AN INITIAL PUBLIC OFFERING
SHAREHOLDER TAX PLANNING ISSUES AND OPPORTUNITIES

Walter R. Rogers, Jr.
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I. BACKGROUND

The U.S. transfer tax system has three components: a gift tax on lifetime transfers, an estate tax on transfers taking effect at death, and a generation-skipping transfer tax on transfers, at any time, to grandchildren or more remote descendants. The gift tax and the estate tax are unified in that the amount of one's lifetime gifts has an effect on the computation of the estate tax at one's death. The generation-skipping transfer tax, or GST, is an independent tax and may apply to a transfer which is also subject to gift or estate tax.

Under the unified gift and estate tax systems, a credit arrangement permits one to transfer the amount sheltered by the unified gift and estate tax credit either during lifetime or at death free of gift or estate tax. This credit-sheltered amount, or applicable credit amount as it is referred to in the tax statutes, is now $675,000 and is scheduled to increase in stages to $1 million by 2006. A married couple may shelter $1.35 million (increasing to $2 million by 2006) from estate tax as their assets pass to the next generation by proper arrangements for the ownership of their assets and proper basic estate planning. Certain smaller lifetime gifts are excluded from the gift and estate tax and do not consume any of the unified credit. Each person is permitted to give $10,000 each year to any number of persons so long as the person receiving the gift has immediate enjoyment of the gift. The law also permits husband and wife to "split" gifts, thereby treating a gift made by one as made one-half by each. An exemption, the GST exemption, sets the threshold of the GST at $1,060,000 by exempting from the GST $1,060,000 of transfers to grandchildren or more remote descendants which would otherwise be subject to the GST. It is often necessary to allocate one's GST exemption on a timely filed gift tax return in order to use it efficiently.

For people who expect to have property in excess of the sheltered amounts, now $675,000 for single people and $1.35 million for married people, and who can afford to make gifts to their children, grandchildren, or more remote descendants, it is good estate planning to make gifts. Making a gift removes the value of the gifted property, any later appreciation of the gifted property, and any income from the gifted property from the donor's assets and thus from the value of the property subject to tax at the donor's death.

If gifts are in order, the next planning concern is value. In order to make best use of the $10,000 annual gift tax exclusion, the applicable credit amount, and, when necessary, the GST exemption, one wants to establish a gift tax value for the gifted property that is as low as

possible. For the same reason, one wants to give away property one expects to appreciate in value. For gifts beyond the sheltered amounts, one wants to establish a low value to reduce the current tax cost of making the gift.

When planning in anticipation of an IPO, a shareholder has a unique opportunity to make a gift of a rapidly appreciating asset at a low value. That is to put the matter positively. If the shareholder does not take advantage of the opportunity, it may cost him or her more to transfer the same shares to his or her children or grandchildren later.

The opportunity arises from the expected difference in the value of the company's shares before and after the IPO. Of course, one expects and hopes that the value of the company's shares will be greater after the IPO than before the IPO, but planning to take advantage of valuation opportunities goes beyond this aspect of the offering. Before the IPO the shares are shares of a privately-held, usually also closely-held, company. As such, when valued for gift tax purposes the shares may be discounted for lack of marketability and for representing only a minority interest in the company. In addition, before the IPO there is usually little or no data available on actual prices at which the company's shares have changed hands. This permits reliance on conservative appraisals of the value of the company and its shares. Furthermore, any sales of the company's shares that have taken place will usually have taken place at a price much lower than the expected public market valuation for the shares.

II. PLANNING TECHNIQUES

There are a number of techniques available to the shareholder who wishes to make gifts of some of his shares in the company before the IPO. Here are brief descriptions of several of the most popular techniques:

A. OUTRIGHT GIFTS

The shareholder may simply give shares to children, grandchildren, other family members, or friends. Outright gifts have the advantage of simplicity but are usually not appropriate for minor children or grandchildren. Outright gifts may also not be appropriate for persons who need assistance managing the gift or who might be tempted to sell and spend the gift in an imprudent fashion. Outright gifts qualify for the annual gift tax exclusion.

B. UNIFORM TRANSFERS TO MINORS ACT GIFTS

When giving to a child, grandchild or other young person under age 21, the shareholder may give shares to a custodian of the shareholder's choice under a state Uniform Transfers to Minors Act, such as the North Carolina UMTA. Under the UMTA, the custodian holds and manages the shares for the young person's benefit until the young person reaches age 21. When the young person reaches age 21, the custodian must transfer the shares (or whatever property is then held by the custodian for the young person's benefit) to the young person

outright. The custodian has authority to deal with the shares and any income from the shares or proceeds from any disposition of the shares just like any other investor but is bound to use the property in his or her custody solely for the young person's benefit. UTMA transfers qualify for the annual gift tax exclusion.

With UTMA transfers, the custodianship is disregarded for income tax purposes. The custodian files no separate income tax return for the UTMA property he or she holds, and the young person reports the income from the custodial property on his or her own tax return.

The principal disadvantage of a UTMA custodianship is that is cannot be extended beyond the young person's twenty-first birthday. For this reason, UTMA gifts are usually limited to smaller gifts.

C. TRUSTS FOR MINORS

An alternative to a UTMA gift is the "section 2503(c) trust" named for the statutory provision which specifies that gifts to such trusts qualify for the gift tax annual exclusion. The terms of the section 2503(c) trust must require that any property transferred to the trust be held by the trustee for the exclusive benefit of the young person who is the beneficiary of the trust until the beneficiary reaches age 21 when the property must be distributed to the beneficiary outright. In practice, the termination of the trust at age 21 is often avoided by giving the beneficiary a right exercisable at age 21, but for only a limited period of time, to withdraw the trust property. If the beneficiary fails to withdraw the trust property, the trust instrument specifies that the trust continues to a later date.

The section 2503(c) trust requires a written trust document and an individual or trust institution to serve as the trustee. The trust is a taxpayer separate from the beneficiary and files its own income tax returns. The trust pays tax on any income from the trust property not distributed on a current basis to the beneficiary (or expended on his or her behalf). The trust generally pays tax on the capital gain income from the trust property.

D. FAMILY LIMITED PARTNERSHIPS (AND FAMILY LIMITED LIABILITY COMPANIES)

Family limited partnerships, or FLPs, are devices for managing family assets and, not incidentally, achieving valuation discounts in transfers of family wealth. (Since limited liability companies, or LLCs, with more than one owner are usually partnerships for federal tax purposes, the family limited liability company, or FLLC, is the functional equivalent of the FLP.) To form an FLP one transfers property to a newly created limited partnership having certain special features in exchange for general and limited partnership interests in the limited partnership. (Usually two persons, such as husband and wife or parent and child, form the limited partnership together to satisfy the partnership requirement of a joint enterprise. The second

initial partner's contribution and interest may be minimal and may be a gift from the primary partner.)

After forming the FLP, the donor gives away some or all of his or her limited partnership interests, retaining his general partnership interests. Since there are restrictions on further transfers of the limited partnership interests, the limited partners have no rights to withdraw assets from the FLP, the limited partners have no control over the FLP, and there is no market for the limited partners' interests in the FLP, the donor values the limited partnership interests given away at a deep discount from a proportionate value of the FLP's assets. (The IRS is very much opposed to FLPs and has had some success in disallowing donors' claimed discounts, but their popularity has been supported by other court decisions allowing some, if not all, of the discount claimed by the donor.)

A shareholder may fund a FLP with shares of the company before the IPO, give away limited partnership interests in the FLP before the IPO, and thus add discount on discount in the valuation process. The shareholder may give limited partnership interests outright, in UTMA gifts, or in trust. As noted below in the discussion of grantor trusts, the shareholder may also sell the FLP limited partnership interests as part of the shareholder's wealth transfer planning.

The FLP is a pass-through entity for income tax purposes and each partner, general and limited, is subject to income tax on that part of the FLP's ordinary and capital gain income properly allocable to such partner. The FLP files its own income tax returns on which it reports its income and the allocation of its income among the partners.

E. GRANTOR RETAINED ANNUITY TRUSTS

Grantor retained annuity trusts, or GRATs, are useful for transferring rapidly appreciating property to junior family members at a discount. One creates a GRAT by placing assets into a trust and retaining the right to annuity payments from the trust for a certain number of years (or for the shorter of a certain number of years and one's life). At the end of the annuity period, the remaining assets in the trust go to named beneficiaries, usually junior family members. When one makes a transfer to a GRAT, the taxable gift is limited to the actuarial value of the interest in the trust passing to others after the annuity payments are finished. If the assets one transfers to a GRAT appreciate more rapidly than the rate of growth assumed in the actuarial computation, the ultimate beneficiaries receive a gift at a discounted gift tax cost.

A shareholder may fund a GRAT with shares of the company before the IPO and thus add discount on discount in the valuation process. Gifts to GRATs do not qualify for the annual gift tax exclusion. Donors rely on their unified credits to shelter the otherwise taxable gifts resulting from the creation of a GRAT. A shareholder who creates a GRAT is taxable on the GRAT's income during the period the GRAT pays the annuity to the shareholder.

GRATs may not be appropriate as vehicles for the transfer of the shares of every company. The trustee of the GRAT must pay the retained annuity, in cash or in property, on at least an annual basis. If the shares do not become liquid soon enough, the shareholder may just receive his shares back in an annuity distribution.

F. LONGER TERM TRUSTS (WITH OR WITHOUT WITHDRAWAL POWERS)

A shareholder may wish to make a gift of shares to an adult child or more remote descendant in trust to provide for management of the shares by someone other than the beneficiary or to protect the trust property and the beneficiary from the beneficiary's possible imprudence, youthful or otherwise. The shareholder may also wish to make a gift of shares to a minor in a trust that does not terminate when the minor reaches age 21. For either of these purposes, the shareholder may use a trust that continues until the beneficiary reaches an age of the shareholder's choosing and has such terms concerning the beneficiary's enjoyment of the trust's property as the shareholder may wish. Such a trust may have more than one beneficiary. These trusts require written trust documents and an individual or trust institution to serve as the trustee.

The trust is a taxpayer separate from the beneficiary and files its own income tax returns. The trust pays tax on any income from the trust property not distributed on a current basis to the beneficiary (or expended on his or her behalf). The trust generally pays tax on the capital gain income from trust property.

Gifts to these longer term trusts do not qualify for the gift tax annual exclusion unless the terms of the trust give one or more beneficiaries a power of withdrawal over gifts made to the trust. These powers, called Crummey powers, are usually of short duration, such as thirty days after the gift to the trust. Trusts featuring Crummey powers are often called Crummey trusts.

G. DYNASTY TRUSTS

Longer term trusts designed to last for multiple generations and to take maximum advantage of a donor's GST exemption are called dynasty trusts. These trusts' terms generally provide that the trust property will be held for the benefit of the donor's children and more remote descendants at least until the donor's grandchildren reach certain ages and often for as long as the law of trusts allows. The idea is to avoid estate taxes at the deaths of junior family members by keeping the property in trust for their entire lifetimes. The GST, which might otherwise apply in such circumstances, is avoided by allocating enough of the donor's GST exemption to the trust when it is formed. Of course, the more favorable the valuation of the gifts to the dynasty trust and the more the trust property appreciates, the better the use made of the GST exemption.

Like other longer term trusts, dynasty trusts require written trust documents and an individual or trust institution to serve as the trustee. The trust is a taxpayer separate from the beneficiaries and files its own income tax returns. The trust pays tax on any income from the trust property not distributed on a current basis to the beneficiaries (or expended on their behalf). The trust generally pays tax on the capital gain income from trust property. Gifts to a dynasty trust do not qualify for the gift tax annual exclusion unless the terms of the trust give one or more beneficiaries a power of withdrawal over gifts made to the trust.

H. GRANTOR TRUSTS

A trust is a grantor trust if someone other than the trust, usually the person who creates the trust, must pay the income tax on all or part of the trust's income, not because he or she receives distributions from the trust, but because the terms of the trust give him or her (or in some cases, his or her spouse) certain powers over the trust or interests in the trust's property. There are a great variety of grantor trusts (the GRAT, mentioned above, is a grantor trust), but the term is used here to refer to a type of longer term trust that a shareholder may create for the benefit of junior family members. The grantor trust differs from other longer term trusts that the shareholder might create in that its income is taxed to the shareholder, not to the trust or its beneficiaries.

Grantor trusts may be attractive to the shareholder for two reasons. First, since the income tax law assumes the creator of the trust owns the trust's assets (and is therefore subject to tax on the trust's income), a shareholder who creates a grantor trust may sell shares to the trust without creating a taxable event under the income tax law. Although the shareholder has permanently transferred shares to the trust for the benefit of junior family members, under the income tax law he or she has merely sold the shares to himself or herself. While for income tax purposes the sale is without consequence to the shareholder, for transfer tax purposes, as long as the sale is based on the current fair market value of the shares, the sale is a sale and not a gift to the trust by the shareholder. The difference in the way in which a sale to a grantor trust is regarded under the income tax and transfer tax laws permits the shareholder to sell shares at favorable prices to a grantor trust before the IPO (usually for an installment payment note) and avoid any gift of the shares which might be taxable or use up the shareholder's annual exclusion or applicable credit amount. Although the shareholder does not move the entire value of the shares out of his or her estate (the shareholder retains the note for the purchase price of the shares), shareholder has transferred all future appreciation on the shares to the trust and its beneficiaries.

The second attractive feature of the grantor trust is that the grantor's payment of tax on the trust's income is not regarded as a gift to the trust. As a result, the shareholder may shoulder the burden of the trust's income tax, and thus enable the trust to grow faster, without suffering any costs under the transfer tax system.

I. GIFTS OF STOCK OPTIONS

A shareholder with vested nonqualified (non-ISO) options to purchase the company's shares might consider a gift of the options before the IPO. Not all nonqualified employee stock options are transferable, but if the shareholder holds options that are vested and transferable, there are gifting opportunities. It is possible that the shareholder may achieve a favorable valuation for the option itself if the option is given away before the IPO. In addition, since the shareholder, not the recipient of the gift, is taxable on the income associated with the later exercise of the option, the shareholder has the opportunity to make a gift-tax-free transfer of the tax liability to the recipient.

III. NECESSARY STEPS

A shareholder may well ask what is involved in attempting to take advantage of these tax planning opportunities. First, there is task of valuing the stock and creating documents to support the pre-IPO valuation in anticipation of later IRS challenges to the valuation used for the gifts (or sales). One must remember the IRS will have the advantage, or bias, of post-IPO hindsight by the time it gets around to its audit. Next, there is the press of time. The shareholder must make his or her gifts (or sales) far enough in advance of the IPO so that under the valuation principles used for tax purposes neither the IPO price nor subsequent public market prices for the shares are determinative of the value of the shares disposed of by the shareholder. With gifts in trust, there is also the need for careful preparation of the trust document by the shareholder's lawyer and careful selection of the trustee. It is also very important that the shareholder file proper gift tax returns with respect to his or her gifts on a timely basis. The filing of a gift tax return with adequate disclosure of the gift and its valuation starts the statute of limitation running against the IRS and any attempts on the part of the IRS to revalue the gift or assess gift tax. Finally, any trust or custodial arrangements created by the shareholder must be properly maintained. Maintenance involves regular, and often expert, attention to management, investment, distribution and tax compliance duties.

In the planning process, valuation and timing are especially important.

A. VALUATION

As noted above, careful valuation of the shares to be transferred and thorough documentation of the valuation and the valuation process are necessary to withstand later challenges by the IRS. The best evidence of value is a contemporaneous written appraisal of the shares by a qualified professional appraiser. It is not unusual, however, for shareholders to rely on recent private sales of the company's stock or less formal valuations based on general valuation principles and the company's performance. The least useful (although perhaps most conservative) valuations are done after the IPO (but before gift tax returns are due) and simply attempt to discount the shares' post-IPO values.

B. TIMING

A further word is in order on timing because, in this type of planning, timing is, unusually important. If the shareholder's transfer of his or her shares comes too late in the IPO process, the shares may ultimately be valued by putting greater weight on the IPO price or the price paid for shares in the public market rather than on more favorable pre-IPO factors. If that happens, opportunity is lost, and in the real world, the shareholder who has made a transfer may be in for an unpleasant, and possibly expensive, tax surprise. The shareholder should, therefore, make his or her transfers before it is certain that the IPO will take place and before it is possible to predict the offering price. (It is even better to make the transfers before the IPO is even formally discussed or explored by the company's management.)

There is no bright line rule to apply in these situations. It is not possible to say with certainty how the various events in the IPO process will affect the valuation of pre-IPO gifts of shares. The tax law recognizes, on the one hand, that future events that are reasonably foreseeable at the date of the transfer may be taken into account in determining the value of a gift. The law also recognizes, on the other hand, that publicly-traded stock and privately-held stock are essentially different types of property. The law further recognizes that many contemplated IPOs never happen and that offering prices may change in the IPO process. Consequently, close analysis, based on familiarity with the tax law precedents, is required in each case. As a result, it is best for shareholders to undertake their tax planning as early as possible. Delay may mean a loss of opportunity.

IV. POSTSCRIPT: INCOME TAX PLANNING

Shareholders do not usually sell their own shares in an IPO. For this reason, most shareholders' planning for the income tax consequences of the disposition of their shares can be done after the IPO. Nevertheless, before the IPO it is not too early to begin thinking about income tax planning. The shareholder's basic income tax planning goals will be to defer the taxation of income realized on the sale of shares in the company or to transfer the tax liability to junior family members who may be in lower tax brackets.

Trusts are generally not helpful as sources of lower tax brackets because of the steeply graduated income tax rate structure which applies to trusts. Children under age 14 are also not always sources of lower tax brackets because their investment income is taxed at their parents' rates. Gifts of shares to others with less taxable income than the shareholder, however, might be expected to produce overall income tax savings on the disposition of the shares. Attention to proper timing of the gifts is important if the shareholder wishes to be sure that the recipient of the shares, and not the shareholder, is taxed on the disposition.

Deferral of income taxation from the disposition of shares, or under some circumstances avoidance of income taxation from the disposition of shares, may be accomplished through use of a charitable remainder trust. A charitable remainder trust, or CRT, in its basic form, is a trust

in which the creator of the trust retains an annuity interest (or a right to the annual distribution of a certain percentage of the value of the trust's assets) for a fixed number of years or for his or her life after which the trust assets pass to charity. Since CRTs are tax-exempt, a sale of appreciated shares donated to a CRT produces no immediate income tax consequence to the donor. While the annuities (or other annual distributions) paid by CRTs are generally taxable to the recipient, CRTs, as a result of their exempt status, may accumulate, free of income tax, any income (including capital gains) in excess of the amount required to satisfy their obligations to the non-charitable beneficiary. Thus, a shareholder may donate $1 million in stock with built-in long-term gain to a CRT, have the CRT sell the stock, and still have $1 million invested in the CRT to generate the annuity the shareholder retained on the donation. The income tax cost of disposing of the same stock outside of the CRT could be as high as $250,000. The ability to defer the erosion of capital in this fashion combined with the current income tax deduction for the value of the charity's interest in the CRT can make a CRT very useful diversification device. Other charitable giving techniques can also lead to very favorable results, but since they are for the most part best done after the IPO, they are best discussed in another paper.