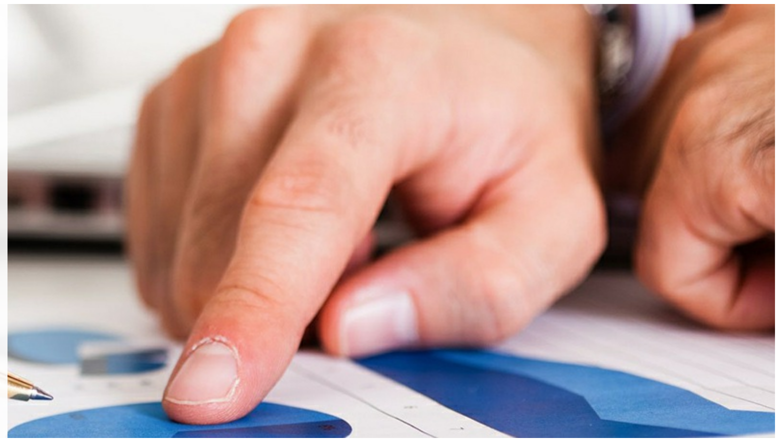
PETROCELLI
FINANCIAL SERVICES LLC

Recapitalization: Voting & Non-Voting Interests



Overview

Recapitalization is basically a change in a corporation's capital structure. Corporations recapitalize for a variety of reasons, but generally to make the company more stable or to bring in new investors. For closely held companies, recapitalizations can also be very effective in estate planning.

When business interests pass to a successive generation, senior family members can transfer company stock in a tax-efficient manner by generating discounts. If the business agreement restricts certain rights, such as the right to vote or the ability to freely transfer the stock, those restricted business interests are typically worth less to an outside buyer, and hence "discountable" for valuation purposes. Regardless of whether the transfer is by gift or by sale, recapitalization into voting and non-voting stock can allow the assets to be transferred at a lower value.

Description and Operations

The process by which an existing corporation can be reconfigured to create different classes of stock—such as voting and non-voting stock—is called "recapitalization." Though not labeled a "recapitalization," a limited liability company or a partnership can undergo a similar transformation by establishing voting and non-voting interests.

Creation of Preferred and Common Stock with C Corporations

Recapitalization can refer to the creation of common and preferred stock. Preferred stock has dividend and liquidation priority over common stock. In other words, the owner of preferred stock has a greater degree of security than the owner of common stock.

Before 1990, a parent would shift common stock to a child and keep the preferred stock. Because much of the value of the company was attributed to its preferred stock, the common stock could be transferred at a negligible gift tax cost. Today, Internal Revenue Code §2701 deters this strategy by effectively setting the value of a company's common stock at the fair market value of the entire company. If §2701 applies, recapitalizing the business and gifting common stock offers little estate tax planning benefit since no discount would apply to the transferred shares.

Section 2701 does not apply, however, where (i) the stock is a marketable security; (ii) common and preferred stock are transferred pro rata; or (iii) the owner retains stock of the same class as the stock transferred. Consequently, if an owner transfers some shares of common stock and retains others, discounting may still be available.

However, many closely held businesses are structured as S corporations, and the IRS prohibits S corporations from having more than one class of stock.

Creation of Voting and Non-Voting Stock

When a business is recapitalized into voting and non-voting common stock, the owner can transfer non-voting stock and retain voting stock without the application of §2701. According to the IRS Regulations, voting common stock and non-voting common stock are substantially the same.[1]

As relates to S Corporations, the regulations expressly provide that if the only difference between stock is voting rights, the IRS will not consider there to be more than one class.[2]

In recapitalizing the business into voting and non-voting shares, voting shares are essentially exchanged for a combination of voting and/or non-voting shares. (Example: The sole owner exchanges his 100 voting shares for 5 voting shares and 95 non-voting shares.) The shares remain identical except for the right to vote. This type of recapitalization merely disentangles control from equity ownership. The owners would work with an attorney who would structure the transaction and draft the documents. State law will control as to what specific actions the corporation must take. Most states require that the board of directors propose amendments to the articles of incorporation and that the shareholders approve the recapitalization by a majority vote.

After the business is recapitalized, non-voting shares could be transferred via gift or sale. The non-voting shares should qualify for discounts based on lack of control due to the fact the shareholders cannot vote on corporate matters. Discounts also may be available for lack of marketability, minority interest, and restrictions on disposition.

Accordingly, by keeping the voting interests and transferring only non-voting interests, the transferor could remove much of the company's value and future appreciation from his or her taxable estate. The interests can be transferred to a child—or a trust for the child's benefit—at a potentially substantial valuation discount.

Tax Implications

Income Tax Considerations

A recapitalization is generally income tax-free. Under IRC §368(a)(1)(E), no gain need be recognized upon a so-called "E reorganization." In order to be valid, the reorganization must have a legitimate business purpose, such as estate planning, beyond mere tax avoidance. Also, with an S corporation, it is important that each share of the newly issued stock has identical rights in the profits and assets of the corporation.

Gift Tax Considerations

If the value of the stock received in a recapitalization is less than the value of stock owned prior to recapitalization, the shareholder could be deemed to have made a taxable gift to other shareholders. It is generally best that any transfers be implemented after recapitalization is complete.

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1 Reg. §25.2701-1(b)(3)(i)
2 Reg. 1.1361-1(l)(1)

Insights and Caveats

Extremely effective asset protection can be accomplished by transferring interests to a trust for the recipient, instead of outright.

Valuation discounts are not explicitly provided for by the Internal Revenue Code; rather, they are a product of administrative and judicial views. It is extremely important to use a qualified appraiser to obtain the business valuation when transferring business interests and claiming discounts.

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