M&A Tax Talk

The case for estate planning pre-sale

Why now?

As taxpayers assess whether to sell a business, estate planning may be a key driver of the decision related to the timing and structure of a divestiture. Proactive planning provides an opportunity to transfer long-term, life-changing wealth for one's family in an organized and tax-efficient manner. Several external factors are at work today to encourage business owners to be proactive with their estate planning:

- Markets have been volatile, which generally supports lower valuations where lack of marketability discounts apply.
- Historically low interest rates may allow taxpayers to use leverage as a means for efficient estate planning.
- The applicable exclusion amount of wealth exempt from estate tax (known as AEA, further described below) is at an all-time high of $11.58M in 2020, adjusted for inflation (and will increase to $11.7M in 2021); Note that this amount is subject to expiration after 2025, absent further tax reform.
- Uncertainty about future tax rates has spurred increased M&A activity as taxpayers look to finalize a sale in a tax year with known tax rates.

If external market conditions propel a taxpayer toward M&A activity, business owners have an opportunity to make estate planning transfers ***pre-sale***.

Just as a truism of the stock market is to "buy low and sell high," a truism for estate planning could be to "transfer low and sell high." A business owner planning for an M&A transaction likely has a price in mind, which may be based on market comparables, revenue multiples, or cash flow analysis. However, this aspirational value for the enterprise as a whole is generally not indicative of fair market value for gift and estate purposes, which is established by a qualified appraisal of the interest to be transferred. Since the interest to be transferred is likely to be a minority interest in the entity to be sold, its appraisal would likely yield a much lower value because it would reflect discounts for lack of marketability (including volatility) or lack of control. This value gap creates a potential opportunity for business owners to make estate planning transfers (e.g., to children or into a trust) at a lower pre-sale value before selling the business for a higher price.

Estate tax 101

The estate tax taxes an individual's personal balance sheet at his or her date of death. The estate tax rate is assessed at 40% of the taxable estate. Current law provides an applicable exclusion amount (AEA), otherwise known as the "lifetime exemption," of $11.58M ($10M indexed for inflation annually). As a result, the vast majority of Americans will not pay estate tax. But, for those who will, proactive planning may significantly reduce their tax exposure, preserving wealth for future generations.

There is also a gift tax that integrates with the estate tax. The gift tax rate is also 40%, and taxable gifts (i.e., those beyond a minimal annual exclusion of $15,000 per donee) reduce a taxpayer's AEA available at death. A similar generation-skipping transfer (GST) tax of 40% applies to transfers which "skip" a generation. Such transfers are also subject to a separate exemption equal to that year's AEA (see Table 1).

A tale of two founders

Proactive planning can be a powerful tool when it comes to wealth transfer taxes. For example, consider two business founders with equal $30.5M taxable estates in September 2020 and no prior taxable gifts (see Table 2). Founder 1 does nothing. In 2020, Founder 2 makes a gift of 45% of the outstanding stock to a trust of which the proportionate share of the enterprise value is $13.725M. However, the fair market value of the stock determined by a qualified appraisal is $11M, reflecting a 20% discount for lack of marketability and lack of control.

In late 2025, both founders sell their business, netting $100M on the after-income tax proceeds of the sale. When both founders' die in January 2026, Founder 1's estate is worth $100M. However, Founder 2's estate is worth only $55M since he gifted 45% of the business to the trust five years prior. On the date of Founder 2's death, the trust assets, which are outside of his taxable estate, are worth $45M. (Note, assuming the founders' stock had a basis of zero, Founder 2's estate would be worth only $30M, and the trust's assets would be worth $70M if it were structured as a grantor trust.)

This example is extreme in its simplicity, but it demonstrates the value of pre-sale estate planning.

Table 1. 2020 federal wealth transfer tax summary

	Gift tax	Estate tax	GST tax
Annual exclusion	$15,000	N/A	$15,000*
Applicable exclusion amount (AEA) aka lifetime exemption	$11,580,000	$11,580,000	$11,580,000
Tax rate (federal)**	40%	40%	40%

* The GST annual exclusion generally does not apply to transfers in trust.
** Certain state and international estate and/or inheritance taxes may also apply. Connecticut is the only state that currently has a gift tax.

Table 2. A tale of two founders

	Transfer before sale	
	Founder 1	**Founder 2**
	No planning	**2020 gift**
Value of business units today	30,500,000	30,500,000
Gift in 2020*		11,000,000
Estate assets in 2026	100,000,000	55,000,000
Adjusted taxable gifts	-	11,000,000
Taxable estate	100,000,000	66,000,000
Estate tax due	37,684,000	22,000,000
Value of estate bequests	62,316,000	33,000,000
Value of gift assets in 2026	-	45,000,000
Value transfer to heirs	62,316,000	78,000,000

*Assumes a discount of 20% for lack of marketability and lack of liquidity and the AEA reverts to half of today's $11.58M.
All numbers are rounded to the nearest $100K.

This example shows a simple outright gift to a trust (which could be enhanced if the trust were structured as a grantor trust). In the example, the retained wealth of Founder 2's family is improved by more than 25%. Estate planning advisers may recommend direct gifts and more advanced techniques to transfer upside value appreciation without transferring the original principal, such as a grantor-retained annuity trust (GRAT) or a sale to an intentionally defective irrevocable trust (IDIT). There may also be a case for pre-sale charitable planning for philanthropic taxpayers.

Conclusion

As with all tax matters, the details matter. Effective estate planning requires thoughtful planning, detailed analysis, and careful execution. Business founders on the verge of a major liquidity event are often focused solely on closing the deal. However, with a little foresight, founders may create a lasting financial legacy for future generations.

For additional reading, see:

- Deloitte Private Wealth Services
- The Personal Side of Selling a Business
- 2020 Essential Tax and Wealth Planning Guide

Want to learn more?
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