Tax Benefits of Advance Planning

Estate planning strategies for founders are typically focused on saving both income taxes and estate taxes. Income tax savings can be achieved by creating and funding multiple trusts with company stock that duplicate any available QSBS exemptions and by designing trusts when possible to be exempt from state and local income taxes that may otherwise apply to the founder personally. Estate tax savings can be achieved by designing trusts that are not includible in the founder's estate at death and can benefit children or further generations without estate tax.

Because these strategies usually require the founder to make gifts of company stock to trusts, and the value of those gifts will count against lifetime exclusions from gift and estate taxes, these tax goals are almost always easier to accomplish earlier in the life cycle of a company.

To understand the key tax benefits of estate planning, let's take a look at both the income taxes and estate taxes faced by two hypothetical co-founders with identical circumstances – Jill and Kate. Jill and Kate are each married, live in New York City, and have two children. They will each realize $100 million cash gain upon a hypothetical exit. Each's stock is QSBS-eligible and has been held for more than 5 years. Jill did no advance estate planning and owns 100% of her stock in her own name. Kate worked with her legal team at Patterson Belknap several years ago to implement estate planning designed to reduce taxes. Her stock is owned 70% in her name and 30% divided equally among three separate trusts for the benefit of her spouse and two children that were carefully designed to achieve the goals described above. Because Kate accomplished this planning early (*i.e.* at a time of lower valuation), the stock that Kate gifted to the trusts several years ago was worth $3 million at the time of the gift – $1 million per trust.

Let's take a look at where Jill and Kate ended up. (Note that for the sake of illustration, dollar amounts and tax rates are rounded and employ some simplified assumptions about Jill's and Kate's tax situations.)

Jill's Exit (No Planning)

Income Tax Analysis

- The first $10 million received by Jill should be excluded from Federal, New York, and New York City taxes as QSBS.
- Balance subject to tax at 23.8% Federal and 14.8% New York State and New York City taxes, for a total rate of ~39%.
- The Tax on the $90 million not sheltered by QSBS is ~$34 million.
- Jill's net after tax proceeds would be ~$66 million.

Estate Tax Analysis

- Let's assume Jill and her spouse have made no lifetime gifts, have no other assets, and the value of their after-tax proceeds remained constant during their lives after the liquidity event.
- The current combined Federal estate tax exclusion is ~$24 million for a married couple. Amounts over $24 million are taxed at ~50% including Federal and New York estate tax.
- Jill's estate is $66 million and the combined estate tax would be ~$22 million
- The net after tax proceeds received by Jill's children would be ~$44 million.

Katie’s Exit (With Trust Planning)

Income Tax Analysis

- The first $10 million received by Kate and by each of the trusts ($40 million total) should be excluded from Federal, New York State, and New York City taxes as QSBS.
- Balance subject to tax at 23.8% Federal and ~14.8% New York State and New York City taxes, for a total rate of ~39%.
- The trusts will pay no income tax since each trust receives $10 million of proceeds from the sale, all of which is sheltered.
- The tax on the $60 million not sheltered by Kate’s QSBS exemption is $23 million.
- Kate’s net after tax proceeds would be ~$47 million.
- Including the $30 million received by the trusts, Kate’s family received $77 million in total.
- ***This is $11 million more in the aggregate than Jill received.***

Estate Tax Analysis

- Let’s assume Kate and her spouse have made no gifts other than the stock gifted to the trusts, have no other assets, and the value of their after-tax proceeds remained constant during their lives after the liquidity event.
- The current combined Federal estate tax exemption is ~$24 million for a married couple, but Kate and her spouse only have $21 million available at death since they used $3 million when they gifted to the trusts.
- Amounts over $21 million are taxed at ~50% including Federal and New York estate tax.
- The funds in the trusts are not subject to estate tax, so Kate’s estate is only $47 million, and the combined estate tax is ~$14 million.
- The net after tax proceeds received by Kate’s children would be ~$33 million from her estate and $30 million from the trusts, a total of $63 million.
- ***This is $19 million more in the aggregate than Jill’s family received.***

As you can see, the tax savings resulting from advance estate planning can be dramatic. However, this is just the beginning of the story, because our assumptions have not taken into account asset appreciation in the years or decades after the liquidity event. If the cash in the trusts that Kate created is invested after the liquidity event, the assets will continue to appreciate without being subject to the ~14.8% New York State and New York City income tax. The compounding effect of that tax savings over a long period of time could be tremendous. In addition, all of that appreciation is outside Kate’s estate and may benefit her children, grandchildren and future generations without estate or generation-skipping tax. ***If these long term tax benefits are taken into account, the disparity between the after-tax proceeds received by Jill’s family versus Kate’s family would be far greater than $19 million.***

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

FOUNDER FOCUS

Patterson Belknap

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact a member of the Founder Focus team:

Michael S. Arlein	212.336.2588	msarlein@pbwt.com	Estate Planning
Brian M. Sweet	212.336.2349	bsweet@pbwt.com	Estate Planning
Edward H. Smoot	212.336.2168	ehsmoot@pbwt.com	Corporate/Employment
Douglas L. Tang	212.336.2844	dtang@pbwt.com	Corporate/Employment
Robin Krause	212.336.2125	rkrause@pbwt.com	Philanthropy
Justin Zaremby	212.336.2194	jszaremby@pbwt.com	Philanthropy

To subscribe to any of our publications, call us at 212.336.2813, email info@pbwt.com or sign up on our website, https://www.pbwt.com/subscribe/.

This publication may constitute attorney advertising in some jurisdictions.
© 2022 Patterson Belknap Webb & Tyler LLP