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Recapitalizing the Closely Held Business for Estate Planning

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"My company's value is increasing faster than I can afford to gift to my children. What can I do to prevent a huge estate tax liability?" Many professionals who consult closely held businesses frequently hear this concern. One technique that can successfully address this dilemma is a recapitalization, which was defined by the Supreme Court as a "reshuffling of a capital structure within the framework of an existing corporation."[1] Recapitalization is an important strategy for the estate-planning attorney, accountant or business appraiser who advises clients on business succession and estate planning.

One specific type of recapitalization, the preferred stock recapitalization, is discussed here with special focus on the resulting benefits, drawbacks and valuation issues. It is important to note that a single misstep can spell tax disaster, thwart the original goals and imperil the financial condition of the company. Only the knowledgeable professional can provide effective advice and use the technique to successfully accomplish the tax, financial and family succession goals of clients.

A client may faithfully follow professional advice and use the personal exemption, along with continuing annual exclusion gifts to pass ownership to the next generation. Still, the business value can keep growing at a rate faster than it can be effectively given away. The situation is critical if the client has limited personal liquidity to pay large gift taxes required on the sizable gifts needed to outpace the growth in value.

The "Preferred Stock Shuffle"

A preferred stock recapitalization, or "freeze," can resolve the problem of increasing estate tax liability and shift future appreciation in company common equity value to heirs. Straight preferred stock (not convertible into common stock), while legally representing equity in a company, is really much like debt in that it does not benefit directly from continued growth in company value.

By exchanging a portion of one's common stock holdings for a newly created class of preferred stock, and then gifting the remaining common stock to offspring, the owner can fix the value (with some exceptions noted later) held for future estate tax purposes. The children bear the benefit in the future growth of value of the common shares along with any individual future estate tax liability. Moreover, the preferred stock might (in certain circumstances) possess voting rights. Thus, the older generation may still hold voting influence or even control. This is obviously important if the next generation is not sufficiently groomed to lead the company.

Valuing Preferred Stock

Although technically equity, nonconvertible preferred stock is really more like debt or a bond from a valuation standpoint. However, it comes behind debt-holders in preference in a liquidation. Preferred stock is valued similar to a bond or other debt instruments. That is, the value is fundamentally the present value of the future stream of payments (dividends in the case of preferred stock, plus any redemption or liquidation proceeds) to be received, with dividends discounted back to their current worth at a discount rate which reflects risk of nonpayment and the time value of money.

Valuing preferred stock can be quite complex. First, is the preferred stock cumulative or noncumulative (if the company misses a dividend the holder does not recapture the lost benefit)? Does it have a liquidation preference, and if so, in what amount? Does the issue have protections or triggers in the event the company takes actions, financial or otherwise, which could endanger the ability of the enterprise to meet continuing dividend payments, now or in the future? All of these factors affect risk and, therefore, the yield (dividends as a percentage of the face value of the preferred issue) required.

Fundamental Credit and Risk Analysis Essential

Other risks must be carefully and fully examined to arrive at the appropriate dividend yield necessary to value preferred stock. Most basic is an analysis of the financial condition of the company and its ability to meet existing debt service requirements and operating needs, along with the preferred dividend from its current and anticipated future cash resources. This involves a full credit analysis. Such analysis includes an examination of liquidity (ability to meet current liabilities from liquid and near liquid assets), working capital, leverage (reliance on debt) and asset utilization. Trends in earnings, cash flows and forecasted future results must also be examined. Also, the nature, terms and loan covenants of the debts in place must be reviewed. How do they increase risk and affect cash flows? What secures these obligations? If there is a default, what is the collateral coverage (at liquidation value of the assets) available to pay off creditors and still cover the preferred stock liquidation preference? Or, will there be a shortfall?

Beyond the numbers are a whole host of other risk factors both internal and external to the company that must be examined. Internal risks might include key person issues, reliance on one or several key customers or suppliers, and access to credit, to name just a few. External variables include an almost limitless array ranging from the economy and the outlook for the industry, to government regulations, competitive threats and new technologies. In order to value preferred stock the business valuator must undertake a full examination of these and many other risk factors.

Recapitalization offers a potential reduction in personal risk. An advantage for the older owner is that by exchanging common for preferred, the individual may be able to lower the risk of the high proportion of net worth they have tied up in the company. This may occur since the preferred shares typically have a liquidation preference and will come ahead of the company common shareholders in the event of a problem. Of course, this is not always true and will depend on the degree of asset protection backing the liquidation preference, the post-recapitalization impact of the dividend requirement on the financial condition of the business, the terms of the preferred stock issue, and a host of other factors.

Why Does Risk Affect the Value of Preferred Shares?

The higher the risk, the higher the yield an investor would require to buy the preferred shares of a company. Risk directly impacts value since the higher the yield required for risk, the lower the present value (in today's dollars) of the respective future income (dividends) streams to the buyer. If the stated dividend rate on the issue is below a market rate, the preferred stock will have a market value below its face amount. Conversely, if the rate is higher than the market, it will have a market value that is at a premium to its stated face amount. Therefore, if the client has decided to exchange common stock in a closely held business worth $3,000,000 for an equivalent value of new preferred stock, the company's attorney and accountant must work closely with the business valuator to devise a preferred stock issue with the right combination of terms and yield which will cause it to have the same fair market value. If the owner gets less in equivalent value than he or she gives up, the IRS could construe the difference to be a gift. Also, excellent legal advice is required since the use of certain credit protection features, and other bells and whistles to lower the required yield on the preferred could run afoul of IRS regulations on estate-planning freezes.

If the recapitalization results in the owner still retaining common shares which constitute a minority interest, it is possible that these shares might be valued for estate tax purposes with discounts for both minority interest and lack of marketability. However, the applicability of these discounts will depend on an examination of the entire transaction, the degree to which the preferred shares have voting rights, if any, the resulting distribution of ownership, the impacts of the bylaws and shareholders' agreements and a host of other factors.

Ideal Climate to Issue Preferred Stock

Since preferred stocks are valued much like debt, their value is highly interest sensitive. That is why an environment of low interest rates is ideal for undertaking a recapitalization. The dividend yield set on the new issue might be lower than in other economic periods since it is correlated to a significant degree with interest rates, lowering the annual impact of the annual cash flow needs of the company to meet the obligation.

"Fixed Value"—Or Is It?

It is not exactly true to say that the preferred stock has a fixed value that is immovable. Changes in three key factors—credit quality, the general level of interest rates, and trends in preferred dividend yields—can change the value of the preferred shares over time from that at the time of the recapitalization. If credit quality improves, thus lowering risk, this may lower the yield a fair market value investor requires on such an issue, raising the value of the preferred stock with its already stated and fixed dividend rate. Conversely, a deterioration in company finances, the industry outlook, or negative changes in the management team, to name just a few, may have the opposite effect. Similarly, changes in the general levels of interest rates and market returns also change the value, much as they impact the value of bonds.

Downside of a Recapitalization

The first, and most obvious, disadvantage is giving up the chance to share in the potential future growth in company value. Second, the company faces a continuing dividend requirement that may drain precious cash flows at a time when the company has more critical needs, such as a new plant and equipment, or product research and development. Rapidly growing companies, which are often the ones growing most in value, are also the ones that most need to reinvest cash flows to support increasing investments in receivables and inventory to support that growth. Also, companies in heavily cyclical industries are especially vulnerable, as preferred stock creates a long-term ongoing liability that does not respect the business cycle.

Can the dividend just be made noncumulative? No. As a result of a desire to prevent abuses during the early and mid-1980s, in 1988 Congress passed Section 2036 (c) of the Internal Revenue Code which implemented such restrictive provisions that recapitalizations were impractical. However, in 1990 Congress changed course and repealed the same provisions, adopting a more moderate stance. As a result, recapitalizations can again be done, albeit with some restrictions, one of them being that the preferred dividend must be cumulative, a factor that places a continuing obligation on the company.

Additionally, special valuation rules under Section 2701 of Chapter 14 of the Internal Revenue Code set forth specifically how the preferred must be valued, as well as the subtraction method for insuring that there is value to the remaining common. First, the 100% control value of the firm must be established, from which is then subtracted the value of the preferred to determine the post-recapitalization value of the remaining common.

Retaining voting rights may create other problems such as the potential for a premium for control to be applied to the value of the preferred stock. *Estate of Trenchard v. U.S.*[2] is an excellent recent example of just such a problem where the Tax Court applied a premium for control to the preferred shares, resulting in an imbalance in value compared to that of the common shares given up in exchange. Typically, a preferred shareholder either has no voting rights or represents such a small minority interest that it unilaterally has little or no control. However, the large voting preferred holder may in fact have real power, and thus, the issue may warrant a premium for control from a valuation standpoint.

IRS Review of Transaction Is Likely

Because of the potential for abuse, the IRS is highly likely to scrutinize recapitalization transactions. Was equivalent value transferred? Or is the preferred stock received really worth far less than common for which it was exchanged? Therefore, it is critical that an expert valuation be prepared by a skilled, independent and unbiased valuator. The valuation must be thorough, professional and well-documented to withstand examination, possibly years in the future.

The written report should examine all of the required valuation approaches, and undertake an exhaustive search for comparable publicly traded preferred stock issues in order to estimate the market dividend yield. These comparables must be fully analyzed and compared to the subject company along a variety of criteria to arrive at a meaningful valuation. Additionally, there must be a complete analysis of the company, its industry, outlook, financial conditions and all of the issues required by sound valuation practice, revenue rulings and case law.

Conclusion

A properly structured preferred stock recapitalizaton can achieve the three goals so often facing the clients of estate-planning attorneys and accountants- reduction of personal investment portfolio risk, minimization of future estate tax liability, and intergenerational transfer of wealth. It is essential that such a transaction involve a skilled valuation professional. Skilled legal and tax counsel must be involved at every step of the process to insure the desired outcome, and that it meets the complex requirements of the Internal Revenue Service. ◆

END NOTES

[1] *Southwest Consolidated Corp.*, 42-1 USTC ¶9248, 315 U.S. 194.

[2] *Estate of Trenchard*, Dec. 50,536(M), T.C. Memo. 1995-121.