's eligibility for QSBS with an experienced advisor is the first step to unlocking this tax benefit.

State Income Tax Strategy:

State income tax can add a significant additional burden on value creation for founders. A thoughtful and proactive approach to entity structure and ownership can avoid this additional tax while also incorporating valuable estate planning elements. It's important to note that state income tax rules vary from state to state. Working with an advisor that is well versed in the applicable jurisdiction is a key starting point.

Under certain circumstances, parents can create and fund a trust for the benefit of a child that is exempt from state income tax. The trust must be organized in a way that carefully considers the residency of the parents (grantor), the child (beneficiary), the trustee, as well as the situs of the trust itself. Organized correctly this strategy can create a "homeless" trust for state income tax purposes.

Since the trust is a unique entity itself, it is also eligible for the QSBS election to shelter federal income tax on gains of up to $10mm, combining for a powerful tool for founders.

ESTATE PLANNING

The federal government limits the amount of wealth that can be transferred from one individual to another without a transfer tax. This can come in the form of either a gift tax during one's lifetime, or an estate tax when assets are passed on after death.

In 2023, the maximum amount of transferable wealth that is exempt from Federal estate and gift tax is $12.92mm per individual (up from $12.02mm in 2022) or $25.84mm per married couple. Any wealth that is transferred by gifting or via an estate beyond these amounts is taxed at 40% at the Federal level. In addition, many states have their own estate tax that can exceed 10% combining for a 50% tax penalty. Avoiding or reducing this penalty can be a powerful tool to maximize the value of a growing business.

On an annual basis, there is also tax-free transfer of $17,000 allowable in 2023 to any single individual in without any impact to the lifetime exemption.

Trust Creation & Lifetime Gifting:

Limits on tax free lifetime gifting are at an all-time high and should be considered as a fundamental consideration in any tax planning strategy. Gifts made to trusts enable grantors to have varying degrees of control over the assets while ensuring they are removed from their estate for tax purposes. Trusts can be structured with specific benefits to beneficiaries including children and future generations, allowing grantors to create a customized framework for passing on their wealth.

Founder equity or other early-stage equity can be a particularly attractive asset to gift as the early valuation may represent a fraction of the expected value over time and allow for much greater utilization of the lifetime gift exemption limit.

Trusts can also be structured in a way that allows the grantor to pay the income tax of the trust, which is commonly referred to as a "grantor trust for tax purposes". This further enhances the wealth transfer impact as it relieves the trust from taxation on its assets.

Estate Freeze Technique - Grantor Retained Annuity Trust (GRAT):

Gifts to thoughtfully structured trusts are an excellent way to utilize the lifetime exemption for estate tax benefits. However, a larger estate may need additional tools beyond the maximum lifetime gifting exemption. In other cases, a founder may not be prepared to make permanent gifts or "max out" their gift exemption. In these situations, it may make sense to consider a strategy that avoids transferring current value and instead transfers potential future appreciation, sometimes referred to as an "estate freeze" strategy. One such approach is a grantor retained annuity trust (GRAT).

A GRAT is a trust with a defined term that is typically established for the benefit of children and future generations. However, transfers to GRATs are not permanent gifts and if structured properly do not count against the lifetime exemption amounts because the grantor retains an annuity interest equal to the value of the asset transferred.

After the grantor contributes assets to the GRAT, the trust must then make an annual payment to the grantor equal to the value of the asset divided by the number of years of the GRAT term plus interest. For example, in a 5-year GRAT, the grantor will receive 20% of the original asset value plus interest at the end of each subsequent year. At the end of year 5, the GRAT will retain any assets that remain from investment appreciation above the required annuity payments.

The power of the GRAT lies in the ability to appreciate assets well above the annuity and interest payments required. To the extent the assets do not appreciate above the annuity payment, the GRAT does not pass along anything to the trust. Also, the grantor must survive the GRAT term otherwise the assets are includable in the grantor's estate. There are several creative options to structure and implement GRATs depending on the goals of the family.

Timing is Everything

In the early days of a new business, it may seem premature to plan for taxes that feel like a distant secondary concern but there are several planning techniques that offer significant value potential for founders and others with growing wealth. It is important to address these decision points well in advance of the stage where an IPO, merger, or acquisition becomes a likely event. Value creation can be greatly enhanced with thoughtful proactive planning and integrated investment strategy.