



HIGHTOWER

Bethesda

Liquidity Event Planning

Strategies for Wealth Preservation
Before & After a Liquidity Event

The liquidity event: seizing the opportunity

A liquidity event is very uncommon—often a once in a lifetime success achieved after years of hard work and dedication. In fact, many business owners, concentrated stockholders or top executives can work their entire career without ever experiencing this type of event. As a result, many business owners find themselves underprepared emotionally and financially for the personal ramifications of a successful liquidity event.

Clearly, these events provide the shareholder with the potential to accumulate substantial wealth that is very often life-changing. But, at the same time, a liquidity event will produce new tax and legal obstacles foreign to all but the most sophisticated of investors and advisors. However, if properly planned for in advance, many of these new challenges can be minimized or eliminated altogether. The earlier you plan, the greater the range of opportunities.

“Keep in mind that planning early to reduce the effective tax rate on a potential transaction can be just as important as increasing the earnings multiple to be used in the calculation of the selling price.”

The reality is, most business owners focus solely on running their business and handling transaction details, leaving personal planning issues to chance. This approach misses what is arguably the most important window of time to take action: before a liquidity event is realized. The knowledge of an experienced financial advisory team can help business owners make the right personal planning decisions before and after a liquidity event, which in turn allows for a more successful outcome.

“A liquidity event is generally defined as a substantial realization of wealth via an IPO or merger and acquisitions.”



Framing end goals early

A liquidity event, which includes an initial public offering (IPO) or merger and acquisition of a closely held business, requires vast amounts of time from leadership in two different but time-intensive roles: running the business and negotiating the numerous details of a successful transaction.

While resources are spread thin, it's easy for attention and concern for personal finances to fall by the wayside. Pre-liquidity planning addresses important considerations and defines end goals early in the process. In the book, *The Seven Habits of Highly Effective People*, best-selling author Steven Covey advocates as habit #2, "Begin with the End in Mind." Just as a business owner should plan ahead for the future of their business, they should also plan ahead for their personal finances. Seizing the opportunity and beginning with the end in mind is precisely the objective of pre-liquidity planning.

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FUTURE CASH FLOW: A CLOSER LOOK

Pre-liquidity cash flow planning offers a detailed look at existing and future cash flow needs. For example, what lifestyle has an individual been living and what are the cash flow needs in the future? An in-depth examination focuses on understanding previous sources of income and the present and future projected expense needs for the family. As future cash flow is examined, consideration is also given to the needs of family members the person would like to take care of in the future, such as children attending college. With proper planning, all goals are defined and understood early in the process, encompassing any potential increases in discretionary spending, general living expenses and lump sum cash requirements that are anticipated

as a result of the successful liquidity event. Putting everything into context, a range of potential outcomes is generated, offering an early opportunity to resolve any discrepancies before the liquidity event has occurred. Oftentimes, the outcome of this type of planning will inform the deal structure itself as business owners understand how a potential transaction will affect them personally, beyond the simple knowledge of a larger bank account.

DEVELOPING A RANGE OF OUTCOMES, ALIGNING GOALS

Sometimes there are discrepancies between cash flow needs and what the liquidity event will provide. For example, an IPO might result in tens of millions of dollars, but those funds might not be immediately accessible. In fact, the ultimate realization of wealth in an IPO could take years to realize. A simple rule of thumb is: until the stock is sold and taxes are paid, it's not spendable money.

In the case of an acquisition event, whether for stock or cash, the outcome becomes a bit more certain but it is still important to gain a better understanding of the fundamental value of money today versus money in the future. For example, what is the potential growth of the monies received, and can the individual truly be financially free?

During the pre-liquidity planning stage, a full-blown forensic view is taken to understand what cash flow is required to fund lifestyle, what monies are accessible today, and what monies will be accessible in the future. Detailed questions are asked to understand where the individual would like to be financially and to account for any potential tax ramifications of the liquidity event. Coordination between key advisors is a challenge, particularly if tax and investment counsel aren't working together to find solutions. Hightower Bethesda leads this process and ensures that the details are taken care of—from start to finish.



Tax trends and early planning

ESTATE TAX CONSIDERATIONS

For 2022, the estate tax exclusion amount is \$12,060,000 per person and \$24,120,000 per married couple free of estate tax. After that exemption, upwards of 40 percent could be exposed to federal estate taxes. Take for example, a married couple with a \$50 million estate. The first \$24,120,000 passes free of estate tax. But after the initial tax free transfer, \$10,352,000 of the remaining \$25,880,000 could be payable to the federal government.

While initially \$25,880,000 may be exposed to estate tax, over time this number could grow significantly, leaving additional wealth exposed. For younger individuals, this is even more important—as they should expect significant estate growth over time.

“Owners and executives often inquire about the best time to plan for a liquidity event. The answer is simple: the sooner the better.”

Fortunately, advanced strategies can be leveraged so that growth is sheltered from estate tax. Some of the more popular strategies include Grantor Retained

Annuity Trusts (GRAT), Intentionally Defective Grantor Trusts (IDGT) and Charitable Remainder Trusts (CRT). Coupled with early planning, a wide variety of tools are available to preserve wealth and minimize tax ramifications.

It's also important to consider the potential benefits of life insurance as a mechanism to restore an estate subject to taxes and preserve the value for heirs. For example, for estates greater than \$10 million, the business owner may decide to establish an Irrevocable Life Insurance Trust (ILIT) to hold permanent insurance designed to pay a certain benefit amount to heirs, free of estate tax. Based on the goals of the family, insurance strategies can be used to replace the value lost from taxes, ensuring that hard earned wealth is transferred in full to future generations.

“As of 2022, the IRS allows each individual to gift up to \$16,000 per beneficiary, per year without incurring gift taxes or using up any portion of one's lifetime exclusion amount (\$12,060,000). When gifts are given within the annual exemption amounts, a gift tax is avoided.”

Sheltering wealth through early planning

A wide range of strategies and tools are available before a liquidity event occurs, and they vary based on the family's lifestyle and their future and personal goals. Working with an experienced advisory team is critical during the early planning stages because the missed opportunities can be substantial. Key advisors can work together to assist with taking advantage of the best options early in the process and sheltering wealth to achieve future financial goals.

PRE-LIQUIDITY VALUATION

For liquidity events, successful planning starts before you are certain a transaction will occur. While personal planning doesn't change the actual business, it does allow for the significant shareholder to take advantage of valuation discounts for lack of marketability and control, thus increasing the attractiveness of early gift and tax planning. For example, in a pre-liquidity valuation, stock is usually evaluated at a lower price when compared to the eventual sale or IPO price. Shareholder preferences, illiquidity, and lack of control all contribute to the shareholders ability to take additional discounts on the listed pre-liquidity evaluation—making transfers to heirs, trusts and other family members even more effective due to the lower basis.

Obtaining an outside independent appraisal is useful in determining fair value of gifting and other strategies. Given the available illiquidity discounts and lack of control aspects noted above, there are good reasons to pay the additional cost of obtaining an independent appraisal in order to take advantage of these discounts and therefore obtain an even lower valuation for personal planning purposes.

“Working with an experienced advisory team is critical during the early planning stages because the missed opportunities otherwise could be substantial”

GIFTING OF SHARES

For owners interested in transferring wealth to family members, there are many different gifting options available. Depending on the individual's goals and strategies, gifts can take a number of forms. As of 2019, the IRS allows each individual to gift up to \$16,000 per beneficiary, per year without incurring gift taxes or using up any portion of one's lifetime exclusion amount (\$12,060,000). When gifts are given within the annual exemption amounts, a gift tax is avoided. For larger gifts above the \$16k per person threshold, a portion of the lifetime exclusion can be applied to avoid current gift taxes; however, this will deplete the available lifetime exclusion amount available for additional planning at a later date.

“In the case of children or young adults as gift recipients, a trust is often created to benefit those who aren't yet prepared to manage wealth effectively.”

Once a gift has left the donor's estate, future appreciation on the stock accrues on behalf of the recipient, more often than not, the younger generation. This is an important part of the pre-liquidity planning process because a low cost basis allows one to transfer a greater number of shares using the annual and lifetime exclusions noted above. Therefore, this gives the grantor the ability to shift a greater value to the next generation. The anticipated rapid increase in value after the deal is finalized would occur outside the grantor's estate.

LEVERAGED GIFTS

An individual may not want to use the \$12,060,000 per spouse lifetime exclusion amount, that passes free of gift tax, for several reasons. The credit may have already been used, the individual may want to preserve the credit for other wealth transfer uses or the person's net worth might be so large that a \$12,060,000 gift will not significantly reduce taxes. In these circumstances, leveraged gifts are beneficial, allowing the donor to target a given amount of wealth to transfer without using up valuable exemption amounts.

In a "leveraged gift" strategy, the owner retains a portion of the gift, which reduces the equity and gift tax exposure. When the value increases due to the liquidity event, so does the "equity" value of the gift that benefits family members. The appreciation allows more value to transfer to younger generations. This type of gift can be accomplished through Grantor Retained Annuity Trusts (GRAT) or sales to an Intentionally Defective Grantor Trust (IDGT). Each approach has unique benefits and advantages.

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(GRAT)

A GRAT allows the owner to transfer assets in exchange for an annuity. The annuity is payable over a specific period of time and the annuity amount is calculated so the present value is equal to the value of the property placed in trust. As a result, no gift tax is due. Present value calculations are based on the IRS prevailing interest rate. When stock is transferred and it appreciates in excess of the annuity amount, the excess amount remains in trust for the beneficiaries and is transferred free of gift and estate tax.

SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUST (IDGT)

A sale to an IDGT can also be established to benefit family members. Once the trust is set up, it purchases shares from the owner at fair market value. The donor receives a note from the trust with a specific interest rate. The original shareholder is treated as owning the asset sold to the trust, and therefore interest payments and principal on the note are not taxable.

The transaction is not treated as a gift as long as the interest rate is at least equal to prevailing rates published by the IRS. When stock appreciates beyond the debt payments, including interest and principle, the excess remains in the trust and passes to heirs free of gift and estate taxes.

The creator of the GRAT and IDGT is responsible for paying income and capital gains tax. However, this allows the full pretax value of trust assets to build while the owner's estate is depleted by the amount of taxes paid. Both the GRAT and IDGT have distinct benefits and pre-liquidity is the ideal time to implement these strategies, especially for an IPO event. Significantly higher public market valuations of an asset can produce a large wealth transfer.

NOTE: On the other hand, if shares appreciate beyond the actuarial annuity amount imputed in the GRAT strategy, then the appreciated portion will transfer to heirs, with the remaining principal amount returned to the client. With today's low interest rates, even a modest rate of share appreciation could result in significant dollars transferred. If shares are sold while still held by the GRAT, the client retains the ability to pay any applicable capital gains tax without the tax payment being classified as a gift. Thus a larger amount can be transferred to heirs.

ASSESSING STOCK OPTIONS

Stock options should be evaluated before a liquidity event takes place. For example, compensatory stock options can be a large asset for executives and owners, presenting some interesting challenges during a liquidity event. Individuals may eventually want to exercise options or liquidate shares, which will trigger tax exposure. Here are some important considerations.

NON-QUALIFIED OPTIONS (NQ)

The spread between a stock's fair market value and exercise price is treated as income when an executive exercises non-qualified options. This spread is taxed based on the individual's tax bracket and is subject to employment taxes and withholding. Depending on the holding period, gains or losses after the exercise of the option may be treated as short-term or long-term capital.

At exercise, the executive has two choices: they can simultaneously exercise and sell the shares, or they can choose to exercise and hold the shares for some period of time. If the shares are held more than 12 months after an exercise and hold strategy, any gain would be treated as long-term capital gains instead of ordinary income. For owners who find themselves in the maximum tax bracket, the tax savings could be substantial to exercise early and hold for capital gains treatment.

INCENTIVE STOCK OPTIONS (ISO)

Executives who meet holding-period requirements may benefit from additional tax advantages because compensation income is not produced upon exercise. Although ISOs may be subject to the alternative minimum tax (AMT), executives can later claim credit for the paid AMT. The credit amount depends on income and deductions in later tax years.

To further illustrate why it is also important to consider early exercise of stock options, we can look at a simplified example. Let's say you have an option at \$1 per share. After five years, you exercise and sell at \$5 per share—worth \$5,000 total. When you sell, you pay taxes on the full \$4 spread at your ordinary income rates—losing 40 percent or more of the value to taxes. Instead, let's say you had planned ahead and decided to exercise at \$1.10 per share and pay taxes on the \$0.10 spread—a minimal amount. When the stock reaches the same \$5 per share price, you sell it. Since you've held the shares for more than 12 months, long-term capital gains tax is assessed on the spread instead of the income tax rate, generating a significant tax savings. In fact, depending on how much stock is owned, this could amount to hundreds of thousands of dollars in tax savings simply by addressing options before the liquidity event occurs.



“Depending on how much stock is owned, exercising options early, before the liquidity event occurs, could amount to hundreds of thousands of dollars in tax savings.”

After the event: post-liquidity considerations

While it's true that more opportunities exist during the pre-liquidity planning stage, there is still plenty to accomplish after the transaction is complete. The best approach depends on the type of transaction—such as the all-cash deal, stock deal or IPO event—and the actions taken before the liquidity event.

ALL-CASH DEAL

An all-cash deal may limit some of the planning opportunities; however, there are still opportunities to shelter wealth from taxation. For example, in cases of closely held businesses, there can be significant value in evaluating the ownership structure of the business. Depending on the potential exit, it can make sense to reorganize in advance of a deal. In cases where this is not an option, taking advantage of retirement and deferred compensation contributions can be leveraged to protect wealth and drive down taxable income. Individuals should also consider any charitable inclinations, such as establishing a Family Foundation, Donor Advised Fund, Charitable Remainder Trust or outright gifts to charity. This can serve a dual benefit, providing a significant tax benefit, while at the same time accomplishing a social benefit to the donor and his or her designated charities.

After the liquidity event, advisors can also evaluate how money is being held to limit tax exposure. For example, investors may qualify for special tax treatment on capital gains tax under section 1202 of the IRS code. Additionally, there may be capital gains exemptions available for deal proceeds used to purchase another qualifying small business.

STOCK DEAL

For a stock deal, it's important to understand the ramifications of holding stock that is now public. Evaluations of private companies are infrequent and the shares are generally illiquid, but that changes when the company becomes public. A public company becomes subject to daily valuations; and because of this, fluctuations in net worth will be substantial.

Therefore, a decision must be made about how much stock to hold and how much to sell. It's a difficult balance to strike when evaluating the desire to preserve hard earned wealth but maintain participation in the upside of the business. However, not diversifying the shares when given the chance could be a significant mistake. Proper planning will help to mitigate this risk.

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HEDGING STRATEGIES

Depending on the shareholder's position within the company, hedging may be possible. Hedging can provide a specific amount of protection from downside risk, but will also cap some of the upside. This is most commonly achieved through a “collar.” For example, let's say a stock is valued at \$100 and the goal is to avoid participating in any losses below \$90. In exchange for applying protection against any moves underneath \$90, the stock owner is allowed only a certain amount of upside—\$12 of upside in this example. So if the stock rallies up to \$115, the stock owner receives the benefit; however, after the \$115 mark nothing further is earned. The result is a locked in valuation range and a deferral of an actual sale.

Some hedging strategies also give shareholders the ability to receive cash without actually selling the stock. Generally referred to as monetization collars,



this approach involves having the stockholder enter into a collar transaction as described above and at the same time entitles the holder to receive a lump sum of cash in the form of a loan from that locked in equity value. These borrowed funds can be withdrawn and used for whatever purpose the owner chooses, such as paying off debt, purchasing a home or even investing in a diversified portfolio of securities. Additionally, withdrawing without selling reduces tax liability at the present point, with the assumption that tax liability might be lower in the future. Other hedging strategies to consider, like post liquidity for stock deals, involve establishing a “put position,” which appreciates in value if the stock value declines, thus offsetting some of the losses. This strategy comes with some expense, though, since it’s essentially buying insurance on the stock.

EXCHANGE FUNDS

This is another tool that assists with diversifying concentrated holdings. It’s essentially a partnership comprised of holders from a number of different companies that combine holdings to create a diversified portfolio. All investors contribute shares to the fund and own a piece of the entire pool of assets, compared with owning just their initial stock. Contribution to the exchange fund is not a taxable event given that specific conditions are met.

For example, a certain portion of the exchange fund’s portfolio must consist of assets other than stock, securities or other named categories of assets. The result is a tax-deferred diversification of the investor’s holdings. Investors should be prepared to maintain the exchange fund for several years, because distribution before that may be taxable.

IPO EVENT

Once a company goes public, shareholders will be subject to lockup, which is an agreement between the business and investment bank taking the organization public. The agreement states that shares cannot be sold within a specific period of days after the IPO event, usually 180 days. Once the contract is fulfilled and the lockup has expired, shares are generally free to be sold in the marketplace.

Most of the strategies articulated in the preceding “stock deal” section are available at this point. For example, stock can be sold or hedged, or a monetization collar strategy can be used. Executives should also consider diversifying concentrated holdings and strategies focused on minimizing current taxation.

CHARITABLE REMAINDER TRUSTS (CRT)

CRTs are a common tax-deferral technique, especially with investors focused on combining charitable giving with tax-deferred diversification. The CRT pays an annual distribution to a beneficiary. When the CRT is established, the donor receives a charitable donation deduction that is equal to the present value of the charity’s expected remainder interest. All income earned by the CRT is untaxed until distribution to the beneficiary occurs.

The holder of stock can sell the shares, not pay capital gains and re-invest the whole amount of the proceeds into a diversified portfolio. The diversified portfolio will remain in trust and income will be distributed annually to the donor. At the end of the trust term, or the donor’s life, whichever option is selected, the remainder value will pass to the charity or charities of the donor’s choice.

IPO EVENT, EXECUTIVE OFFICER / SECTION 16 INSIDER

Corporate officers of companies involved in an IPO event have an entirely different layer of restrictions. For example, they are subject to a level of reporting to the public whenever a transaction is made. Within 48 hours of doing anything with stock—including gifting it, selling it or exercising options—they must report it. They are also subject to material insider information rules. To manage these rules, owners should consider special planning resources post-liquidity.

10B5-1 PLANS

Without this type of plan, owners are confined to selling or transacting company stock during “open windows.” This is typically three business days following an earnings announcement. To manage these rules and restrictions, some executives opt to use a 10b5-1 plan. These plans are filed with the SEC and include a stated-in-advance program with which the officer establishes some metrics inside the plan before relinquishing control. The plan is essentially on autopilot—with a trader associated with the selling system—generally based on price, number of shares and/or certain dates.

Once these items are established, they should not be modified. Modification is only possible if it’s allowed under the insider trading policy of the company and the holder is within an open window.

10b5-1 plans must be adopted during an open window and generally have a cooling-off period of anywhere from two weeks to 90 days.

“Without a 10b5-1 plan, owners are confined to selling or transacting company stock during “open windows.”

INSIDER TRADING POLICIES

After the transaction is complete, an understanding of insider trading policies becomes important. This can include restrictions on how stock is sold and whether hedging is allowed. An experienced advisor can help the owner navigate concerns and questions involving corporate insider trading policies.

ON-GOING MONITORING

A liquidity event is a milestone of success. Owners and executives work hard to build a business, and closing a transaction brings that hard work full circle. Moving forward, individuals should continue to reassess and monitor strategies executed before and after the liquidity event, to ensure the strategies are performing as expected and make any necessary adjustments that reflect changing goals and plans for the future.





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