# Pre-IPO Lifetime Gifts of Stock or Options

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Founders and officers of startup companies who own company stock and stock options should not pass up the opportunity to realize significant tax savings by waiting until their company has gone public to make gifts of that stock.

Specifically, the best opportunity to transfer the stock to family members or others is available only *before* the company goes public. An illustration should make this clear:

Assume that XYZ Corporation stock is presently valued at $1 per share. Our client, the founder and CEO of XYZ Corporation, transfers 100,000 shares of stock to an irrevocable trust established for the benefit of his or her children. He or she has made a taxable gift of $100,000 (subject to limited exceptions, gifts to trusts typically do not qualify for the annual gift tax exclusion).

Provided that neither our client nor his or her spouse has utilized any of their respective $675,000 federal estate and gift tax exemptions during their lifetimes, they may each elect to treat the transfer as if one-half of it were made by each of them, and apply $50,000 of their respective exemption amounts to the gift. Thereafter, each would have $625,000 of exemption still available to apply against additional lifetime taxable gifts or against estate taxes at death.

Assume that after the gift to the trust has been made, XYZ Corporation goes public or is purchased by another company. The stock now climbs to a value of $10 per share, so that the current value of the 100,000 shares transferred to the trust has increased to $1,000,000. The benefit? $900,000 of value has been transferred estate and gift tax-free.

Of course, there is always a risk that the stock would decrease in value after the transfer to the trust. In that case, the estate and gift tax exemption utilized will have been wasted. However, the risk is often worth taking when measured against the risk of *not* making the transfer to the trust before the stock increases. For example, if our client waited to transfer the stock to the trust until *after* the stock has increased in value, our client and his or her spouse would *each* consume $500,000 of their respective $675,000 exemptions, leaving little opportunity for any further tax-free lifetime giving, and very little of such estate tax exemptions available upon their deaths.

Of course, after the IPO the stock of XYZ may continue to appreciate, and all subsequent appreciation in its value will escape estate and gifts taxes in the estates of both our client and his or her spouse. Depending upon the terms of the trust and additional planning with respect to the Federal generation-skipping transfer ("GST") tax, trust assets may also pass tax free not just to children but also grandchildren and more remote descendants.

On balance, contributing the stock to the trust before the company goes public is very often a risk well worth taking.

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The Grantor Retained Annuity Trust - Reducing Taxes by Delaying Gifts

Almost everyone wants to minimize estate and gift taxes and maximize assets passing to his or her family. The Grantor Retained Annuity Trust ("GRAT") is a powerful estate planning technique that, in the right situation, can help a client obtain these twin objectives by transferring substantial assets to family members at almost no transfer tax cost.

**How a GRAT Works**

The client establishes a GRAT (an irrevocable trust) and gifts assets to the GRAT. The client retains the right to receive an annuity from the GRAT, consisting of either a fixed dollar amount or a fixed percentage of the initial value of the trust's assets, but only for a term of years. After the annuity term ends, the client's interest in the GRAT terminates, and the trust property is transferred to (or held in trust for) another beneficiary or beneficiaries.

The client is deemed to have made a gift to the remainder beneficiary or beneficiaries when the GRAT is initially funded. However, the value of the client's gift is reduced by the actuarial value of the client's retained annuity. The actuarial value of the annuity is a function of the applicable Internal Revenue Service interest rate (the Section 7520 rate), the amount of the annuity payable to the client, the number of years for which the annuity is payable, and the age of the client at the time the GRAT is established. The lower the Section 7520 rate, the higher the value of the client's reserved annuity, and the lower the gift tax value of the gift. Similarly, the longer the annuity term, and the larger the annuity, the lower the gift will be.

If the client outlives the annuity term, none of the trust assets will be subject to estate tax upon his or her death. In particular, all of the appreciation in the value of the trust assets after the client contributes them to the trust will be excluded from the client's estate. In addition, if the client has contributed assets to the GRAT that produce income above the relevant Section 7520 rate (currently 7.4%), the additional income is also accumulated for the remaining beneficiaries of the trust without additional gift or estate taxes.

Despite all of their potential benefits, a GRAT involves one significant risk. If the client dies during the term of the annuity, all of the benefits of the GRAT are lost, and the client's estate taxes will be the same as if the GRAT had never been created. Specifically, all of the GRAT's assets would be reincluded in the client's gross estate for estate tax purposes at their date of death value. On the other hand, any estate and gift tax exemption used by the client when he or she created the GRAT would be restored to the client's estate, to be applied against estate tax liabilities, and any gift tax payment made upon creation of the GRAT would be credited in full against such estate taxes. In order to minimize the risk, a client should consider creating a GRAT with an annuity for a term of years that he or she is very likely to outlive.

**In Conclusion**

In conclusion, a GRAT is an excellent estate planning vehicle for a client who has assets that are likely to appreciate substantially in value, who has a life expectancy of several years or more, and who wishes to retain an interest in the trust property for several years before such property passes to other beneficiaries.

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Planning for Key Executives and Investors Before an IPO: The Benefits of A "Defective" Grantor Trust

Key executives and investors who hold stock in a company which is contemplating an initial public offering should consider the sale of stock to a "defective" grantor trust as part of a sound estate planning strategy.

Such a trust takes advantage of opportunities created by the "grantor trust" rules which affect income taxation of certain irrevocable trusts. The rules were enacted to prevent the shifting of income from a high tax bracket individual (the grantor) to a trust, or to trust beneficiaries, in lower tax brackets, typically the grantor's children or grandchildren. Decades ago, when such rules were adopted, there was a wide "spread" between the lowest and highest federal income tax brackets, with a top marginal tax rate of 91%. The rules provide that, if the grantor retains (even indirectly) certain controls over the trust property, the grantor, rather than the trust or its beneficiaries, will be taxed as the owner of the trust's income, deductions, and credits, regardless of who actually receives distributions of trust income. Therefore, tax planners sought to avoid grantor trust treatment when drafting trust documents.

Since the top marginal rate for federal income tax has been reduced to 39.6%, the focus of tax planning has shifted to the gift and estate tax, which has a top marginal rate of 55%. Tax planners may achieve significant gift and estate tax savings by intentionally violating one or more of the grantor trust rules, to create a "defect" in the trust, with the *aim* of subjecting an irrevocable trust to grantor trust status.

So-called "defective" grantor trusts exploit the disparities between the income tax and the estate tax rules applicable to irrevocable trusts. While the grantor trust rules treat the grantor as the owner of trust assets for federal *income* tax purposes, transfers to a defective grantor trust are completed gifts for federal gift tax purposes. Therefore, none of the trust property is reincluded in the grantor's gross estate for federal *estate* tax purposes upon the grantor's death.

Two principal income tax benefits are derived from the use of a defective grantor trust. First, because the grantor is treated as the owner of the trust, the income generated by the trust's assets is taxed in the grantor's personal income tax return (as if the trust did not exist), but the trust's income is held in the trust or distributed to the trust's beneficiaries. The grantor's payment of such income taxes is the economic equivalent of an additional gift to the trust (equal to the trust's income tax liabilities). However, the grantor incurs no gift tax in conjunction with such tax payments because he or she is merely extinguishing his or her own liability.

By selling assets such as corporate stock to a grantor trust, the grantor may generate further tax savings. For maximum benefit, such a sale should take place prior to the IPO because all appreciation in value subsequent to the sale will escape estate and gift taxes.

Specifically, the grantor would first make an initial contribution to the trust (e.g., $100,000), constituting a taxable gift. The individual would then sell much more substantial assets (e.g., $1,000,000) to the trust in exchange for a promissory note. The amount of the initial gift of trust property should be large enough to ensure that the trust has the financial resources to repay the amount due under the promissory note.

Under the terms of the note, the trust would be required to pay the grantor only interest for a lengthy period of time. A balloon payment would be due at the end of the note's term. However, the trust would always have the right to prepay the principal balance in whole or in part.

The interest rate would be determined by reference to IRS tables, which are updated monthly and are intended to preclude the trust from paying interest at rates materially below market rates. Very often, the trust assets produce an overall return in excess of the interest paid to the grantor. If so, any such excess return is retained by the trust free of estate and gift taxes.

The most important element of this plan is that no gain or loss is recognized, for capital gains tax purposes, when principal payments are made to the grantor by the trust because the trust is treated as the grantor's alter ego for income tax purposes. If the grantor dies before the trust repays in full the amount due to him or her, the value of the promissory note will be included in the grantor's gross estate for estate tax purposes. However, the lowest interest rate the grantor may charge, while complying with applicable IRS rules, will still be somewhat below market rates of interest, and therefore the fair market value of the note for estate tax purposes may be less than its face value.

One caveat: if the amount due to the grantor is not repaid prior to the grantor's death, installment payments made following the grantor's death *will* generate capital gains taxes. For this reason, if at any time it appears that the grantor has a short life expectancy, it is important that the trustees act swiftly to repay the entire balance due to the grantor. However, any such repayment would not be paid in cash. Instead, the trustees would repay the amount due to the grantor by using appreciated securities, which have a low cost basis but a fair market value equal to the amount due. Once again, neither the grantor nor the trust will recognize any capital gain when such appreciated securities are used to make the repayment.

If the amount due to the grantor is prepaid in full, upon the grantor's subsequent death the promissory note would no longer exist. Instead, the grantor's estate would include the securities transferred to the grantor by the trust to pay its indebtedness to the grantor. However, like all other assets in the grantor's estate, such securities will receive a new cost basis upon the grantor's death, equal to the fair market value of such assets as finally determined for estate tax purposes.

Melinda Page Carnes

Strategies for Making Gifts to Charities and Spouses

Donors making gifts to charities or spouses have an opportunity to realize substantial tax savings. In some instances, these savings can be maximized by making gifts of assets that have substantially appreciated in value. Such gifts can have particular importance for people who, because of an IPO or other transition, hold securities that have appreciated substantially in value.

**Gifts to Charities**

A gift to charity during the donor's lifetime typically results in an income tax deduction. The amount of the deduction, however, can vary depending on the nature of the gift and the type of charity.

In general, a donor making gifts of *cash* to public charities such as churches, hospitals, schools, and charities which receive substantial public support may deduct up to 50% of his or her adjusted gross income (computed without regard to any net operating loss carryback for the year). In contrast, gifts of cash to most private foundations will allow a donor to deduct up to 30% of his or her adjusted gross income. In either case, contributions in excess of the maximum deductible amount may be carried forward and deducted in the next year, subject to the same percentage limitations. If necessary, the deduction can be carried forward for up to five years.

For example, assume a donor with adjusted gross income of $100,000 makes a gift of $70,000 in cash to a public charity. The donor may deduct up to $50,000 in the year of the gift. The balance of $20,000 may be deducted in future years. The following year, if the donor has the same adjusted gross income and donates $45,000 in cash to a public charity, then in addition to the $45,000 deduction, the donor may deduct $5,000 from the carryover balance of $20,000. The remaining $15,000 can be carried into the following year.

The potential tax savings increase significantly when the donor gives to a public charity long-term capital gain property (in general, property held for more than one year). Such a contribution is deductible up to the full amount of the asset's fair market value. However, the deduction is subject to a reduced ceiling of 30% of the adjusted gross income. Furthermore, if the gift is made to a private foundation, the deduction is limited to 20% of adjusted gross income, but only for contributions of certain publicly traded securities (any other asset contributed to a private foundation, except cash, generates a deduction limited to the donor's cost basis).

For example, a taxpayer with adjusted gross income of $100,000 makes a gift to the public charity of $54,000 in securities with a basis of $15,000. The amount of the deduction will be $30,000 (30% of $100,000) with a carryover of $24,000. If no contributions are made the following year, and the adjusted gross income remains the same, then the full $24,000 can be deducted. If the above gift were instead made to a private foundation, then the deduction would be limited to the $20,000 (or, if the securities were not publicly traded, the deduction would be limited to the cost basis of $15,000), but the balance of the contribution would be carried over for up to five years.

This tax structure offers obvious benefits to a shareholder of a company involved in an IPO who now owns securities with a high market value but a low cost basis. In the above example, the donor ultimately receives an income deduction for $54,000, without ever being required to pay tax on the $39,000 of capital appreciation. Of course, when the charity sells the securities, it will not be taxed on the appreciation. Everyone wins - except the government.

**Gifts to Spouses**

As with gifts to charities, there are tax advantages to making a gift to spouses of property that has already appreciated in value.

Under current law, $675,000 of a decedent's estate, minus any taxable gifts made during his or her lifetime, will pass free of estate taxes upon his or her death. This amount will increase in stages each year to a maximum of $1,000,000 in 2006 (or sooner under proposed legislation). All property passing to a decedent's spouse is entitled to the estate tax marital deduction, thereby also passing free of estate taxes. Accordingly, in a typical arrangement for couples with substantial assets, each spouse has an estate plan by which $675,000 (or up to $1,000,000 in 2006) passes to beneficiaries free of estate taxes, and the remainder is left to the surviving spouse. Thus, no estate taxes are paid on the first spouse's death, and each spouse has taken full advantage of his or her lifetime estate and gift tax exemption.

This plan can be thwarted, however, if one spouse owns all the assets. To use a simple example under current law, assume the wife has an estate of $1,350,000 and her husband has an estate of nothing. If he dies first, his exemption will have been wasted. Upon the wife's subsequent death, her estate could be subject to estate taxes on $675,000 ($1,350,000 minus her exemption of $675,000).

Accordingly, a typical estate planning strategy involves transfer of assets from the spouse who already holds sufficient assets to use his or her exemption in full to the spouse who has insufficient assets. In the above example, if the wife makes a gift of $675,000 to her husband or to a "QTIP" trust for his benefit, so that each spouse's estate will then be worth $675,000, they will each be able to take full advantage of their respective estate and gift tax exemptions.

Making a gift of appreciated assets can be an obvious way of achieving this result. For example, if the wife had securities with a cost basis of $100,000, but a fair market value of $675,000, a gift of the securities will increase the husband's estate by $675,000. This may be more attractive to the wife than transferring cash or property with a cost basis of $675,000.

Another significant advantage of gifting appreciated assets occurs when it appears that the donee spouse is ill and likely to die first. By gifting appreciated assets, the asset will receive a "stepped-up" basis upon the donee spouse's death, provided that the donee spouse lives at least one year after the gift (or, even if the donee spouse dies within one year, provided that the donee spouse leaves such assets under his or her estate plan to persons other than the donor spouse). In the above example, if the husband dies two years after the gift is made, the securities will receive a new cost basis of $675,000 (or whatever the fair market value of the securities may then be), rather than

$100,000. Substantial tax savings will result if the recipient (a trust or an individual beneficiary) later sells the securities.