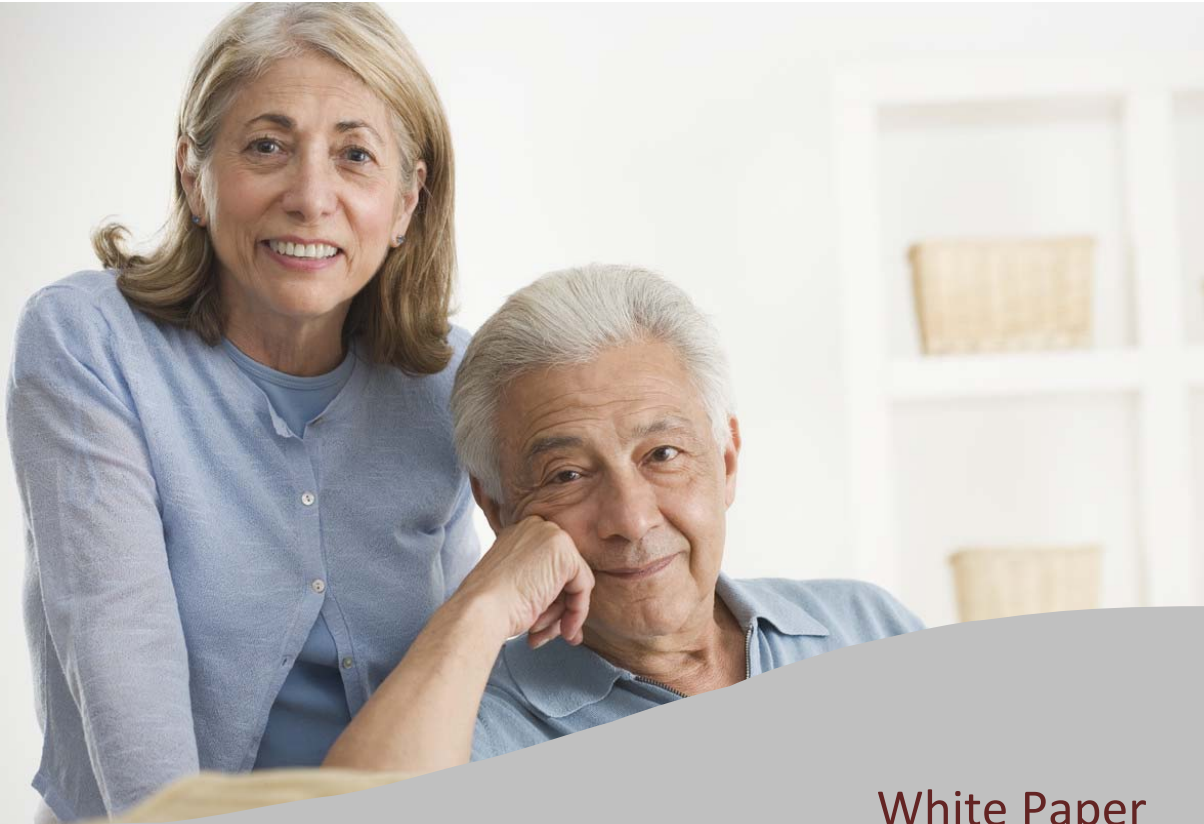




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White Paper

Estate Freeze Technique:

*Recapitalization*

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# Estate Freeze Technique: *Recapitalization*

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## What is it?

In a corporate recapitalization, the owner of a closely held corporation recapitalizes the corporation by creating two classes of stock: common stock and preferred stock. The owner then transfers part of his or her interest in the business to a younger generation by gifting or selling to them the common stock. The owner retains a portion of the business in the form of the preferred stock. In this way, any future appreciation in the business will be attributed to common stock transferred out of the owner's estate. The value of the owner's retained interest (the preferred stock) remains constant (or frozen).

Prior to the addition of Sections 2701 and 2704 to the Internal Revenue Code, gift tax may have been incurred when the owner gifted away the common stock to the younger generation. However, recapitalizations were generally structured so that a very low value for gift tax purposes was assigned to the common stock transferred. Various rights (dividend rights, voting rights, preferential liquidation rights, etc.) could be associated with the owner's preferred stock, which would lapse upon the owner's death thereby reducing the value of the retained preferred stock for estate tax purposes. Essentially, the business owner could have his or her cake and eat it, too.

Congress saw the inequity of corporate recapitalizations under the old rules and enacted Internal Revenue Code Sections 2701 and 2704 (effective October 8, 1990). Section 2701, among other things, put a statutory monetary value on the interest retained by the owner (zero, in most cases) causing the gift of the common stock to the children to be valued at the full fair market value of the company. Section 2704 ignores lapsing rights associated with the owner's retained interest for purposes of valuing these retained interests for estate tax purposes. Sections 2701 and 2704 are extremely complicated. One result of their enactment has been that corporate recapitalizations have become much less attractive as an estate freezing technique.

Although corporate recapitalizations are less attractive estate-freezing techniques than they used to be prior to the enactment of Sections 2701 and 2704, there are still situations where a recapitalization makes sense for a business owner. There are two strategies that estate planning attorneys now follow. First, they structure the recapitalization so that the retained interest held by the owner has value (i.e. is not deemed to have a value of zero through application of Section 2701), thus reducing the amount of the gift to the children. Second, many attorneys structure the recapitalization so that Section 2704 does not apply.

## When can it be used?

Section 2701 applies when owner retains applicable interest in the company and transfers junior equity interest to a family member

Section 2701 applies to transactions in which a junior equity interest (usually common stock) is transferred to a member of the transferor's family and, after the transfer, the transferor holds an applicable retained interest which is defined in Section 2701 to be any interest in an entity with respect to which there is a distribution right (if the transferor and applicable family members have control of the entity immediately before the transfer) or a liquidation, put, call, or conversion right. For purposes of Section 2701, a junior equity interest is defined as common stock (or any partnership interest) in which the rights to income or capital are subordinate to the rights of all other classes of stock. The term member of the family includes the transferor's spouse, any descendant of the transferor or the transferor's spouse, and the spouse of any such descendant. Where the transferee is not a member of the transferor's family (e.g., niece or nephew of the transferor), the classic corporate recapitalization retains some of its vitality but Section 2704 will still apply to limit the effect lapsing voting or liquidation rights have on the valuation of the retained interest in the transferor's estate.

## Applicable retained interest will be valued at zero in most transactions

In most cases, Section 2701 values the applicable interest (i.e., the preferred stock) retained by the transferor at zero. Thus, the gift of the common stock to the children will be valued at the full fair market value of the company with no reduction for the value of the interest retained by the transferor. As noted above, for purposes of Section 2701, an applicable retained interest is an equity interest for which there are either extraordinary payment rights or, if the transferor and applicable family members hold control of the company immediately before the transfer, a distribution right.

An extraordinary payment right is any put, call, or conversion right; any right to compel liquidation; or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. Under Section 2701, such an extraordinary payment right is valued at zero. A distribution right is the right to receive distributions with respect to an equity interest, such as the right of a preferred shareholder to receive dividends. Distribution rights are similarly valued at zero unless the distribution right is a qualified payment right.

## To avoid having the transferor's interest valued at zero, a distribution right must be a qualified payment right

Under Section 2701, if the transferor and applicable family members hold control of the company immediately before the transfer, all distribution rights held by the transferor will be valued at zero unless such distribution rights are qualified payment rights. A qualified payment right is generally a fixed rate cumulative payment, or a payment that the transferor elects to treat as such a payment. Cumulative means that if there is not enough money in the company to pay the dividends one year, then the unpaid dividends must be paid as soon as the company has enough funds to make the payment. It

can include a dividend on cumulative preferred stock, payable at least annually. It may also be any other cumulative distribution payable at least annually at a fixed rate or in a fixed amount. Finally, a qualified payment right may be any distribution right for which an election is made to treat it as a qualified payment right. These qualified payment rights are valued using traditional valuation principles. Thus, to avoid having the retained interest valued at zero (and the gift to the younger generation valued at the full fair market value of the company), you must design the retained interest so that it can be classified as a qualified payment right.

**Example(s):** Say you own 100 percent of the stock of XYZ Corporation, and the fair market value of the company is \$3 million. You would like to transfer part of the company to your son and daughter, so you hire an attorney who structures a recapitalization for you. After the recapitalization, you own 2,000 shares of cumulative preferred stock (having a par value of \$1,000 per share) and 2,000 shares of common stock. The preferred stock's dividend rate is 8 percent payable annually. The right to a cumulative annual dividend is a qualified payment right because it is cumulative, has a fixed interest rate, and is payable annually. You transfer the common stock to your son and daughter. After a professional appraisal, the cumulative preferred stock is valued at \$2.2 million. The value of the gift to your children is \$800,000 (which is subject to gift tax). Any future appreciation in the company will be attributed to the common stock that you have removed from your taxable estate through the gift.

Note: If the stock retained by you had a noncumulative dividend right, the dividend preference would not have been a qualified payment right and the preferred stock would thus have been valued at zero. Thus, the gift of common stock to your children would have been valued at \$3,000,000 and the transfer would be substantially more costly from a tax perspective.

## Owner's retained interest must be valued under Internal Revenue Code Section 2704 for estate tax purposes

Prior to the enactment of Section 2701 and Section 2704 of the Internal Revenue Code, one of the main advantages of a recapitalization was that the preferred stock retained by the transferor of the company could be structured so that the voting, dividend, and preferential liquidation rights would lapse upon the death of the owner. The lapse of these rights would cause the value of the transferor's interest to be reduced for estate tax purposes.

Congress considered this tactic to be abusive and passed Section 2704 of the Internal Revenue Code. Section 2704 requires that at the death of the transferor, the preferred stock included in his or her estate will be valued as if the lapsing rights did not exist. In other words, the stock will be given a much higher value for estate tax purposes than prior to the enactment of Section 2704. Again, the passage of Section 2704 made recapitalizations much less attractive as an estate freezing technique.

**Example(s):** Say you and your daughter control the XYZ Corporation, a company that you started 25 years ago. You have recently recapitalized XYZ Corp. and you now own all the preferred stock with voting rights, dividend rights, and preferential liquidation rights which rights will lapse upon

the death of the preferred stockholder. Under Section 2704, the lapsing rights will be ignored in valuing the preferred stock at the time of your death. Prior to the enactment of Section 2704, the value of the preferred stock (with the lapsing rights) would have been greatly reduced upon your death thus decreasing its impact on your estate tax liability.

## Reverse freeze may be used to avoid Section 2701

One tactic used by estate planners to avoid the adverse consequences of Section 2701 is to structure a reverse freeze. In this case, members of the older generation (typically the parents) recapitalize the corporation, but instead of giving the common stock to their children, they retain the common stock and gift the preferred stock to their children. Because the common stock is junior to the preferred stock, Section 2701 does not apply. The reverse freeze recapitalization is usually structured so that the preferred stock will have substantial noncumulative dividend rights and no voting rights. The noncumulative nature of the dividends and the lack of voting rights should reduce the value of the preferred stock for gift tax purposes. After the recapitalization has occurred, dividends will be paid to the preferred stockholders (the children). The payment of these dividends should transfer the current earnings from the company to the younger generation, thus reducing the net worth of the company and the value of the common stock held by the owner. The future growth of the company is thus converted into income paid to the younger generation.

**Example(s):** Say you own all the stock of the XYZ Corporation and the company is worth \$2,000,000. You recapitalize the corporation, retaining the common stock for yourself and transferring all the nonvoting, noncumulative preferred stock with a 7 percent dividend to your children. The common stock is valued at \$800,000, and the preferred stock is valued at \$1,200,000. The value of the preferred shares has been minimized because it is nonvoting and the dividend is noncumulative, thus reducing the potential transfer tax cost. The company makes a dividend payment annually to the children, and the cash drained from the company reduces the net worth of the company. The value of the common stock is either frozen or reduced, so at the time of your death, estate taxes from inclusion of the common stock in your estate will be minimized.

## Strengths

### Corporate recapitalization, if structured properly, allows you to transfer growth of corporation to younger generation

In limited circumstances, a recapitalization of a closely held corporation can transfer the future growth of the company to younger generations while minimizing the transfer tax costs. Unfortunately, with the passage of Sections 2701 and 2704 of the Internal Revenue Code in 1990, the previous advantages and benefits of the classic recapitalization have been greatly reduced. However, as noted above, there are still ways to structure a recapitalization so that it either falls outside of Sections 2701 and 2704 (a

reverse freeze or sale to nonfamily member) or results in some transfer tax benefits to the owner of a closely held corporation.

## Recapitalization may allow owner to control corporation while transferring future appreciation to children

In the classic recapitalization, two classes of stock are created: preferred stock and common stock. The preferred stock has voting rights, liquidation rights, and preferential dividend rights. Generally, the owner keeps the preferred stock and gifts the common stock to his or her children thus allowing the owner to retain control over the company while transferring the right to future appreciation in the company to his or her children.

**Caution:** With the advent of Section 2701, gift tax may be assessed on the transfer of the common stock to the children.

**Example(s):** Say you are the sole owner of the XYZ Company. You expect the company to grow rapidly in the future, and you are concerned about the impact that growth will have on your potential estate tax liability. You would like to be able to both retain control of the company and to remove any future appreciation in the company from your estate. One way to accomplish this goal is to do a recapitalization. You create two classes of stock--preferred and common. The preferred stock retains all voting rights, liquidation rights, and preferential dividend rights. You keep the preferred stock and gift the common stock to your children. Any future appreciation in the company should be reflected in the common stock that has been removed from your estate through such transfer. Because the voting rights are attached to the preferred stock, you can continue to control the company. Of course, if the transaction fails to meet the requirements of Section 2701, the value of the preferred stock will be zero, and the value of the gift of the common stock will be the entire fair market value of the company potentially subjecting the transfer to substantial gift tax consequences.

## Tradeoffs

### Recapitalization may result in substantial transfer tax at time of the gift of common stock to younger generation

With the enactment of Section 2701, a recapitalization may result in a substantial gift tax being incurred at the time the common stock is gifted to a younger generation. In most recapitalizations, the older generation retains the preferred stock and gifts the common stock to the younger generation. Under Section 2701, the preferred stock may be valued at zero in this situation, and thus the common stock is valued at the fair market value of the entire company. If the company has a substantial net worth, then this transfer may result in assessment of gift tax.

**Example(s):** Say you own a closely held company that has a current fair market value of \$4,000,000. You recapitalize the company and retain the preferred stock, gifting the common stock to your children. The transaction fails to meet the requirements of Section 2701, and your preferred stock is valued at zero. The gift to your children is then valued at \$4,000,000 and this amount will be subject to the gift tax. Prior to the enactment of Section 2701, you would have been able to put a high value on the preferred shares thereby reducing the value of the common shares for transfer tax purposes, so it may have been possible to avoid incurring any gift tax on the transfer of the common stock.

### **Recapitalization may result in substantial estate tax liability**

Prior to the enactment of Section 2704, recapitalizations were almost always set up so that the dividend rights, voting rights, and liquidation rights in the preferred stock lapsed upon the death of the shareholder. You could then claim that the value of this preferred stock for estate tax purposes, had been greatly reduced. Under Section 2704, however, any lapsing rights in the preferred stock will be ignored in valuing the stock for estate tax purposes. Therefore, the full value of the preferred stock (taking into account any rights associated with the stock) will now be included in your taxable estate. This can substantially increase your estate tax liability if you hold preferred stock upon your death.

### **Preferred stock issued in recapitalization may be classified as Section 306 stock and may cause adverse tax consequences**

In a recapitalization of a family-owned company, the preferred stock that is issued to the older generation will often be classified as Section 306 stock. Section 306 of the Internal Revenue Code applies to stock (other than common stock issued with respect to common stock) that has been distributed as a tax-free dividend to existing shareholders. The analysis to determine if the preferred stock issued in a recapitalization is Section 306 stock is extremely complicated. Only a highly competent tax attorney or accountant should be consulted to make this determination. In most recapitalizations though, the preferred stock will be Section 306 stock. If the preferred stock is Section 306 stock, then the preferred shareholder may realize ordinary income when the stock is sold or exchanged. The sale of the stock will give rise to ordinary income to the extent the amount received would have been treated as a dividend had the corporation issued cash instead of the preferred stock.

It is important to note that the Section 306 classification applies only if the stock is sold or transferred during the lifetime of the holder. If the stock is held until the time of the death of the holder, then the stock is no longer classified as Section 306 stock. The stock will also not be considered Section 306 stock if the entire interest is sold to an unrelated party or, under certain circumstances, if the stockholder's entire interest is redeemed by the corporation.

## Preferred stock issued in recapitalization may qualify for Section 305 treatment, causing adverse tax consequences to holder

Section 305 of the Internal Revenue Code deals with the tax treatment of distributions made by a corporation of its own stock or rights to acquire its stock. Distributions of stock may, in certain circumstances, be taxable as dividends (i.e. as ordinary income). Most recapitalizations will not involve a distribution that will be treated as a taxable dividend. However, where the preferred stock that is issued to the older generation is redeemable at a premium, the redemption premium may be treated as a taxable dividend.

**Caution:** The rules surrounding application of Section 305 are very complicated and beyond the scope of this discussion. Please consult additional resources, your attorney, or other tax professional.

## Recapitalization may raise other gift, income, and estate tax issues

In addition to the tax issues discussed in the previous sections, there may be additional gift, income, and estate tax issues raised by a recapitalization. When the value of preferred shares received by a shareholder is less than the value of the common shares transferred, the preferred shareholder is deemed to have made a gift to the other shareholders (if the other shareholders are related to him or her). If the shareholders are not related to him or her, then the preferred shareholder is considered to have paid additional compensation (which will be taxable) to the other shareholders. If the value of the preferred shares received by the preferred shareholder is greater than the common shares transferred, then the other shareholders are considered to have made a gift to preferred shareholder (if they are related) or to have paid additional compensation to the preferred shareholder (if they are not related). If a gift is involved, then gift tax may be incurred. However, the value of the common shares transferred should not then be included in the taxable estate of the transferring shareholder.

## Corporation not eligible for subchapter S treatment if it has more than one class of stock

One of the disadvantages of a recapitalization is that the corporation will no longer be able to elect S corporation treatment. After a recapitalization, there are two classes of stock outstanding, and a corporation cannot elect S corporation treatment if it has more than one class of common stock outstanding. For many closely held companies, giving up the ability to elect S corporation treatment which allows the shareholders to be taxed as if the company were a partnership (i.e. income and deductions "pass through" the corporation to the shareholder thus avoiding the corporate level tax) could be a very large disadvantage, especially when individual tax rates are lower than corporate tax rates.

**Example(s):** Say you are the sole shareholder of a very profitable closely held corporation. You have elected S corporation treatment, meaning that all of the income from the company has been passed through to you and taxed once at your tax rates. You are thinking about

recapitalizing your business. One of the tradeoffs that you should consider is that your business will cease to qualify for S corporation treatment. Now, instead of all the corporate income being passed through to you and taxed at your income tax rates, some of that income may be doubly taxed--once at the corporate level and then again at the individual level when the income is paid out to the shareholders.

## **Large cumulative dividend on preferred stock may drain corporation of needed cash**

Typically in a recapitalization, a large, cumulative dividend is required to be paid on the preferred stock (to boost the value of this class of stock). For many closely held corporations, the payment of these dividends every year may severely drain the company of needed cash. In many instances, it may not make business sense to put the future financial health of the company at risk just to try to reduce the cost of transferring the business to the younger generation. If you succeed at reducing the cost of transfer of the business to a younger generation at the cost of the business itself, what has the younger generation really gained? Furthermore, you should understand that the dividends payable to the preferred shareholders are not deductible by the company (unlike salary), and therefore the money used to pay the dividends will be taxed twice--once at the corporate level and again to the individual who receives the dividends.

## **Recapitalization may be extremely expensive and difficult to implement**

With the enactment of Sections 2701 and 2704 of the Internal Revenue Code, recapitalizations have become extraordinarily complex and technical. To structure and to document a recapitalization, you need to hire attorneys, tax advisors, valuation experts, and other professionals to guide you through the statutory and regulatory maze. Unfortunately, none of these professionals work cheaply (and if they did, you would not want to hire them). Furthermore, recapitalizations have become so complicated that many estate planners have stopped recommending them to their clients. Fortunately, there are other methods available to reduce the transfer costs of gifting stock in a closely held company to the younger generation.

## **How to do it**

### **Don't try this at home**

Recapitalizations have become extremely complex and technical. There are numerous legal, tax, and valuation issues that must be addressed before, during, and after a recapitalization. Failure to follow all of the requirements can have disastrous income, gift, and estate tax consequences. Therefore, you should hire a team of experts to guide you through the entire process.

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## Hire competent, experienced legal counsel

You should hire a competent and experienced attorney to structure and document the recapitalization. Because Sections 2701 and 2704 are very complex and very technical, any attorney that is hired should have extensive knowledge about and experience with these sections. The attorney should also have extensive experience with securities and general corporate law issues. Among the other tasks in a recapitalization, new securities will have to be issued to old and new shareholders, stock certificates will have to be transferred, and votes of shareholders or of the board of directors will have to be taken. All of these tasks require the work of an attorney.

## Separate tax advisor may also have to be hired

In addition to hiring an attorney to set up the recapitalization and to draft all of the necessary documents, you may have to hire a separate tax attorney or tax accountant to give tax advice before, during, and after the recapitalization. The tax laws governing recapitalizations are very complex, so only an accountant or attorney who specializes in this area should be hired to give tax advice.

## Appraiser may be needed to value stock and other assets of company

You may also have to hire an appraiser to value the stock and assets of the company that you want to recapitalize. In many cases, appraisal of a closely held company can be very difficult given that shares in closely held companies are not publicly traded and are usually not sold in arms length transactions. Because there is no ready market for determining the value of stock in a closely held company, many appraisers are forced to base their appraisals on sales of shares in comparable companies; however, it may be difficult to find other similar types of companies to use in a comparison appraisal. Due to the complexities involved in appraising closely held corporations, you should use a professional appraiser experienced in corporate valuations.

## Tax considerations

### Income Tax

#### Most recapitalizations recognized as tax-free reorganizations

A recapitalization is an exchange of stock or securities of one corporation for other stock or securities of the same corporation. Typically, the owner of the common stock exchanges the common stock for a combination of common and preferred stock. Most recapitalizations are recognized under the Internal Revenue Code as tax-free exchanges, so the owner of the common shares does not incur a tax liability when the recapitalization takes place. To qualify as a tax-free exchange, the recapitalization must have a valid business purpose (among other requirements). In the case of a closely held corporation, there may be both personal and corporate benefits to recapitalization. In general, as long as a valid business purpose for the recapitalization can be identified, then the transaction should qualify as a tax-free exchange.

### Income tax may be due if boot is received in connection with recapitalization

Taxable gain may be recognized as the result of a recapitalization if the shareholder receives boot in the exchange. Boot refers to cash or some other property that the shareholder receives as part of the exchange in addition to stock. Gain will also be realized if the total value of the stock and boot received is greater than the value of the securities exchanged. However, gain will be realized only to the extent of the boot received. The gain is considered ordinary income if the distribution has the effect of a dividend.

**Example(s):** Say you own all the common stock of the XYZ Company, and the company has a fair market value of \$1 million. You decide to recapitalize the company by having it issue \$900,000 of preferred stock (as a dividend) to you. You also have the corporation pay you \$100,000 in cash. You next gift away all of the common stock to your children. You have received \$1 million (\$900,000 in preferred stock and a \$100,000 cash dividend). You only have to recognize \$100,000 (the amount of the boot) of the gain for income tax purposes. This gain would generally be treated as ordinary income, because the distribution had the effect of a dividend (your proportionate interest in XYZ was unaffected by the distribution).

### If preferred stock in recapitalization is classified as Section 306 stock, the future sale of preferred stock may result in ordinary income

In many recapitalizations, the preferred stock retained by the senior family member of the company will be classified as Section 306 stock. The definition of Section 306 stock is extremely complex, but in most recapitalizations of closely held companies, the preferred stock will fall within the Section 306 stock definition. If it does, then a future sale of that preferred stock may result in the recognition of ordinary income as well as capital gains. Ordinary income is taxed at a higher rate than long-term capital gains, so Section 306 treatment should be avoided if possible. If the preferred stock is held until death, then it is no longer considered Section 306 stock. If the shareholder's entire interest is sold to an unrelated party, then the proceeds from the sale are not taxed as ordinary income. Again, this is an extremely technical and complex area, so an experienced, competent tax advisor should be consulted prior to engaging in this type of transaction.

### Ordinary income may be recognized if preferred stock is redeemed at premium after specified period of time

In most recapitalizations, preferred stock is not redeemable by the corporation. If the recapitalization is structured so that preferred stock is redeemable for a premium (i.e., a price higher than the issue price), then this stock may be subject to Section 305 and the redemption premium thus treated as a distribution to the shareholder. Such deemed distributions are considered ordinary income to the shareholder and are taxed as such.

## Gift Tax

### Recapitalization may result in substantial transfer tax at time of the gift of common stock

After the enactment of Section 2701, a substantial gift tax may be incurred as the result of a recapitalization where preferred stock is retained by the owner and common stock is gifted to other individuals. In most recapitalizations, the original shareholder in the company retains the preferred shares and gifts the common shares to a younger generation. If the transaction is structured this way and fails to meet the requirements of Section 2701, then the preferred shares may be valued at zero. The common shares (and the gift of the common shares) will then be valued at the full fair market value of the company. If the company has a substantial net worth, then gift tax may result from the transfer of the common stock.

### Exchange of stock in recapitalization may have gift tax consequences

An exchange of stock in a recapitalization may have gift tax implications if the value of the preferred shares received by a shareholder is less than the value of the common stock surrendered by that shareholder. In certain situations, the shareholder who received the preferred stock may be deemed to have made a gift to the other shareholders. A gift tax may have to be paid on this gift if the gift does not qualify for the annual exclusion and the applicable exclusion amount (formerly known as the unified credit) has been completely used. If the value of the preferred stock received by a shareholder is greater than the value of the common shares he or she surrenders, then the other shareholders may be considered to have made a gift to that shareholder. Again, the other shareholders may be liable for a tax on this gift.

**Example(s):** Say you are the controlling shareholder of XYZ Company. You exchange 750 of the outstanding 1,000 common shares of XYZ for 5,000 shares of 7 percent noncumulative voting preferred shares that have a par value of \$100. The exchange qualifies as a tax-free recapitalization. If the other shareholders of XYZ are related to you, then the exchange is a gift from you to the other shareholders to the extent that the value of the common stock you surrendered exceeds the value of the preferred stock you receive. You may have a gift tax liability on this transaction.

## Estate Tax

### Section 2704 may increase estate tax liability of preferred stockholder

Prior to the enactment of Section 2704 of the IRC, most recapitalizations were structured so that the dividend rights, voting rights, and liquidation rights would lapse upon the death of the owner of the stock. The owner's estate could then claim that the value of the stock, for estate tax purposes, had been greatly reduced by the lapsing of these rights. However, in those situations falling under Section 2704, all lapsing rights in the preferred stock will be ignored in valuing the stock for estate tax purposes. The full value of the preferred stock, including all rights associated with the stock, will thus be included in

the taxable estate of the preferred shareholder. This change under Section 2704 may substantially increase your estate tax liability if you hold preferred stock upon your death.

### **Value of common stock gifted to children will not be included in taxable estate of preferred stock owner**

In a recapitalization, once the older generation transfers the common stock to the younger generation, any appreciation in the value of that common stock will not be included in the taxable estate of the older generation. As noted, the older generation may have to pay a gift tax on the value of the common stock when it is gifted to the younger generation. However, any future appreciation will not be taxed in the estate of the owner. Thus, a recapitalization still works to some extent to freeze the value of the estate of the owner of the company.

**Example(s):** Say you are the sole shareholder of a medium-sized company and are concerned about the effect of the company's appreciation on the size of your estate. You decide to do a recapitalization, retaining all of the preferred stock in the corporation and gifting the common stock to your three children. The transaction fails to meet the requirements of Section 2701. Your preferred shares are valued at zero, and the common shares are valued at \$3 million. You pay the applicable gift tax at the time of the transfer to your children. The future appreciation of the company will be reflected in the common shares now held by your children. Upon your death 10 years later, the company is worth \$8 million. The additional \$5 million worth of value in the company is not included in your taxable estate. That additional value is attributed to the common shares that were removed from your estate at the time of the transfer to your children.

### **In community property states, both husband and wife should participate in recapitalization**

In a community property state, if one spouse owns the company, then the shares of the company held by that owner-spouse may be considered community property, therefore the nonowner spouse's consent and/or participation must be obtained before the recapitalization can be accomplished.

## **Questions & Answers**

### **After the enactment of Sections 2701 and 2704, are there still situations where a recapitalization makes sense for a business owner?**

The passage of Sections 2701 and 2704 of the Internal Revenue Code greatly curtailed the use of recapitalizations as an estate freezing technique. Nonetheless, there are certain situations where it may make sense for a business owner to recapitalize the business. One situation is when the business owner wants to transfer part of the business to a nonfamily member. Section 2701 does not apply in this case. The traditional valuation techniques can be used to value both the preferred and common shares and the resulting gift to the nonfamily member.

Another situation where a recapitalization makes sense is when the preferred shares are entitled to a cumulative, fixed dividend. In this case, the preferred shares retained by the owner are not valued at zero. The value of the common shares for gift tax purposes is the value of the corporation reduced by the value of the preferred shares retained by the owner. A recapitalization of this sort may allow the owner to retain control of the company while gifting away the common stock (and any future appreciation associated with the common stock) to his or her children. In any case, an experienced estate planning attorney should be consulted to discuss the various methods of recapitalization.

### **What are the alternatives to a recapitalization?**

After the enactment of Sections 2701 and 2704, estate planners have begun to use other techniques with business owners to freeze the value of the business. One strategy that has become very popular is to create a family limited partnership to hold the business interests and gift the limited partnership interests to the younger generation. The gift of interests in the limited partnership typically qualifies for valuation discounts (i.e., the value of the limited partnership interests can be discounted for gift tax purposes from the underlying value of the assets in the partnership). Another strategy is to have the business owner simply gift shares of the common stock of the company to members of the younger generation. Here again, the value of the shares can be discounted. If the annual exclusion and applicable exclusion amount are utilized, the owner may be able to avoid any transfer taxes on such gifts. Over time, a substantial percentage of the company may be transferred to the younger generation without incurring any gift or estate taxes.

### **What is the minimum value rule, and how does it work?**

Because the value of the common stock transferred to the younger generation is equal to the value of the entire company minus the value of the preferred stock retained by the owner, the common shares may be given a very low value if the preferred shares have been highly valued. However, under Section 2701, junior equity interests (i.e., common stock) cannot be valued at an amount less than 10 percent of the sum of the total value of all equity interests in the company plus the total amount of the corporation's indebtedness to the transferor or an applicable family member.

### **In what other instances will Section 2701 not apply?**

There are four other instances where Section 2701 will not apply. One is when the common stock that is transferred is a marketable security (traded on an exchange or over-the-counter markets). The second is when the preferred stock that is retained is a marketable security. The third is when interests of the same class are transferred (e.g., where the owner retains common stock and transfers common stock to the younger generation). Finally, the special valuation rules of Section 2701 will not apply to a transfer where there is a pro rata reduction in each class of equity interests held by the owner and all applicable family members immediately before the transfer.

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

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