MANAGING WEALTH FROM A LIQUIDITY EVENT

Pre, During, and Post Transaction Considerations

+ INTRODUCTION

Entrepreneurs and corporate executives put an immeasurable amount of time and energy into building their businesses. They also take on a significant amount of financial risk because a majority of their net worth is represented by company equity, which often is illiquid and highly concentrated.

Raising capital, selling a company, taking a company public, executing a dividend recapitalization, or other so-called "liquidity events" are rare opportunities for entrepreneurs and executives to turn their concentrated equity positions into enduring, diversified wealth. Given the complexities related to taxes and potential SEC restrictions related to the various forms of compensation that executives receive, careful planning is paramount when it comes to fully capitalizing on the opportunities related to liquidity events.

At Callan Capital, we have experience guiding entrepreneurs and executives through the process of understanding their compensation packages and thinking strategically about liquidity events. Below, we outline some of the best practices that client should consider in the years leading up to a potential transaction, in the months immediately surrounding the transaction, and in the years following the transaction.

+ PRE-TRANSACTION CONSIDERATIONS

In any aspect of wealth management, time is one of your greatest resources. This is especially true for entrepreneurs and executives focused on maximizing the value of their equity. The earlier you start mapping out your vision for what you want to achieve financially and understanding your resources, the more flexibility and leverage you have in shaping the outcome.

- Determine your "numbers:" The first step is to work with your financial advisor to articulate your desired lifestyle post-liquidity event and then determine the amount of wealth needed to achieve that vision. Whatever your goals—retiring early, buying a vacation home, spending more time traveling, or funding your children's college education—you need to quantify the cost of those goals and then determine the present value of the assets needed to fund this lifestyle. We refer to this amount as your "critical capital." Another term we like to use is your "work-optional" number, or the amount of after-tax wealth you would need to retire immediately following the liquidity event. The amount of after-tax wealth beyond your "critical capital" is your "excess capital," which can be used for wealth transfer or philanthropy. Knowing these numbers is essential for creating a long-term strategy for your wealth.

- Decide where you want your wealth to go: Essentially, all of your wealth will end up in one of four buckets: funding your lifestyle, transferring wealth to your children and other loved ones, supporting charities, or paying taxes. You need to let your advisor know how you prioritize these four categories. For some people, minimizing taxes is their top priority, and they're willing to implement extensive planning strategies to reduce their tax liability. For other clients, they prefer to maintain flexibility, rather than commit to irrevocable strategies for the sake of reducing their tax bill. It's also important to think about how much you're comfortable giving to your children and when you want to make the funds available to them. Many parents worry that transferring "too much, too soon" to children may negatively affect their work ethic and sense of responsibility.

- Test your assumptions (scenario planning): Perhaps the biggest variable in planning for a liquidity event is the valuation of your equity. Often, entrepreneurs and executives have unrealistically high expectations for what their stock is worth; they then make planning decisions based on these faulty assumptions. To help you understand the range of potential outcomes, we recommend that you have your advisors run calculations to show how much after-tax wealth you would receive under best-case, base-case, and worst-case valuations.

- Understand your executive compensation package: Executives often receive multiple forms of compensation, including traditional equity, stock options, restricted stock, employee stock purchase plans, deferred compensation, and life insurance. Each of these forms of compensation has a unique set of tax consequences, downside risk, and upside potential when it comes to generating liquidity. It's important to have an advisor who is an expert in executive compensation evaluate your various forms of equity and other forms of compensation to determine the amount of after-tax wealth that could be generated by a liquidity event.

- Start the clock on long-term capital gains: With incentive stock options (ISOs), the "bargain element" (i.e., the amount between the exercise price and the market price at the time of exercise) is taxed as ordinary income, which has a highest marginal rate of 37%, unless the stock is sold through what is deemed a "qualifying disposition." To be a qualifying disposition, the sale of the stock must be at least two years after the option's grant date and at least one year after the option was exercised. With a qualifying disposition, the bargain element plus any additional gains in the stock price are treated as long-term capital gains, which have a top rate of 23.8%. The bargain element, however, is included in alternative minimum tax (AMT) calculations in the year of exercise.

- Take advantage of valuation discounts: One of the most powerful pre-transaction planning strategies has to do with the fact that your equity likely will have a lower valuation before the transaction than the valuation used for the transaction. By transferring equity to children or other loved ones before the transaction valuation has been determined, the subsequent appreciation occurs outside of your estate, increasing the amount that you can transfer to loved ones without incurring estate tax. Many business owners choose to make these transfers through a grantor retained annuity trust (GRAT). Transferring shares to take advantage of the valuation discount, however, isn't without risk. If the transaction valuation ends up being higher than you anticipated, then you may end up transferring more wealth than you intended. Conversely, if the transaction valuation ends up being significantly lower than you anticipated, this may mean that you didn't retain enough wealth to fund your lifestyle goals.

+ DURING THE TRANSACTION CONSIDERATIONS

The months leading up to a fundraising round, merger, IPO, or recapitalization can be very stressful for entrepreneurs and their executive team. In addition to your regular responsibilities of keeping the business running smoothly, you have to carve out a large amount of time to work with your investment bankers, attorneys, and accountants to prepare for and execute the transaction. This can include preparing the financial statements and market reports that potential acquirers or investors will need to conduct their due diligence, giving management presentations, conducting roadshows, and, in the case of an IPO, preparing the S-1 filing. As important as these tasks are, you need to also be thinking about the wealth management aspects of the transaction during this exciting time.

- Coordinate your team of advisors: You will likely have many professionals working on your (or your company's) behalf during a liquidity event. Investment bankers will be focused on negotiating with potential buyers (in the case of a merger or acquisition) or investors or lenders (in the case of an IPO, equity raise, or dividend recapitalization), as well as structuring the transaction. Your wealth advisors, which in addition to your financial planner may also include your accountant and estate planning attorney, will be focused on what the transaction means for your personal liquidity and tax situation. It is important that all of your advisors are communicating with each other and working as a team on your behalf. It's particularly important to have your lead financial advisor working with your investment bankers because your personal financial goals may help inform what valuation is acceptable to you in the transaction.

- Minimize the tax impact: Another reason to have all of these advisors working in concert is to identify ways to minimize your tax liability. For example, some C corporations may be eligible for the Qualified Small Business Stock election, which exempts up to $10 million of gains from taxation. If you plan on implementing any wealth transfer strategies in association with the transaction, you will want to create the trusts in time to take advantage of the potential pre-transaction valuation discount. In the case of an acquisition, it's also important to have your attorneys and accountants analyze whether your compensation post-merger will be deemed an "excess parachute payment" under Section 280G of the Internal Revenue Code. This complicated—and little-known—rule can trigger significant excise taxes for corporate executives. The potential for this tax should be addressed during the negotiation process. Also, the buyer of an S corp can realize significant tax benefits relating to accelerated depreciation. Thus, during the negotiations, the seller can push to have a portion of these savings added to the sale price.

- Identify restrictions on your equity: When a company goes public, there are myriad restrictions on when executives and other insiders can sell their stock. For example, the underwriting investment bank typically imposes a six-month lockup period after the IPO, during which executives and other insiders can't sell their shares. Even beyond the lockup period, executives and other insiders are prohibited from selling their stock when they're in possession of material, non-public information (i.e., "blackout periods"). Understanding and navigating the complex restrictions related to blackout periods are critical to developing an effective wealth management strategy related to an IPO.

- Consider implementing a 10b5-1 plan: Despite the selling restrictions placed on executives of public companies, there are methods for insiders to generate liquidity from their concentrated equity positions. One of the most effective ones is implementing a 10b5-1 plan. These plans allow insiders to sell stock on predetermined dates and at predetermined prices—even during blackout periods—as long as the plans were adopted during a time when the executive didn't have access to non-public, material information. While a 10b5-1 plan can be adopted after an IPO, putting one in place during the IPO process can be a very effective strategy. With the S-1 filing, the company's attorneys go to great lengths to ensure that all material information is disclosed to potential investors. Thus, this period can be an opportune time for executives to establish their 10b5-1 plans, which can be cancelled at any time.

+ POST TRANSACTION CONSIDERATIONS

Now that the transaction has been completed, your focus, from a wealth management perspective, can shift to implementing the strategy—and most importantly, enjoying the fruits of your hard work and passion.

- Turn concentrated equity positions into a diversified portfolio: Having a large portion of your wealth represented by the stock of a single company is a high-risk, high-reward proposition. This is especially true for companies that have recently gone public or have highly volatile stock prices, as is often the case with technology and life sciences companies. Generating liquidity and converting a concentrated equity position into a diversified portfolio can be an important part of creating a balance sheet that aligns with your risk tolerance and long-term financial goals. Like 10b5-1 plans, exchange funds can be an effective way for executives to achieve diversification. With an exchange fund, you pledge a portion of your concentrated position to the fund in exchange for shares of a diversified portfolio. In addition to achieving diversification, exchange funds can also be an effective mechanism for deferring capital gains on low-basis stock.

- Build a philanthropic legacy … and reduce your taxes: Besides being a powerful way to help others and strengthen your family's legacy, philanthropy can be an effective tool for minimizing your tax liability. If you're expecting to undergo a significant liquidity event (whether it's the sale of a company, an IPO, a recapitalization, a stock-option exercise, or a bonus), you may want to consider aligning the timing of your charitable giving with your tax liabilities to avoid facing a large tax bill in the year of the liquidity event. While private foundations remain widely used charitable-gifting vehicles, donor-advised funds (DAFs) have been growing in popularity because of their flexibility. With a DAF, you get to deduct the full value of the assets contributed to the DAF in the year of the contribution (subject to adjusted gross income limitations), but you can wait until subsequent years to determine when and to which charities the DAF's assets will be distributed.

- Educate your family about wealth: Minimizing estate and capital gains taxes is just one aspect of an effective wealth transfer strategy. You also need to prepare younger generations emotionally and intellectually to be good stewards of the wealth. For some families, this education takes place over a series of ongoing, informal conversations about the meaning of wealth and about managing finances responsibly. Many other families choose to hold regular family meetings, which may be facilitated by outside advisors. Regardless of which approach you choose, it's important to be strategic and intentional about educating younger generations.

- Be nimble and flexible: Finally, it's important to realize that no amount of planning can account for all of the unpredictability and uncertainty of life. Market conditions constantly change, new tax laws and SEC regulations are adopted, and your personal life goals will evolve. Thus, flexibility should be a vital part of your wealth management strategy. Through ongoing conversations with your financial advisor, you can continually reassess your plan as new opportunities emerge and as your vision for the future continues to come into focus.

+ WORKING WITH SPECIALISTS

Navigating the complexities related to executive compensation and liquidity events requires a high degree of specialized expertise among your team of advisors. There are many potential pitfalls that, if not managed properly, can have major implications in terms of taxes and risk in your portfolio. At Callan Capital, we specialize in guiding entrepreneurs and executives through these complex and critically important times in their financial lives.

Important Disclaimers: Callan Capital does not provide individual tax or legal advice, nor does it provide financing services. Clients should review planned financial transactions and wealth transfer strategies with their own tax and legal advisors. For more information, please refer to our most recent Form ADV Part 2A which may be found at www.adviserinfo.sec.gov. The tax information provided in this document is for general informational purposes only—it is not meant to be used, and cannot be used, by individuals to avoid federal, state or local tax penalties. Taxation varies depending on an individual's circumstances, tax status and transaction type; the general information provided in this guide does not cover every situation—for complete information on your personal tax situation, you should always consult with a qualified tax advisor.

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