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The Unique Challenges of Pre-Liquidity Planning in 2024 (and 2025)

Introduction

Effective pre-liquidity planning is always important for a business owner considering a sale or other transaction. But several recent and upcoming developments—related to estate laws, small-business tax exemptions, residency trends, philanthropic endeavors, and high interest rates—make 2024 a uniquely challenging year.

The following article outlines why these developments are particularly salient for founder-owned companies and offers guidance specifically tailored for them in the run-up to a liquidity event.

Looming Changes to Federal Gift and Estate Tax Exemptions

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The Tax Cuts and Jobs Act (TCJA) of 2017 significantly increased the federal lifetime estate and gift tax exemption, which reached $13.61 million for individuals and $27.22 million for couples in 2024. Without further action from Congress, those levels will effectively be halved in 2026.[1] Given mounting federal debt levels, it is likely that any push to extend the higher exemption levels will face serious resistance, regardless of which party controls the White House and Congress.

While two years might seem a long way off, founder-owners who will soon come into new wealth stemming from a liquidity event should start planning for the change as soon as they can. The necessary steps often take time and include conducting an independent valuation for estate and gift tax purposes (which can be quite different than the valuation for the company sale), establishing irrevocable trusts, and working with a trust and estate attorney and a CPA.

Depending on specific goals, family situation, and the types of assets within the estate, founder-owners may want to utilize estate-planning vehicles like GRATs (grantor retained annuity trusts) to freeze asset values and transfer future appreciation, or SLATs (spousal lifetime access trusts) in order to utilize the current high estate exemption levels before the sunset. These irrevocable trusts are tailored to each family situation and, importantly, they require time to design in coordination with tax and legal advisors because of the complexity involved.

Evolving Qualified Small Business Stock Rules

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It's also a good idea to determine whether somewhat obscure tax rules could apply to your ownership structure. Through the sale of qualified small business stock (QSBS), company shareholders in many industries can avoid taxes on up to 100% of the taxable gain on $10 million (or 10 times the aggregated adjusted basis of a stock at the time of issuance). QSBS exemptions are designed to encourage investment in small companies and have become increasingly popular—and the IRS has made some important rulings to QSBS in recent years.

One, in 2022, signaled that the IRS is willing to issue rulings to taxpayers in the process of negotiating a sale, as opposed to only after it is completed, providing greater pre-closing clarity.[2] Another ruling, in 2023, provided clarity about acceptable timing when it comes to "stacking" QSBS exemptions, a somewhat questioned practice of increasing the number of taxpayers—often family members or trusts—who are eligible.[3] For companies that meet the QSBS criteria, it is important to understand the recent rulings, particularly when it comes to timing.

1 *Congressional Research Service, Expiring Provisions in the "Tax Cuts and Jobs Act" 11-21-23*
2 *IRS PLR-122237-21 03-02-22*
3 *US Tax Court Memo 2023-24*

Domicile Migration and State Tax Crackdowns

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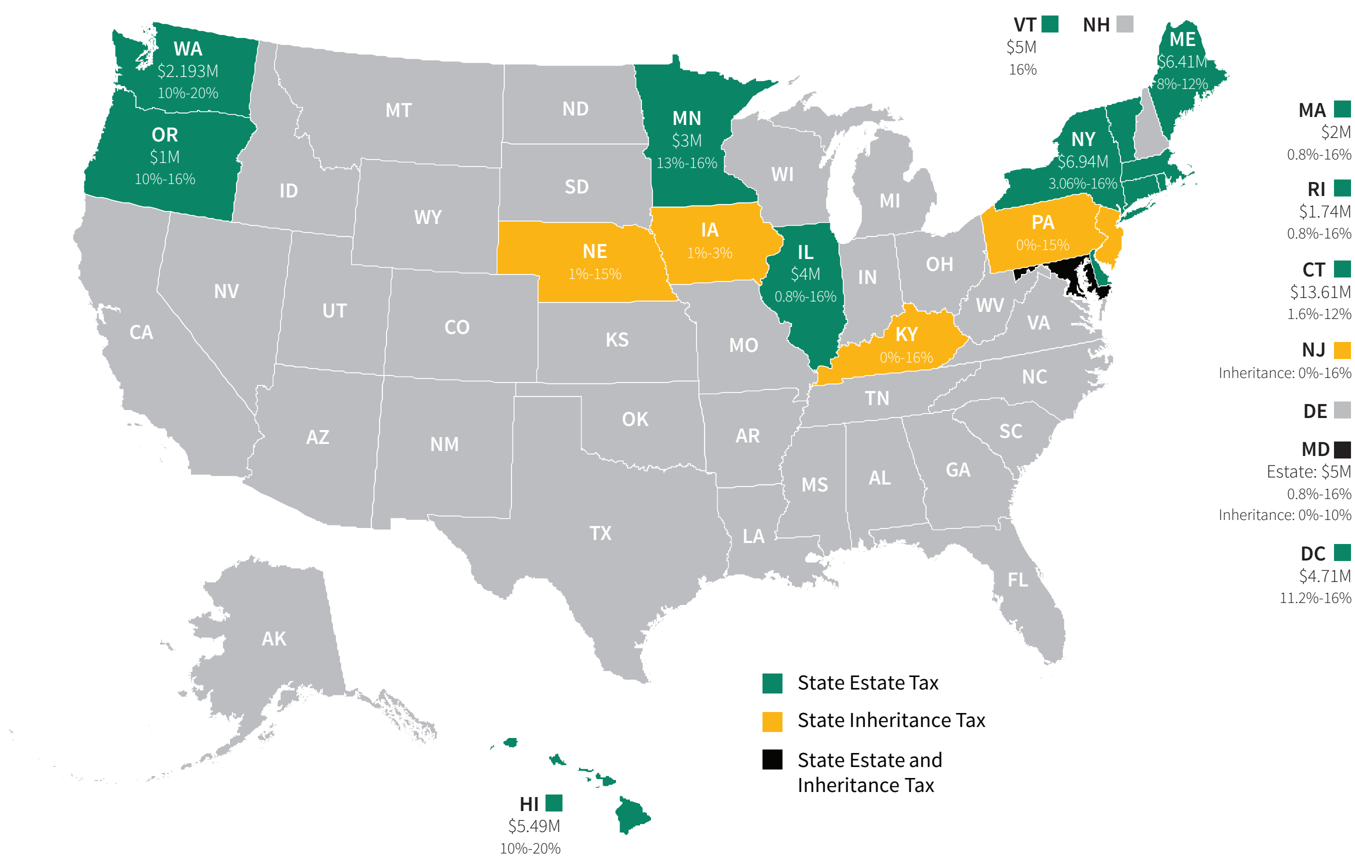
With the recent wave of wealthy individuals and families moving from high-tax states like California and New York to low-tax states like Florida and Texas, high-tax states have increased efforts to retain revenue. Much of the migration has been driven by differences in income tax rates, but founder-owners considering both a geographic move and a liquidity event at about the same time should know that many states—often those hit hardest by tax-motivated migration—also have state estate tax or inheritance taxes of which founders should be aware.

Critically, high-tax states are intensifying searches for business owners who have relocated to lower-tax states in conjunction with a liquidity event—and they are also ramping up the frequency and severity of residency audits while sometimes pursuing litigation. That means it is crucial for business owners to understand the requirements for establishing domicile in a new state and the time it can take. Beyond the requirements, there are non-mandatory steps that can strengthen the case for domicile in a state, from registering to vote in a new state to using professionals, such as doctors, dentists, accountants, and attorneys, who are based there.

Additionally, and similar to changing domiciles for individuals, irrevocable trusts can be housed in tax-favorable states, including Delaware, Nevada, and Wyoming. These states provide unique attributes such as strong asset protection laws, as well as low income tax rates and administrative fees that make them attractive as a potential situs for a long-term irrevocable trust designed to provide financial support to future generations.

2024 Estate and Inheritance Tax: Does Your State Have an Estate or Inheritance Tax?

State Estate and Inheritance Tax Rates and Exemptions in 2024



Philanthropic Regulatory Developments to Watch

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Founder-owners, in the wake of a liquidity event, often direct newfound wealth at charitable endeavors—with many turning to donor advised funds (DAFs). DAFs have fewer administrative burdens than private foundations while providing donors similar tax advantages and flexibility over how donated funds are used. However, they have faced criticism for not distributing enough to charities. Some of that criticism is misplaced, but the IRS recently issued rules requiring distributions every two years. Additionally, the IRS and Treasury Department issued proposed regulations in November 2023 aimed at providing greater clarity on what defines a DAF and a donor-advisor, as well as whether distributions are subject to an excise tax.

These kinds of complexities show why founder-owners need to plan for charitable giving well before a transaction is finalized, possibly opting to pre-fund charitable giving. Understanding the nuances of all available vehicles is important. Besides DAFs and private foundations, those options include charitable lead trusts (CLTs) and charitable remainder trusts (CRTs), which we discuss in the next section of this article.

Dealing With Evolving Interest Rates

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Different charitable vehicles are attractive depending on the interest-rate environment, which is why business owners should consider rates around the time of a liquidity event while learning the lesson of recent years that rates can be quite volatile. These considerations are important for anyone deciding between CLTs and CRTs—two commonly used irrevocable trusts.

In a CLT, financial support is provided to one or more charities for a set period, with the remainder going to noncharitable beneficiaries. CRTs are just the opposite—with noncharitable beneficiaries getting paid first. That means CRTs work better in a high-rate environment in which the actuarial value of the remainder gift to charity is increased and also the corresponding charitable deduction. The effects of rate swings also go beyond charitable instruments. For instance, periods of inverted yield curves present an opportunity to earn material interest on taxes due on proceeds of liquidity events.

It's Rarely Too Early to Start Planning

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The above article is based on our extensive work providing pre-liquidity planning advice to founder-owners because they face some of the most important decisions of their lives. The advice will shift as each founder-owner's situation and goals is unique, but it provides a roadmap of what is a particularly challenging time in and around major liquidity events.

To learn more and get answers about your specific situation, please do not hesitate to reach out to our pre-liquidity planning team.

William Blair's Pre-Liquidity Planning Group

Pre-Liquidity Planning Group

Our team works with investment banking clients and business owners to maximize after-tax proceeds and establish customized plans to achieve financial goals and objectives.

Tax Efficiency
Maximize the after-tax individual shareholder proceeds

Financial Independence Modeling
Create a substantial, inflation-resilient, tax-efficient income stream that maintains a current or desired lifestyle

Optimize Estate Structure
Maximize wealth transfer opportunity and achieve charitable goals

Risk Management
Review and adjust asset titling, insurance coverages, personal and cyber security assurance, asset protection

Contact

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