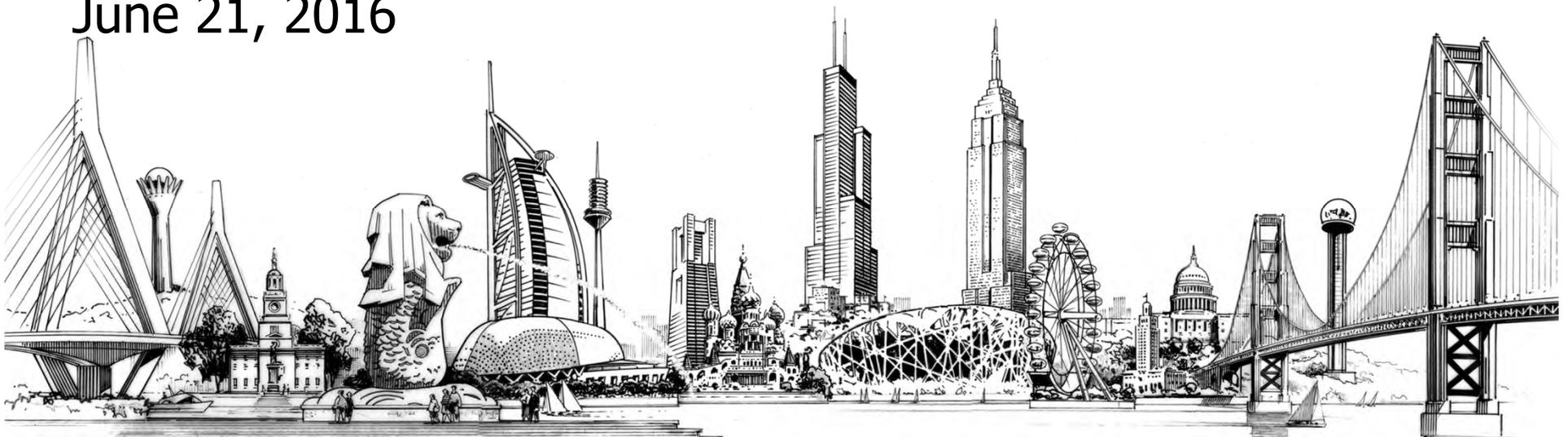


**Morgan Lewis**

**M&A ACADEMY: ESTATE  
PLANNING IN  
CONNECTION WITH  
M&A TRANSACTIONS**

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# Why Estate Planning

- It's not just about drawing up a will to name guardians for children and dispose of assets at death.
- Estate planning creates structures to hold and transfer assets during life as well as at death.
- Good estate planning avoids or minimizes gift tax, estate tax, and generation-skipping tax ("transfer taxes"), as well as income tax.



# Why Estate Planning

- The tax rate that applies for gift, estate and generation-skipping tax purposes is between 40 – 50% of the value transferred.
- The income tax rate that applies to capital gains is roughly 20%.



# Why Estate Planning

- If equity interests in a business are transferred well before a liquidity event or other value-enhancing transaction, substantial estate and gift taxes will be saved, while income taxes are unlikely to be increased.
- In many cases, good, timely estate planning can more than double the value of a deal to the client's family.



# Estate Planning – the basics

- The federal transfer tax exemption is about \$5.5 million per person, \$11 million for a married couple.
- There is an unlimited marital deduction which means that at death, Bill Gates or Warren Buffett could leave their entire estates to their wives and no estate tax would be due.
- However, the transferred assets would be included in the estate of the surviving spouse.
- The marital deduction operates to defer but not reduce taxes.



# Estate Planning – the basics

- State tax exemptions and rates vary from state to state.
- They are important but typically don't drive planning.



# Estate Planning – the basics

- In the case of a married couple there will typically be no transfer tax payable on the first death due to a combination of their exemptions and the marital deduction.
- Estate tax will generally be payable on the death of the second spouse.



# Estate Planning -- use of trusts

- Trusts provide a structure for managing assets.
- For example: Charlie Client wants to save taxes and provide funds for the future benefit of his wife and children. He doesn't have a high net worth – yet – but is optimistic his early-stage company will increase substantially in value over time. He should consider the following:



# Estate Planning -- use of trusts

- Create an irrevocable trust with an independent trustee who may make distributions to Charlie's wife and children.
- Transfer a non-voting equity interest in his company to the trust.
- Charlie will need to obtain an appraisal to document the value of his gift for gift tax purposes.



# Estate Planning -- use of trusts

- This gift tax value is low – this is an early-stage company. Assume the value is \$1 million.
- Valuation discounts would typically be available because the transferred interest is non-voting, and therefore lacks the ability to control the company, and because there is not an established market for shares of the company stock.
- Charlie will not have diluted his voting control over the company because the interest transferred was non-voting.



# Estate Planning -- use of trusts

- No gift tax was payable on the \$1 million transfer because this value is less than Charlie's \$5.5 million exemption.
- 5 years later, the company is acquired by a larger company.
- The trust receives \$10 million in the acquisition.
- The increase in value from \$1 million to \$10 million will not be subject to transfer tax.



# Estate Planning -- use of trusts

- The trust may be designed so that either the trust or Charlie must pay the tax on the gain.
- If the trust pays the tax on the gain, its value will be depleted but Charlie won't need to raise any cash to pay the tax personally.
- If Charlie pays the tax the trust will not be depleted – and Charlie will not be considered to have made an additional gift to the trust.



# Estate Planning -- use of trusts

- A trust designed so that the trust grantor pays the tax on trust income is called a grantor-type trust.
- Designing a trust in this way is tax-efficient as it provides a way to make indirect, non-taxable gifts.
- However, the trust grantor must have enough liquidity to make the tax payments.



# Estate Planning -- use of trusts

- If Charlie had not made the \$1 million gift 5 years ago, his estate would include the \$10 million. The ultimate estate tax on this amount could be \$5 million, meaning that Charlie could only benefit his family with an after tax amount of \$5 million.
- As a result of the gift in trust, Charlie's family could be better off by about \$5 million.



# Estate Planning – other benefits of trusts

- Trusts can protect beneficiaries from creditors, including divorcing spouses, and from themselves.
- Having assets held in a trust can make funds available for children, but can also help to keep children from losing drive and ambition.
- Trusts can be designed to provide for good investment management.



# Estate Planning – other benefits of trusts

- Trusts as shareholders can also be valuable to the company, as an independent trustee holding assets for the benefit of family members may be easier to deal with than dealing with the family members themselves.



# Estate Planning – earlier is better, but it's never too late

- Even if a company or its principals have signed a letter of intent, trust transfers can still save significant transfer taxes.
- Deal contingencies and uncertainties can result in substantial discounts from the ultimate sale price.
- Even if tax savings aren't optimal, the trust will still provide a good structure for managing a portion of the family's assets.



# Estate Planning – earlier is better, but it's never too late

- Example:
  - Daniel D. Ferrel is a founder of a high-tech company, Smart Genes.
  - The company has a single class of stock outstanding.
  - The company has been getting 409A appraisals. As of December 31, 2015, the appraised value of the company stock was \$50 per share.



# Estate Planning – earlier is better, but it's never too late

- Daniel owns 250,000 shares
- At \$50 /share, his stock is worth \$12.5 million.
- Daniel is 37 years old. He is married and has three children.



# Estate Planning – earlier is better, but it's never too late

- Daniel's estate planning lawyer has been advising him for several years to give some of his stock to an irrevocable trust for the benefit of his family.
- Daniel has been reluctant to part with any of his stock because he does not want his control to be diluted.



# Estate Planning – earlier is better, but it's never too late

- On February 15, 2016, the company signs a letter of intent to be acquired by a private equity fund.
- The letter of intent contemplates a purchase and sale agreement would be entered into by April 30, and, if due diligence is completed satisfactorily, the sale would close by June 30, 2016.



# Estate Planning – earlier is better, but it's never too late

- The acquisition price would be \$250/share.
- At this price, Daniel's stock would be worth \$62.5 million!
- If stock with this value was transferred by gift or at death, estate and gift taxes could amount to over \$30 million.



# Estate Planning – earlier is better, but it's never too late

- On February 16, the day after the LOI is signed, Daniel calls his estate planning lawyer.
- Daniel explains that now that he has a net worth of over \$60 million, he is ready to think about estate planning.
- “After all,” he says, “even if I end up losing \$30 million in estate and gift taxes, my family and I will still have about \$30 million left, and that’s pretty good!”



# Estate Planning – earlier is better, but it's never too late

- “We can do a lot better,” his lawyer tells him. “Here’s how.”
- Daniel and his lawyer have a good relationship with the company’s board of directors. They are able to convince the board to recapitalize the company by issuing 9 non-voting shares for each voting share outstanding.



# Estate Planning – earlier is better, but it's never too late

- When the recap has been completed, Daniel owns 250,000 voting shares and 9 X 250,000, or 2,250,000, non-voting shares.
- The estate planning lawyer explains that just because a LOI has been signed, that does not mean that Daniel's stock has instantly become worth the deal price.



# Estate Planning – earlier is better, but it's never too late

- Due diligence is yet to be completed.
- There may be substantial contingencies that must be resolved before the closing.
- Numerous statistical studies demonstrate that a large percentage of potential deals do not progress beyond a LOI or purchase and sale agreement to a closing.



# Estate Planning – earlier is better, but it's never too late

- If stock in Smart Genes is transferred, an appraiser must be retained to determine the value of the stock. The choice of appraiser is critical.
- An appraisal involving the valuation of stock which is the subject of a pending transaction is one of the more difficult assignments an appraiser will undertake.



# Estate Planning – earlier is better, but it's never too late

- In Daniel's case, the appraiser would take into account the value of the stock if no deal was pending (the "no-deal value") and also would consider the value that would result if the deal closed (the "deal value").



# Estate Planning – earlier is better, but it's never too late

- The appraiser would attempt to forecast the likelihood that the deal will close.
- It is important that the appraiser has some statistical basis for making this judgment.
- It is also important that the appraiser be sophisticated enough to assess the deal terms and to assess how significant the conditions to closing are.



# Estate Planning – earlier is better, but it's never too late

- The value that would be reported for gift tax purposes would fall somewhere between the deal value and the no-deal value.
- In general, the farther away the date of Daniel's transfer is from the closing date, the less weight will be given to the deal value.



# Estate Planning – earlier is better, but it's never too late

- Daniel decides he would like to take advantage of whatever discount from the deal price he can obtain, but he does not want to pay any gift tax.
- He also wants to retain stock with significant value. He does not want to give up any voting power.



# Estate Planning – earlier is better, but it's never too late

- Thanks to the recapitalization, Daniel can transfer non-voting stock and not reduce his voting power.
- Daniel can take advantage of his gift tax exemption and give away roughly \$5.5 million worth of stock without having to pay gift tax.



# Estate Planning – earlier is better, but it's never too late

- The problem is, how much stock would that be, given the valuation uncertainties?
- Even if the appraiser has completed the appraisal quickly, the appraiser's value estimate is not binding on the IRS. The IRS may challenge the appraised value, particularly if the deal closes at the \$250 per (original) share price.



# Estate Planning – earlier is better, but it's never too late

- Daniel and his estate planning lawyer, in an attempt to be conservative, decide that for planning purposes they will value Daniel's stock at 80% of the deal price, or \$200 per original share, in deciding how much stock to transfer to the trust.
- Daniel plans to give away \$5 million worth of Smart Genes.
- The value for gift tax purposes, based on the appraisal, may be less than this figure, but Daniel wants to leave some margin for error.



# Estate Planning – earlier is better, but it's never too late

- A \$5 million gift would be less than the amount that can be sheltered by Daniel's lifetime gift tax exemption.
- To provide even more safety, Daniel's estate planner could develop a formula to limit the value given, so that even if the IRS successfully challenges the appraised value no gift tax payment would result.



# Estate Planning – earlier is better, but it's never too late

- Often a client will worry that too much value will build up in the trust, potentially making children wealthier than the client wants them to be.
- One way to deal with this issue is to include the client's spouse as an eligible beneficiary of the trust.



# Estate Planning – earlier is better, but it's never too late

- If the Smart Genes transaction closes, stock that was valued at \$5 million for gift tax purposes could be sold for \$6,250,000.
- The \$1,250,000 value increase would be held in the trust free of gift tax and estate tax.



# Estate Planning – other techniques

- Both Charlie Client and Daniel D. Ferral were able to make good use of an immediate gift to an irrevocable trust.
- Other techniques are available that allow possible future appreciation in an asset to be transferred at no gift tax cost.



# Estate Planning – other techniques

- One common technique involves GRATs (Grantor Retained Annuity Trusts)
- GRATs allow future appreciation in an asset's value to be transferred free of gift tax.
- In a GRAT, the Grantor transfers an asset to a trust and retains the right to receive an annuity from the trust.



# Estate Planning – other techniques

- The annuity is typically calibrated so that its value, based on actuarial calculations and taking into account an assumed investment return (the “7520 rate”), is equal or almost equal to the value of the asset transferred to the trust.
- This type of GRAT is called a “zeroed-out” GRAT.
- This technique works best when interest rates are low, as they are now.



# Estate Planning – other techniques

- In April, 2016, the 7520 rate was 1.8%.
- If the asset transferred to the GRAT appreciates at a rate greater than 1.8% while held in trust, the excess value will pass to children or a trust for children tax-free.



# Estate Planning – other techniques

- If the grantor dies before the trust terminates, the trust will likely be included in the grantor's estate for estate tax purposes and the GRAT will have accomplished nothing.
- This is one of the reasons why estate planners often favor short-term GRATs, such as two-year GRATs.



# Estate Planning – other techniques

- Suppose Daniel D. Ferral transferred 10,000 shares of stock worth \$200/share to a 2-year, zeroed-out GRAT.
- The value transferred to the GRAT would be  $10,000 \times \$200$ , or \$2,000,000.
- Assuming level annuity payments, Daniel would receive 2 annuity payments of about \$1,027,000 each. (The amount is greater than \$1 million to account for the 1.8% investment return assumption.)



# Estate Planning – other techniques

- If the stock appreciated from \$200 to \$250, then after paying out the two annuity payments to Daniel, the trust would still have about \$450,000 left.
- This amount could pass tax free to children or a trust for children. The donor's spouse could also be included as an eligible trust beneficiary.



# Estate Planning – other techniques

- Imagine how much better a GRAT would have worked if Daniel had funded it when the stock was worth \$50/share rather than \$200!
- Funding a zeroed-out GRAT does not require the payment of any gift tax. If the IRS increases the value of the transferred stock on audit, all that happens is that the amount of the annuity payments increases.



# Estate Planning – other techniques

- Numerous other techniques are available to safeguard wealth, reduce taxes, and benefit charities.
- Common techniques involve planning for discounted transfers of interests in family holding companies or LLCs, installment sales to “defective” grantor trusts, and charitable lead and charitable remainder trusts.



# Estate Planning – other techniques

- Many clients are concerned about making their children too wealthy at too young an age. A good estate planner can help design trusts that will both reduce taxes and help provide a structure that will not deprive children of drive, ambition, and motivation.



# Estate Planning – what else is involved

- Your estate planning lawyer will want to discuss your goals for your family and your finances.
- If you are charitably inclined, your estate planning lawyer will be able to advise you on how to structure charitable gifts to best serve the charity and to take advantage of tax incentives.

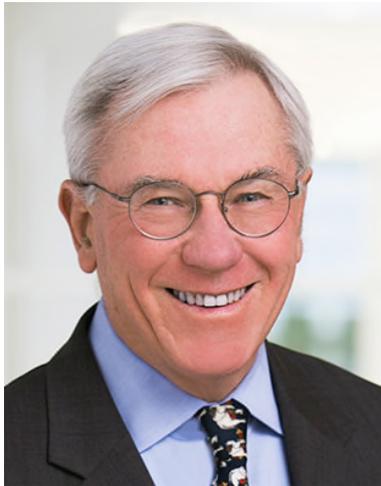


# Estate Planning – what else is involved

- The “estate planning package” will generally include wills, revocable trusts, health care proxies and durable powers of attorney.
- Often irrevocable trusts will be recommended to hold life insurance policies or to receive lifetime gifts.
- Even if current asset levels don’t exceed exemptions, possible growth in asset values may suggest tax planning is advisable.



# Biography



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With more than 35 years of experience in estate planning, Thomas E. Peckham's practice focuses on the areas of sophisticated estate planning for high net-worth individuals, estate and trust administration, and related tax and business planning. Tom serves as the Massachusetts State Chair of the American College of Trust and Estate Counsel and is a member of the State Chairs' Steering Committee.



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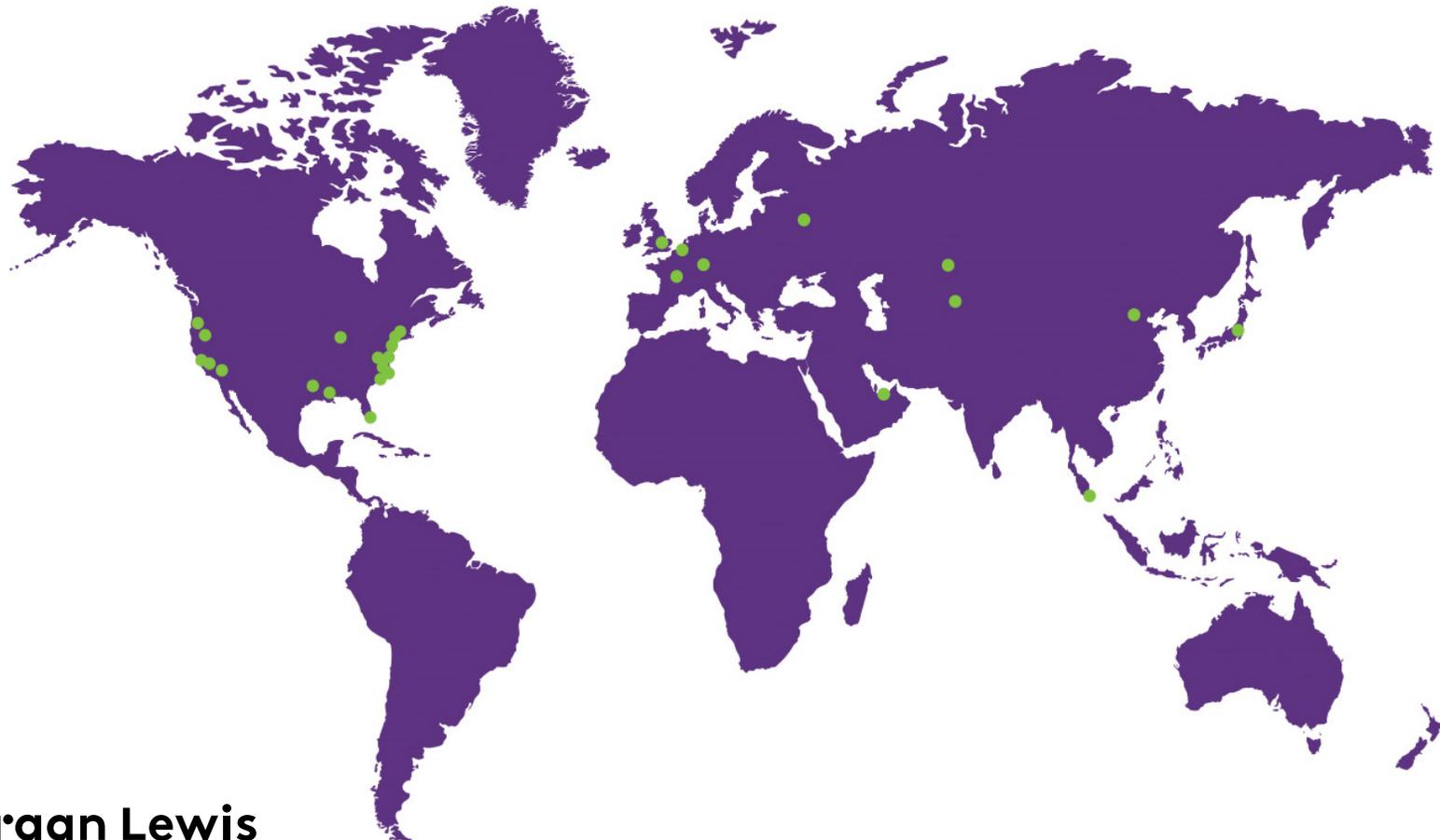
Sara A. Wells devotes her practice to estate planning, estate and trust administration, tax planning, and business succession planning. Sara assists clients in the creation of their estate plans, including establishing various irrevocable trusts to help clients make tax-efficient transfers to family members. She also administers estates, including the preparation of probate court documents and estate tax returns, and advises Personal Representatives on their fiduciary duties.

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Middle East  
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