FEATURE:
FAMILY BUSINESSES

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Playbook for Advising Young High-Net-Worth Entrepreneurs

Four ways to add strategic value

In the world of high growth ventures, successful new companies are creating monumental wealth for young entrepreneurs. Yet, amid a focus on scaling their businesses and pursuing exit strategies, young entrepreneurs often overlook a crucial element of personal finance: income tax planning.

Founders of high growth companies are often young, single or just starting a family, with a significant portion of their wealth concentrated in the equity interests of their companies. While traditional estate planning is important, it won't immediately interest this group. The timely need is expert guidance on how they can best mitigate often onerous state and federal income taxes on a liquidity event.

Without proper guidance, young entrepreneurs can miss opportunities. While they're driven to seek professional advice, particularly prior to a liquidity event, advance planning will have the biggest impact.

Providing the right guidance requires a unique approach that prioritizes income tax planning but doesn't foreclose traditional estate tax planning. Adding to the complexity is a typically narrow window to implement specific tax strategies, given that clients are primarily focused on running their business or planning for an exit.

As the wealth landscape evolves, so must the playbook advisors use to support the next generation of entrepreneurial leaders.

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Four Ways to Add Value

Here are four ways advisors can add strategic value to the financial lives of high growth entrepreneurs:

1. **Identify innovative income tax strategies.** Mitigating income taxes is key for young, high-net-worth (HNW) entrepreneurs, although they may not always recognize the need. Tax strategies surrounding company stock are an area in which advisors can add particular value. Such stock often increases in value rapidly, presenting the ideal asset for tax planning.

   One area of focus should be Internal Revenue Code Section 1202, known as the qualified small business stock (QSBS) exclusion, which provides an exemption from federal income tax on the sale of stock in a "qualified" small business. Most states follow the federal rule and provide a tax exemption, with some notable exceptions like California, New Jersey and Pennsylvania.

   The basic requirements for QSBS eligibility are:

   - The company must be a U.S. C corporation with less than $50 million in gross assets when the stockholder acquires the stock. The stock must have been acquired from the issuing company for either cash, services or property (including intellectual property).
   - The stock must have been owned for at least five years prior to sale. The holding period doesn't include time holding an option or a note that was later exercised or converted into stock. The 5-year countdown begins only after the conversion to equity has been completed.
   - The company doesn't fall into one of the ineligible industries, such as certain types

of service businesses (for example, health care providers, legal practices, financial services firms and architects) and natural resource businesses (for example, farming and mining). Note, however, that while a traditional financial services or health care firm may not qualify for the exemption, a fintech or biotech start-up likely would.

Under current rules, 100% of the gain for stock acquired after Sept. 27, 2010 can be excluded from taxable income. For stock acquired before that date, a partial exclusion is possible. The exclusion applies up to the greater of $10 million or 10 times the aggregate adjusted income tax basis of the qualified stock sold. Most founders will have a zero basis, so the $10 million exclusion will be the relevant limit.

Crucially, the QSBS rules permit gifts of QSBS-eligible stock to other taxpayers who step into the donor's shoes with respect to QSBS eligibility and the holding period. An effective and common QSBS strategy is the creation of irrevocable nongrantor trusts to which the founder makes gifts of stock. Each trust would qualify for its own QSBS exclusion and may sell up to $10 million of QSBS tax-free, a strategy known as "stacking."

For example, if a founder has a spouse and two children, this family of four may be able to shelter up to $40 million from income tax with properly structured trusts. For young entrepreneurs who plan to have a family, establishing trusts with "placeholder" beneficiaries, such as parents or siblings, may be necessary. In certain asset protection jurisdictions, such as Delaware, it may even be possible for the founder to establish a nongrantor trust that includes the founder as an eligible beneficiary, providing the founder with added flexibility if they're unsure of plans to marry or have children.

Many entrepreneurs either aren't aware of the QSBS exclusion or haven't carefully considered what they should do to maximize the benefits. This neglect can result in a large tax bill when it comes time to prepare for an initial public offering, negotiate financing or seek out a buyer for the business. Ideally, QSBS planning should happen well before a deal is signed and while valuations are low.

In addition to optimizing for QSBS, these nongrantor trusts may be structured to avoid not only income tax on the initial exit but also state income tax on future income earned by the trust. Different states tax trusts based on factors such as the residence of the grantor, trustee and beneficiaries. Take care to select the trustee, in particular, to optimize the trusts for tax minimization.

The new playbook reverses some concepts of traditional trust planning by seeking to include the entrepreneur as a beneficiary rather than solely focusing on the transfer of wealth to future generations.

Another option is to fund a short-term grantor retained annuity trust (GRAT) with company stock, administered with annuity payments in kind. A GRAT can be used to capture appreciation of company stock for transfer to children or other family members without using the founder's gift exemption. The stock remaining in the GRAT after the founder receives the required annuity payments may also qualify for a QSBS exclusion if directed to a nongrantor trust. Because a GRAT strategy requires at least two years to work, planners must be mindful of the timing of an expected exit. Assuming the founder has gift exemption available, making gifts may be preferable to relying on a GRAT strategy to transfer stock. Because a GRAT is a grantor trust, the strategy has no income tax benefits until the GRAT term is completed.

2. **Create non-traditional trust structures.** The new playbook reverses some concepts of traditional trust planning by seeking to include

the entrepreneur as a beneficiary rather than solely focusing on the transfer of wealth to future generations. Founders are often young, don't yet have families and face uncertainty regarding the size of their potential wealth creation event. As a result, they're ambivalent about gifting stock to others. A strategy that includes the founder as a potential beneficiary goes a long way to addressing these issues.

One example is a sale to a third-party settled nongrantor trust in exchange for an installment note. This strategy requires a third-party settlor (usually a family member, such as a parent) who funds a trust for the founder's benefit through a cash gift. The trust creator will typically allocate generation-skipping transfer tax exemption to the trust. Hence, it's not only excluded from the founder's estate but also exempt from transfer tax for multiple generations. In addition, the trust will often be structured to be exempt from state income taxes and offer the founder the traditional creditor protection benefits of a third-party settled trust. The trust can be designed to include a limited power of appointment to provide the founder with the flexibility to make future modifications to the trust.

Once the trust is funded, it purchases stock from the founder in a taxable sale for a down payment and a note. The seller will recognize immediate gain with respect to the down payment received (which might qualify for the QSBS exclusion). The balance of the gain likely can be deferred using the installment method, and the founder will recognize this gain only when the note is repaid (or, under a related party rule, immediately on the trust's sale of the stock, if disposed of within two years of the initial sale).

Interest payments received by the founder during the term of the note (if any) will be taxable to the founder, and there may be a deferred tax interest charge, depending on the size of the note. Because gain will be realized, the sale strategy will work particularly well early in the company's lifecycle, when the share value is low, and the trust can buy the stock for a small amount.

The trust's income tax basis in the company stock would be based on the price paid to the founder. If the trust is structured to be exempt from state income tax, there will be tax savings on the realized gain when the trust sells the stock. The trust would need to hold the stock longer than one year to avoid short-term capital gains treatment.

The QSBS exclusion generally wouldn't be available to offset the trust's taxable gains because the founder acquired the stock by purchase and not directly from the company. For this reason, the optimal stock for a founder to sell to the trust may already be disqualified from QSBS, such as shares acquired by a founder after the company is already worth more than $50 million or that likely won't meet the 5-year holding period. However, in an alternative approach, if the trust purchases stock from the company itself when the company is first incorporated, rather than from the founder, the trust would have all of the benefits mentioned above, and the acquired stock may also qualify for QSBS treatment.[1]

3. **Incorporate charitable giving strategies.** Charitable planning is a mainstay of any planning playbook. The next generation of entrepreneurs is known to be focused on social impact, so the discussion of charitable planning is all the more relevant.[2]

Giving strategies should be based on a combination of factors, including the founder's individual tax situation, the type of assets being gifted and the founder's philanthropic objectives. Some options include:

- *Create a charitable remainder trust (CRT).* This strategy benefits both the entrepreneur and the charity. Property is gifted to the trust, and the entrepreneur receives an annuity that allows capital gains from the sale of the contributed stock to be spread over multiple years, deferring the tax. If the CRT qualifies for its own QSBS exclusion, a portion of the annuity payments received by the founder may be exempt from tax. The founder will also receive the benefit of a charitable deduction for the actuarial value of the remainder interest that passes to charity when the trust terminates.

- *Establish a private foundation (PF).* A good option for long-term philanthropic goals, a PF is a legal entity that the entrepreneur can control. It allows tax-deductible charitable contributions while the assets grow and are distributed over time, subject to an annual distribution requirement of 5% of the foundation assets. Foundations include a host of tax and corporate filing obligations, which may be a turn-off for a founder who's looking for simplicity.
- *Start a donor-advised fund (DAF).* This flexible charitable account offers an immediate income tax deduction in the year it's created. It has no initial funding or minimum distribution requirements, though proposed legislation would require such distributions. The account is opened with a sponsor organization that has final control over assets and must approve distribution requests. Unlike a PF, a DAF has no administrative burdens but may be less customizable in terms of governance and certain types of charitable gifts.
- *Incorporate charitable features in family trusts.* Due to the uncertainty of a company's prospects, a founder is often faced with the difficult decision of making gifts of stock without knowing the ultimate dollar value of what the founder is giving away. Many founders are concerned about leaving too much wealth for their children and desire flexibility to "right size" a family trust in the future after the stock is monetized. Planners should ask the founder if they wish to include a "charitable leak-out" feature that gives the trustee discretion to make donations to charity in addition to family members. To give the founder peace of mind that the trustee won't exercise this power without the founder's knowledge, the provision could be drafted to require that the trustee notify the founder prior to exercise.

4. **Don't neglect fundamental estate planning.** While HNW entrepreneurs' immediate need will be to focus on income tax planning, as their advisor, you can add significant value and peace of mind by ensuring that they don't neglect traditional estate planning. Depending on their age and experience, they may not have an estate plan. It's important to walk them through the value of putting a complete estate plan in place, including a will, revocable trust, power of attorney and health care proxy so that their family is protected and future intentions are clear.

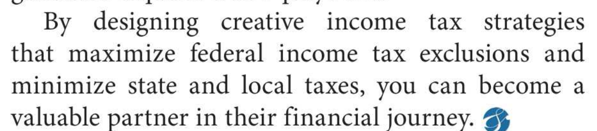
   Estate planning for high earning entrepreneurs should include strategies to address potential estate tax liquidity issues created by a concentrated position in company stock.

   One way to do that is through an irrevocable life insurance trust. This trust keeps the life insurance proceeds out of your client's taxable estate by transferring the insurance into a trust. It then provides the beneficiaries a tax-free distribution on the client's death. This is a good way to address any liquidity concerns after death (for example, to pay estate taxes or maintain property).

A Fresh Approach

Today's young entrepreneurs have built their wealth in a nontraditional way. Thus, advising them and offering them effective financial and tax planning guidance requires a new playbook.

By designing creative income tax strategies that maximize federal income tax exclusions and minimize state and local taxes, you can become a valuable partner in their financial journey.



Endnotes

1. *https://pbwt2.gjassets.com/content/uploads/2023/06/Introducing-the-GOAT-Trust.pdf.*
2. *See* Jeff Finkelman, Colleen Silver and Paulina Mejia, "How to Guide a Conversation Around Sustainable Investing," *Trusts & Estates* (March 2022).