Direct Investing: Structuring Family Investments in High-Growth Companies

As a growing number of our clients, especially founders and entrepreneurs, include "direct" investments in startup and early-stage companies in their personal and family investment plans, we are often asked to consider when the capital of a family trust or other entity – rather than an individual's personal capital – should be deployed.

Drawing on our experience providing planning advice relating to founder equity, as well as advising multigenerational families and their family offices regarding the legal and tax aspects of investments, we have provided here some thoughts to consider when aligning direct investments with other family planning objectives:

1. **Traditional estate planning goals weigh in favor of trust ownership for high-growth investments:** Traditional estate tax planning usually entails shifting investment growth and value to someone other than the individual investor, so that the growth accrues outside of the investor's estate for estate tax purposes. For younger investors, those taxes may be decades away, but early estate tax planning is still a worthwhile goal, especially when other objectives can be achieved simultaneously. Federal and state estate taxes apply at an effective rate of up to 49.6% (depending on an investor's state of residence) once lifetime exemptions are exhausted. High-growth investments can be excellent assets to acquire or own within a trust to minimize the use of lifetime exemptions. Trusts can also be useful for non-tax objectives, such as providing protection against claims of creditors and claims of spouses upon divorce, in a way that individual ownership often cannot.

2. **High growth potential requires high flexibility:** In the most common form of traditional estate tax planning, the primary investor/donor will fund a long-term trust (or "dynasty trust") with cash or other investments to be held and reinvested for the benefit of younger generations or other family members. There are many differing funding mechanisms for trusts (including gifts, GRATs, and sales), but if the original source of funds is the investor/donor, there is usually one major limitation: he or she cannot retain any personal interest in the trust as a beneficiary (*but, see #4 below*). This creates a worry that *too much* value will end up in trust. We encourage donors to consider building in the ability for a spouse (a "spousal access provision") and/or a charitable organization (a "charitable leak provision") to benefit in certain situations. Or, when an investor is single and/or does not presently have children, the investor might consider a broader class of family beneficiaries.

3. **Understand the key differences between <u>grantor</u> and <u>nongrantor</u> trusts when it comes to state and local income taxes and QSBS:** A *grantor trust* is a trust whose income remains taxable to its donor during life, rather than being taxed to the trust itself. *Grantor* trusts are ubiquitous in traditional estate tax planning because they allow a trust to grow even more quickly outside the investor/donor's estate. A *nongrantor trust*, on the other hand, is generally treated as a separate taxpaying entity that will pay its own taxes. Estate planning trusts can usually be created in either format, but the distinction has important consequences for investments in high-growth companies:

    - <u>State and local income taxes:</u> If an investor lives in a high-tax jurisdiction such as New York City, a *nongrantor trust* – unlike a personal investment or an investment within a *grantor trust* created by that investor/donor – can often be designed to be exempt from state and local income taxes on some or all of its investment income. That means that major taxable liquidity events can usually occur within a *nongrantor trust* without being immediately diminished by state and local income taxes.

- Qualified small business stock (QSBS): A *nongrantor trust*, as a direct investor in an issuing company, qualifies separately from the donor for any QSBS benefits that may be available to a company's equity holders. The separate qualification can be important where a family's total capital gains with respect to a single issuing company might one day exceed the typical QSBS exclusion cap of $10 million per taxpayer. Making direct investments within a *nongrantor trust* from inception can avoid having to make gifts of QSBS stock later in order to optimize these QSBS benefits. And, it might provide greater flexibility if the ability to gift QSBS stock is ever curtailed by future tax legislation.

4. **Consider trusts created by someone other than the primary investor (such as a parent):** Families with inherited wealth are often aware of the benefits of using capital of existing family trusts (such as those created by senior generations) for making new investments. A trust established by someone else can be extremely powerful for direct investing because it can allow the investor to have all of the estate tax, QSBS, state/local income tax, and non-tax benefits mentioned above, without giving up the ability to later participate in investment proceeds as a potential trust *beneficiary*.

   What if multigenerational trusts don't already exist? Even at a more modest scale, a parent could fund a dynasty trust for an investor/beneficiary and his or her family with seed capital that is intended to grow over time as direct investments are made (provided that trust qualifies as an investor with respect to the issuing company). And, an investor/beneficiary or others should be able to provide further leverage to such a trust through cash loans or purchase money loans designed to provide a greater pool of investment capital within the trust in earlier years, if desired.

5. **Beware of the QSBS drawbacks of passthroughs:** It is common for private investors, including family offices and private investor groups, to pool their capital through passthrough entities such as partnerships or LLCs in order to make investments. But special care should be taken when using that format for direct investments in stock that may qualify as QSBS. Investors who hold QSBS indirectly as partners in a partnership can be limited in their ability to engage in trust planning later. And QSBS benefits can be inadvertently lost in certain common transactions, such as when a partnership acquires stock as a contribution from its partner, rather than directly from a company. Where a passthrough vehicle may be involved, it is almost always helpful for a trust to be a partner/investor from inception.

6. **Don't ignore the possibility of future capital needs:** Experienced investors are aware that they may be called on for future investment capital as a company progresses in its life cycle. Sometimes additional capital can be provided to a trust through further gifts or loans, but the ability to do so can depend on the type of trust being used, so it's useful to consider these common needs during the initial planning phase.

Patterson Belknap has a multi-disciplinary team of lawyers who are focused on the legal needs of founders and entrepreneurs. A description of the full range of our services and attorney contacts can be found here. Please visit the Founder Focus Resource Center for more content on broad range of topics of interest to founders and their professional advisors.

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