Keys to Sound Business Succession and Continuity Planning

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I. INTRODUCTION

In a closely held business, the owner—whether alone or with a group of associates—has built an enterprise in which a great deal of personal wealth as well as a family's future economic well-being may be invested.

Estate and business succession planning should begin early in a company's life cycle. If any one of the co-owners leaves the business – because of death, permanent disability, or retirement – the departing owner and the business each face many pressing questions. For example, the continuing owners may not wish to work with a stranger to the business or with their former colleague's previously uninvolved surviving spouse or other family members. They will therefore need a means for buying out the departing owner's interest. They will also want to maintain business continuity. Further, the departing owner will want to maximize the value and liquidity of his or her interest in the business to ensure personal, and family, financial security. A deceased owner's estate may be faced with an estate tax liability. Both sides must also consider the income tax consequences associated with a transfer of a departing owner's interest in the business.

A business with more than one owner should consider buy-sell agreements as a means of ensuring a smooth transition of ownership and continuity in the business, while at the same time creating a market for a departing owner's interest in the entity. Insurance on the owners' lives often accompanies a buy-sell agreement. Insurance proceeds may also be used to pay estate taxes when an owner dies. Insurance is also a means to provide liquidity and financial security for an owner's family. There are a vast array of options to properly protect the owner of a closely held business, the owner's family, and the business in the event of death, retirement, or disability.

For the owner of an interest in a closely held business, choosing the right type of insurance coverage is one of several essential strategies. Given the myriad of choices, it is important to consult a qualified professional early in the planning process, as part of a comprehensive business succession planning program.

A sole business owner does not have existing partners to contend with. By the same token, the sole owner does not have existing partners who are motivated to continue the business. Thus, sole owners are faced with the task of identifying an appropriate successor to continue the business (if desired) and to ensure that their families have an alternate means of financial security, if the business will not continue as an ongoing enterprise.

Finally, a retiring owner may want to consider various structures in order to retire while maintaining control and/or a steady income stream from the business.

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II. BUY-SELL AGREEMENTS

A. Purpose of a Buy-Sell Agreement

Buy-sell agreements are an essential estate and business planning tool for a business with more than one owner. A buy-sell agreement can assure that the deceased owner's estate (and family) will receive liquidity instead of an unmarketable interest in a closely held business. The planning process can provide the deceased owner, while alive, with the opportunity to negotiate and obtain the fairest or best price for his or her interest in the business. In the case of retirement or disability, the buy-sell agreement provides a market for the departing owner's interest and can provide an additional source of retirement or disability funds for that owner. Finally, the buy-sell agreement may establish a valuation of the stock for estate tax purposes.

B. Events that Trigger the Buy-Sell Agreement

The buy-sell agreement typically provides that any one or more of the following events will trigger either an option to buy, a right of first refusal, or a mandatory obligation to buy and sell: (1) death; (2) disability; (3) termination of employment, if the shareholder is also an employee; (4) desire of a shareholder to sell stock; (5) divorce; (6) bankruptcy or any similar situation in which shareholder-creditors may obtain rights to stock ownership or control.

C. Types of Buy-Sell Agreements

The two most common purchasers of a departing owner's interest are (1) the remaining owners, using a "cross-purchase" arrangement, and (2) the business itself, using a "redemption" arrangement.

1. Cross-Purchase Arrangement

Under the cross-purchase arrangement, if an owner withdraws from the business, the *continuing owners* will acquire the withdrawing owner's interest *directly* from the departing owner or from the owner's estate for a purchase price determined under the agreement. The funds for the purchase are supplied by the remaining owners and not by the business entity itself. This can prevent an unintended shift in control over the business and can also be used to increase control in certain owners.

2. Redemption Arrangement

With a redemption agreement, the business entity redeems the departing owner's interest upon the occurrence of a specified triggering event.

3. Employee Stock Option Plan (ESOP)

In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Contributions of cash to the plan are generally deductible by the corporation. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits. ESOPs are only available to corporations.

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100 percent vested within three to six years, depending on whether vesting is all at once or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value. Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or

relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues.

Owners of privately held companies can use an ESOP to create a ready market for their shares. Under this approach, the company can make tax-deductible cash contributions to the ESOP to buy out an owner's shares, or it can have the ESOP borrow money to buy the shares. In C-corporations, once the ESOP owns 30 percent of all the shares in the company, the seller can reinvest the proceeds of the sale in other securities and defer any tax on the gain. An ESOP is attractive because it allows the closely held business owner to reinvest the proceeds from the sale of his or her stock to the ESOP in marketable securities which may provide the business owner with greater liquidity, or to make a charitable contribution of said proceeds without incurring capital gains tax.

At the same time, an ESOP provides a tax-exempt medium for employees to participate in the business. The intent is to facilitate employees' participation in the fortunes of the corporation by which they are employed, creating a sense in them of ownership and pride. The ESOP may enter into an agreement with a shareholder to acquire all or part of his or her shares. It may be beneficial if the owner has identified key employees who ideally would take over the business when the owner departs it.

ESOPs can be costly to set up and administer.

4. Additional Alternatives

There are a number of additional buy-sell agreements that can be used. The cross-purchase and redemption forms can be combined into a hybrid type of buy-sell agreement by giving the entity the primary right to acquire the selling owner's interest and permitting (or requiring) the remaining owners to redeem the withdrawing owner's interest to the extent the primary right is not exercised.

It may also be desirable for the withdrawing owner to agree to sell all or a part of his or her interest to a successor. Usually, this successor is someone who is either a complete outsider with no ownership or employment relationship with the entity or someone who is connected with the business in some way other than by ownership.

D. Pricing Mechanics of the Buy-Sell Agreement

When a buy-sell agreement is drafted, the parties should establish a method for fixing the price. Although occasionally the valuation method selected yields an inappropriate price when finally used, waiting until the time of an owner's departure diminishes the certainty that the agreement is intended to establish. There are three general approaches to establishing the price for the business interest: (1) fixed price; (2) formula price; and (3) appraisal.

1. Fixed Price

Under the fixed price approach, the parties initially negotiate a fixed price to be paid upon the occurrence of a triggering event, *e.g.*, retirement or death. It is crucial that the parties build into the agreement some mechanism by which this price may be periodically adjusted in order to reflect increases or decreases in the value of the business.

2. Formula Price

With the formula price method, the parties may agree that the purchase price will be determined by a specified formula. While the criteria will depend upon the type of business involved, two common methods are a specified multiple of either annual earnings or asset book values. It is also important to establish the date of valuation in the buy-sell agreement. Otherwise, a valuation date after the event causing the buy-out might provide an opportunity for the remaining owners to alter the valuation result.

3. Appraisal

If the parties decide to hire an appraiser, the most important thing is to identify the appraiser or to set forth how the appraiser will be selected. The procedure for the selection of an appraiser should be carefully spelled out and should

address: (1) who should participate in the selection; (2) how disagreements should be handled if the parties are unable to agree upon the appraiser; and (3) who should bear the cost of the appraisal. One method may be to choose three appraisers, with the purchasers to select one, the sellers to select one, and the two appraisers chosen select a third. The agreement should also provide the standards by which the appraiser is to operate in determining value.

E. Funding the Buy-Sell Agreement

Once a valuation approach is determined, the parties should agree on how the buy-sell agreement should be funded to ensure that there will be some certainty about the source and extent of liquidity. The purchasing party or entity may obtain the funds to purchase the withdrawing owner's interest from a variety of sources.

Through self-funding, an owner may use his or her own resources to supply the requisite funds. When there is a reliable source of funding, payment in full at the closing may be possible. The purchaser may also have the option to take a loan to fund the entire purchase price, or any part thereof, with interest, which should be evidenced by a promissory note.

While self-funding is an option, frequently it is not economically viable for a purchasing party. Hence, one of the most common ways to fund the purchase obligation is through insurance proceeds. With many options available, the type of insurance an entity chooses will depend upon the individual needs of the owners and business, as discussed in Section V, below.

III. INCOME TAX CONSEQUENCES

The federal income tax consequences for the parties to a buy-sell agreement will differ, depending upon whether the entity is a C-corporation with unrelated shareholders, a family C-corporation, an S-corporation or a partnership or limited liability company.

A. C-Corporations with Unrelated Shareholders (*i.e.*, Non-Family Owned Corporations)

1. Cross-Purchase Agreements

a. Tax Consequences to Withdrawing Shareholders

The withdrawing shareholder whose shares are purchased by the remaining shareholders will recognize gain or loss depending on the difference between the amount the departing shareholder receives and the shareholder's basis in his or her stock. If the withdrawal is triggered by death, the shares receive what is known as a "basis step-up," meaning that the deceased shareholder's estate will have a basis equal to the value of the shares on the date of the deceased shareholder's death. Thus, if there is a buy-sell agreement in place which is effective in fixing value for tax purposes, there will normally be no resulting gain when the deceased shareholder's estate sells the shares.

b. Tax Consequences to the Purchasing Shareholders

The income tax treatment of the purchasing shareholders will depend on the way they fulfill their purchase obligations.

If the shareholders undertake the purchase with their own funds (which may include the proceeds of insurance that each shareholder purchased on the lives of each other shareholder), the tax consequences will be no different from those resulting from the purchase of any other asset, and the price paid will constitute the acquirer's tax cost for the acquired shares (which may, and indeed almost certainly will, differ from the cost basis of the shares they already own). *Thus, the remaining shareholders will effectively receive an increase in the basis of their stock.*

The participation of the corporation in the acquisition could be problematic, unless the buy-sell agreement (in its form before occurrence of the triggering event, because a post-mortem amendment will not suffice) provides for the

possibility of purchase by the corporation (*i.e.*, a hybrid form of buy-sell agreement as discussed above). If the corporation's redemption is not pre-planned in this fashion, its purchase will be treated as a constructive dividend to the continuing shareholders and may cause the remaining shareholders to recognize dividend income in an amount equal to the proceeds employed by the corporation in the redemption.

2. Redemption Agreements

a. Tax Consequences to Withdrawing Shareholders

Generally, if the corporation is not controlled by members of the departing shareholder's family, the withdrawing shareholder will be deemed to have sold his or her stock to the corporation, realizing gain in an amount equal to the difference between the redemption proceeds and the shareholder's basis in the shares. When the event giving rise to the redemption is the shareholder's death, his or her successor in interest (*i.e.*, his or her estate or a beneficiary) will have no gain in the usual situation, because the shares in question receive a step-up in basis, as described above.

However, if all of the departing shareholder's stock is not redeemed in the transaction, it is possible that the redemption will be treated as a dividend which will likely be less favorable from a tax perspective to the departing shareholder (or the shareholder's successor in interest). In such an event, it is important to consult with a qualified tax advisor before proceeding.

b. Tax Consequences to the Continuing Shareholders

The continuing shareholders' respective ownership percentages will change as a result of the buyout of their fellow shareholder's shares, but the redemption will not have any tax consequences for them. Thus, the remaining shareholders' basis in their respective shares remains the same. This may make a cross-purchase structure more favorable to the remaining shareholders than a redemption because a cross-purchase structure generally results in an increase in the remaining shareholders' cost basis in their shares.

3. Sale to ESOP – Tax Consequences to the Selling Shareholders

The ESOP is intended to facilitate employees' participation, through stock ownership, in the fortunes of the corporation which employs them. However, there are various tax complexities which may make the ESOP a less desirable shareholder in a closely held corporation. There is also a cost associated with an ESOP's continuing administration. An ESOP should not be pursued without prior consultation with a qualified tax advisor.

B. Family Owned Corporations

1. Cross-Purchase Agreements

Generally, the tax result is the same as for non-family owned corporations.

2. Redemption Agreement

When the shareholders are related, it is more difficult for a redemption to qualify as a sale or exchange (and therefore receive capital gains treatment) as opposed to dividend treatment as described above. Usually, the redemption will be treated as a sale or exchange only if the departing shareholder ceases to have any connection with the corporation (*i.e.*, as a shareholder, director, or employee).

Sale or exchange treatment is preferable for income tax purposes. First, capital gains have historically been taxed at a rate lower than dividends, although those rates are currently the same. Second, in a sale or exchange only the gain (*i.e.*, the excess of the redemption proceeds over the departing shareholder's basis in the stock) is taxed. Conversely, if the redemption is treated as a constructive dividend, then *all* of the redemption proceeds could be subject to tax. In the case of a deceased shareholder whose shares received a basis-step up, the deceased shareholder's estate would not realize any taxable income from a sale or exchange but would be taxed if the redemption was treated as a constructive dividend.

3. Sale to ESOP

A sale of the departing shareholder's shares in a family corporation to an ESOP is less likely to run afoul of the dividend treatment received by the redemption agreement.

C. S-Corporations

1. Cross-Purchase Agreement

a. Tax Consequences to the Withdrawing Owner

Under a cross-purchase agreement, the withdrawing shareholder or the shareholder's estate will recognize capital gain on the difference between the basis of the interest being transferred and the amount received in the exchange.

b. Tax Consequences to Purchasing Shareholders

The continuing shareholders of an S-corporation should have no concern about constructive dividends.

2. Redemption agreement

Except in the case of S-corporations with accumulated earnings from prior C-corporation status, the redemption distribution is treated as reduction in the departing owner's basis. To the extent that the redemption proceeds exceed basis, the excess is treated as a capital gain. If the redemption proceeds are less than the departing owner's basis, the loss may be non-deductible in the case of a family owned corporation.

D. Partnerships and Limited Liability Companies

1. Cross-Purchase Agreement

a. Tax Consequences to the Withdrawing Owner

Under a cross-purchase agreement, the withdrawing partner/member or his or her estate will recognize capital gain on the difference between the basis of the interest being transferred and the amount received in exchange. If the withdrawing partner/member is, in fact, the estate or beneficiary of a deceased prior owner, then most, if not all, of the taxable gain should be eliminated by the step-up in basis to fair market value that is received.

b. Tax Consequences to the Purchasing Owners

The purchasing partners under a cross-purchase agreement will not have any tax consequences from the transaction, per se.

2. Redemption Agreement

Generally, a partnership's or LLC's redemption of a partner's interest will have the same tax consequences for the withdrawing partner and remaining partners as a buyout pursuant to a cross-purchase agreement.

As in the case of distributions generally, a partnership usually does not recognize gain upon the liquidation of one partner's interest in the partnership.

IV. PAYMENT OF ESTATE TAXES

An owner of a substantial interest in a closely held business also needs to consider estate tax issues, especially when the owner is not married or leaves a substantial portion of his or her estate (*e.g.*, the closely held business interest) to someone other than the surviving spouse. Generally, transfers at death to spouses (or certain trusts for a spouse's benefit) do not trigger estate taxes.

The liquidity problem inherent in the ownership of an asset for which there exists no ready market raises the question of how to raise cash for the payment of taxes and other death-associated expenses without being obliged to dispose of the asset at a "fire sale" price and/or at a prohibitive income tax rate. A shortfall of sufficient liquid assets to pay the estate tax incurred as a result of the transfer may necessitate a forced sale or liquidation of the business itself. A number of favorable tax options along with insurance proceeds may be used to solve these liquidity problems.

First, it is important to determine whether the business owner's estate will be subject to federal estate taxes. Unfortunately, as shown by the following brief discussion, the estate tax laws are in a state of flux.

Currently, an individual can leave a bequest of $2 million dollars free of federal estate tax; in 2009, this amount rises to $3.5 million. In 2010, the federal estate tax is eliminated altogether, and in 2011, the federal estate tax returns and each individual may leave a bequest of only $1 million without triggering estate taxes. To repeat, the estate tax is generally not a problem when the first spouse of a married couple dies because of what is known as the unlimited marital deduction. In addition, with proper planning, a married couple can leave to their family double the amounts outlined above. Finally, many states have their own death taxes which are triggered at amounts that are lower than the federal tax amounts outlined above.

If the business owner is subject to estate tax, a number of techniques can be used to reduce or even eliminate the tax. Strategies include structuring an estate plan to take advantage of certain deductions and credits available to a married couple, taking advantage of exclusions for certain annual gifts which are below a specified amount, and employing structural devices to reduce the value of closely held business interests for estate tax purposes or shift a portion of the business's future appreciation to younger generations. An in-depth discussion of these techniques is beyond the scope of this paper. Owners of business interests with significant value should consult a qualified tax advisor.

A. Deferral of Federal Estate Tax Liabilities

Buy-sell agreements can be combined with several tax options available to business owners to help solve liquidity needs. If the business owner's estate meets certain requirements, the federal tax code allows for payment of federal estate taxes in annual installments which, under appropriate circumstances, are payable over 15 years. This can allow the family to retain the business and use a portion of its positive cash flow to meet the estate tax liability.

To qualify for deferral of payment of federal estate taxes, the closely held business interest must constitute a significant portion of the decedent's estate (approximately 35 percent), the business must be an active trade or business, and the decedent's estate or successor in interest cannot dispose of more than half of the business interest received from the decedent within ten years of the decedent's death.

B. Redemption of Stock to Pay Expenses

A corporation may be permitted to redeem stock owned by a deceased stockholder to the extent of federal and state death taxes (including interest), funeral expenses, and administration expenses without the redemption being treated as a dividend. Rather, the redemption will be treated as a sale or exchange even though the redemption would not otherwise qualify because, for example, the decedent's estate or successor interest, did not fully divest itself of its interest in a family owned business. Because the decedent's shares received a basis step-up, distributions from the corporation trigger minimal income tax consequences if the corporation will be the source of the cash for the payment of estate taxes and costs of administration, and stock in the corporation is to be distributed to family members or

trusts for their benefit. Assuming the redemption is made shortly after death, there should be little or no capital gains tax paid by the party making the redemption.

C. Loans

The personal representative may also elect to borrow the funds necessary to pay estate taxes from a third party, including an entity controlled or owned by the decedent's estate or beneficiaries. Borrowing from a third party might allow the deceased owner's estate to deduct the interest payment for estate tax purposes as a cost of administration. It could even be feasible to structure the loan arrangement so that the entire interest payment over the term of the loan can be deducted as a cost of administration when the estate tax return is filed. There are various technical requirements associated with qualifying for this deduction, and it is therefore important to consult a qualified tax advisor before arranging for such a loan.

Regardless of the funding arrangement, the business owner must plan how to finance the deferred tax or loan payments. If the business is taxed as a C-corporation, great care must be taken in planning for distributions from the corporation to avoid dividend treatment. Once an appropriate option has been selected, it is important to periodically monitor the situation to anticipate and avoid potential pitfalls.

V. INSURANCE

A. Background

With an array of options to choose from, insurance proceeds may be used to fund a buy-sell agreement, pay off estate taxes, or provide financial security for the family of the deceased owner. The type of insurance a business owner or an entity chooses depends on individual preferences and needs. With the number of options available, it is important to consult a qualified insurance professional early in the planning process.

B. Term Life Insurance

Term life insurance provides only pure insurance coverage. Because it has no cash-value build-up, it is less expensive in the insured's younger years than whole-life coverage. As the insured ages, however, the term life premium becomes significantly more expensive, eventually overtaking the normally level premiums of cash-value insurance.

By definition, term insurance is protection for a specified term, *e.g.*, 20 years, after which it may automatically expire unless it is a renewable policy. The owner of the policy pays a fixed annual premium for the specified term. Even if a renewable term policy is purchased, the cost of insuring the aging owner for another term can be prohibitive. One way to circumvent the problem is to purchase a rider with the original term policy to allow the insured to convert the policy to whole-life insurance. The premium may increase upon conversion, but the insured may not need to provide new evidence of insurability (*i.e.*, undergo a subsequent medical examination). The less expensive term policy with a convertibility rider may enable a new company with limited assets to use life insurance to fund a buy-sell agreement. In later years, when the company can afford the higher whole-life premium, the term policy can be converted.

C. Cash-Value Life Insurance

Cash-value life insurance combines protection and savings, because part of the premium pays for pure life insurance coverage and part of it accumulates tax-free in the cash-value build-up inside the policy where it is available to the policyholder if it is needed before the policy matures, *e.g.*, in the event of the lifetime withdrawal of the insured from the business. Cash-value policy premiums are usually level throughout the policy's existence but are significantly higher than premiums for term insurance during the policy's earlier years.

1. Whole-Life Insurance

A common type of cash-value policy is the whole-life or level-premium policy, sometimes called the "life-to-100" policy, because it may provide protection to age 100 or for the insured's whole life. The whole-life policy (also called

"ordinary whole life") has a cash value component because the amount of the earlier premiums exceeds the cost of pure term insurance; the excess is accumulated in an interest-bearing reserve fund that later offsets the higher cost of protection as the insured ages. In a whole-life policy, both the premium and the death benefit are fixed.

Because whole life is the least expensive form of permanent (vs. term) protection, this type of cash-value policy is advisable for business owners who can afford only modest amounts of insurance. Because of its level premium feature, it is also advisable for owners of businesses in which little growth is anticipated.

2. Universal Life Insurance

Another type of cash-value policy is the universal life policy, which allows the insured to vary the amounts of the premiums, the death benefit, and the cash value, thus offering greater flexibility than the whole-life policy. This flexibility is possible because the premium is unbundled, as illustrated in the insured's itemized statement showing the amounts of the premium that are (1) used to purchase the death benefit; (2) invested for the cash value; and (3) applied to the insurer's cost to maintain the policy. In such a policy, the insured may adjust both the amount of death benefit purchased and the amount of the cash-value investment. (The third component, the insurer's expenses, is fixed.) For example, the insured/owner may adjust (1) the death-benefit portion of the universal-life premium in order to reflect changes in the value of the business, or (2) the cash-value component of the premium, as well as select investment options for the cash-value component, if the insurer allows the insured to adjust the amount of risk undertaken in investing this portion of the premium. Thus, a business owner who is more risk-tolerant or financially sophisticated may invest the cash-value portion in markets whose growth conditions reflect that of the subject business. If the cash account is well invested, the cash value in the policy should be worth more when the business is performing well, because both continuously reflect the market. Also, in years when the market is off and the policy owner may have difficulty finding funds to pay the premium, a well-invested cash account may be tapped to pay some or all of the premiums.

3. Survivor Joint-Life Insurance

Another type of cash-value life insurance policy (in which the underlying policy may be whole life, universal life, or another kind of cash-value policy) available for funding buy-sell agreements is the survivor joint-life policy, which is one policy insuring two or more lives. In the context of buy-sell arrangements, the joint-life policy pays benefits on the death of the first insured co-owner (*i.e.*, it is a "first-to-die" policy), and again at the second death, etc. The major attractions of the survivor joint-life policy are that it: (1) insures two or more lives at a much lower cost than separate individual policies on, for example, each owner's life, which enables the business owners to obtain more insurance coverage if needed; (2) allows co-owners to be insured for different amounts, depending upon the proportional interest each owns in the business; and (3) makes insurance possible or more affordable when one co-owner's poor health makes him or her uninsurable. Also, the joint-life policy can be accompanied by riders that: (1) pay up the policy after the first death, *e.g.*, where the sole surviving owner will not need increased coverage; (2) provide the option to change one of the insureds, *e.g.*, where a new co-owner replaces the deceased owner; or (3) provide an option to split the policy into separate policies if an unforeseen dissolution of the business occurs.

D. Disability Insurance

Buy-sell agreements funded with life insurance, which have traditionally protected surviving owners only on the death of a co-owner, do not provide adequate protection when a co-owner survives but is disabled. The healthy, remaining owners are still faced with potential issues, such as profit drain, indecision, and sharing control with members of the disabled owner's family (who may lack the disabled owner's experience and skills). A disability buy-sell provision, funded with disability insurance, allows the healthy co-owners to buy the disabled owner's interest after a pre-established waiting period, *e.g.*, after two years, during which the extent of the disability can be assessed.

It is very likely that one policy can be purchased that will provide all of the above benefits. For example, a survivor joint-life universal policy with an adjustable cash-value component can be purchased with a disability rider and other options as well.

E. Deductibility of Life Insurance Premiums

1. Cross-Purchase Agreements

Premiums paid by co-owners to insure one another's lives are considered to be personal expenditures and, as such, may not be deducted for income tax purposes.

2. Redemption Agreements

A corporation is similarly barred from deducting the premiums it pays for insurance to fund its obligations under a redemption agreement; such premiums are classified as nondeductible capital expenditures, rather than ordinary and necessary business expenses.

VI. RECAPITALIZATIONS

A. Background

A recapitalization is a transaction in which an equity owner transfers his or her interest in the issuing entity in exchange for another kind or class of interest in the equity.

A recapitalization involves two or more classes of equity interests to separate the various rights represented by an ownership interest in the entity, such as the right to share earnings, voting control, future appreciation, and net liquidation proceeds. A "preferred" interest, for example, gives the owner a priority right to a fixed amount of earnings and net liquidation proceeds. A "common" interest gives the holder a right to earnings and net liquidation proceeds above the amounts granted to the holders of preferred interests and always contains the right to the future appreciation in the net value of the entity. An S-corporation, however, cannot have classes of stock which provide varying economic rights.

An interest in an entity (including S-corporations) may be or may not be coupled with a right to vote.

B. Recapitalizations as a Planning Tool

Recapitalizations serve several functions as an estate or retirement planning tool. A recapitalization may be used to shift future growth to junior owners as a means of reducing the value of the senior owner's estate and the estate tax due upon the senior owner's death. A recapitalization may enable a senior owner to transfer control of the entity to junior owners or to the next generation while maintaining the right to receive income from the business, *e.g.*, for retirement. A recapitalization may also improve the donor's personal financial security during retirement by giving him or her a priority right to both the dividends and liquidation proceeds through a preferred interest.

A recapitalization accomplishes estate tax planning and retirement goals without forcing the donor to surrender management and control of the business. For example, an owner can recapitalize his or her interest into voting and non-voting interests and transfer only non-voting interests.

C. Post-Mortem Recapitalizations

The management of a company may consider a recapitalization in order to shift control from a surviving spouse or other inactive beneficiaries of the deceased owner's estate to other owners who participate in the operation of the business. A recapitalization may also be a suitable solution when the deceased owner's surviving spouse inherits an interest in a closely held entity, and needs a source of fixed income, but the company is unable or unwilling to purchase the spouse's stock outright. In either situation, the company could create a second class of ownership interest, either nonvoting common or nonvoting preferred, paying fixed annual dividends, which would be distributed to the spouse in exchange for the spouse's voting common interest. Such a recapitalization would provide the spouse with a fixed income and assure the surviving owners that they would be able to operate the company without interference from the spouse. If the company wished to be in a position to eliminate the spouse's interest when it was

financially able to do so, it could make the newly issued interests callable, and would have the right to repurchase the spouse's interest.

VII. CONCLUSION

Proper estate and succession planning can help prepare for many complex tax, economic, and family issues, while at the same time address business management and control concerns. The best approach depends on the needs of the owners and the structure of the business, all of which may change drastically over time.

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