CHAPTER 77

Corporate Recapitalization

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WHAT IS CORPORATE RECAPITALIZATION?

A corporate recapitalization is the reorganization of a corporation's capital structure. The capital structure includes stock ownership and the rights associated with each class or type of issued stock.

For shareholders of a closely held business, recapitalization is a succession strategy. Recapitalization, also referred to as "reorganization," is a division of rights associated with corporate stock. There are many ways to use a recapitalization. It is a valuable tool when combined with other strategies, such as gifting programs, structured sales, or an Intentionally Defective Grantor Trust (IDGT).

The most common way to recapitalize a corporation is to arrange the stock rights to imitate a Limited Partnership structure. After the recapitalization, all voting control is held by a limited number of shareholders (just like the General Partner in a Limited Partnership) and the bulk of the ownership is held by non-voting shareholders (like Limited Partners in a Limited Partnership).

For comparison, think of your business as a television and remote control. A recapitalization allows you to separate the ownership of the television from the remote control. It allows you to transfer ownership of the television, but keep the remote control. The remote control is the voting stock and the television is the non-voting stock.

HOW DOES A RECAPITALIZATION WORK?

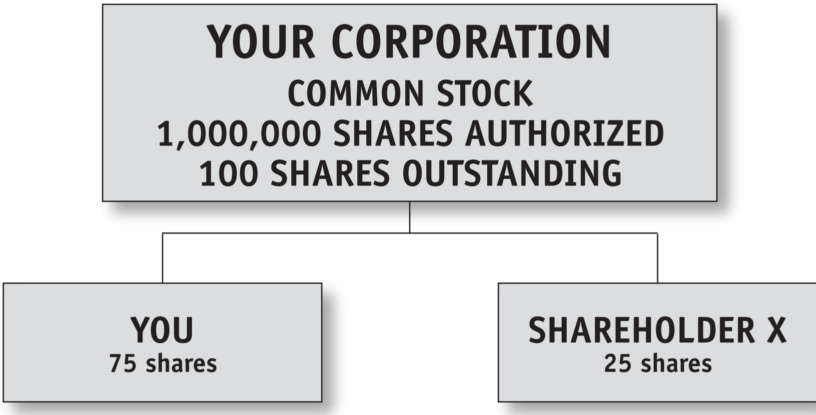
The recapitalization is simple in theory. It is always finely tailored for each set of circumstances. A typical corporate recapitalization will require the issuance of a new class or type of stock that is either non-voting or is one with different ownership interests than those previously owned by the shareholders.

There are several ways to structure a recapitalization to meet each corporation's specific needs. A general recapitalization is outlined in the following example.

> **EXAMPLE:** Assume you own a corporation with your friend, Shareholder X. Corporation has 100 shares of stock outstanding (issued) and 1,000,000 shares authorized. You own 75% and Shareholder X owns

25%. You decide you would like to recapitalize the corporate stock. See Diagrams 1 and 2.

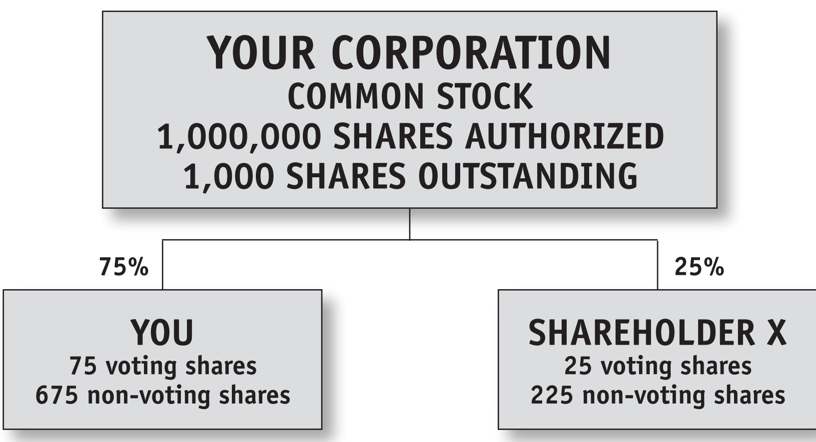
Diagram 1. 100 Shares Outstanding



To recapitalize, you decide to issue non-voting common stock. The non-voting stock is issued in the selected ratio based on your specific goals, needs of the corporation, and shareholders.

> **EXAMPLE:** The new issuance ratio is 9:1. Nine new shares of non-voting stock are issued for each share of common (voting stock) currently held by each shareholder. Immediately after the recapitalization, you still own 75% of the corporation and Shareholder X owns 25%. See Diagram 2.

Diagram 2. 9:1 Ratio Recapitalization 1,000 Shares

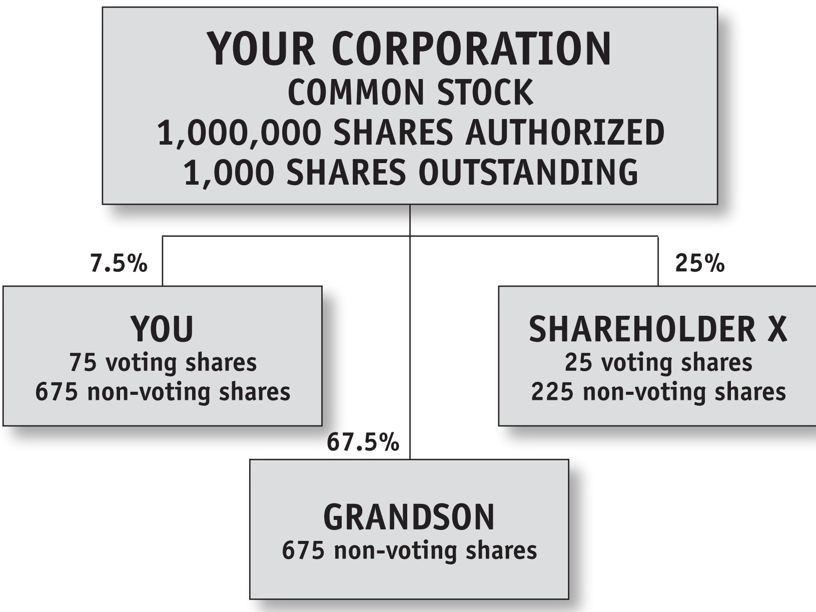


The ownership percentages remain the same. You own 75% and Shareholder X owns 25%. However, the stock or capital structure has changed.

The split of voting and non-voting ownership affects the valuation of stock for lack of control discounts.

> **EXAMPLE:** After the reorganization, assume you give all of your non-voting stock to your grandson. This is where you separate the television from the remote control. Your grandson now owns 67.5% of the corporation. Due to the non-voting nature of grandson's stock, it is not a controlling interest. The non-voting stock has a lower monetary value because of its "lack of control." After your gift, you own 7.5% of the Corporation, but you still have voting control of the Corporation. You give your grandson the television and you retain ownership of the remote control. See Diagram 3.

Diagram 3. Gift of Non-Voting Stock to Grandson



WHY RECAPITALIZE?

As part of your business and succession planning corporate recapitalization is an important step. It is not necessary for every corporation to recapitalize its stock. However, it provides the framework for several advanced planning techniques. In addition, when done properly, recapitalization triggers valuation discounts.

Your attorney should consider corporate recapitalization prior to any IDGT transaction involving corporate stock. The recapitalization enables you to transfer the non-voting interests to the IDGTs, while you retain control of your corporation until you decide otherwise.

Another reason to consider recapitalization is to accommodate new shareholders or investors. You may want to gift or sell your non-voting stock to your family or key employees today. Particularly if you have children or grandchildren working in your business, a transfer of non-voting stock is a very important incentive and an aid to your tax planning. If you consider new equity investors, each investor will have its own criteria for recapitalization.

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