RECAPITALIZATION: A Tactic For Transfer

The Key to Transferring Ownership in a Family Held Business May Lie in Recapitalizing

by William Holtz

Construction companies, which are usually closely held, are likely to meet special problems in transferring ownership interests within a family structure or to key employees.

Many such companies attempt to retain top management by offering an interest in the business. However, the cost of a meaningful interest in the firm is generally exorbitant.

In fact, the sum of money involved could easily be used instead to launch another construction company. It is also typical for parents with sizable estates to encounter difficulties in providing for family inheritance of the business.

Properly structured recapitalization is the key to resolving these situations. Recapitalization usually involves a process whereby a new class of stock is used in exchange for that which is presently outstanding.

The intent is to reduce the book and fair-market value of the previous outstanding stock to a level which makes it a viable alternative investment for key employees or members of a closely held family corporation.

Conversion to Preferred

Assume that Mr. Owner, age 55, started a company twenty years ago with a $50,000 capitalization, all consisting of common stock, and that the business is now valued at $2-million. None of the Owner's children are interested in assuming management's responsibility.

The company has established a solid record of earnings' growth over the past six years, and all indications point to further growth well into the future.

Two key employees, Mr. Field and Mr. Inside, are candidates for an ownership interest. Owner believes that without them he would be hard pressed to manage his thriving business and would find it difficult to plan for eventual retirement.

An engineer who joined the company eleven years ago, fresh from college, Field (age 32) is now in charge of all field operations. Inside, age 34, has eight years of experience with the company, and now heads its financial operations.

Field and Inside have each offered to commit $10,000 in response to Owner's professed willingness to relinquish 40 percent of the business on the condition that he is given some measure of security for his existing investment.

New Arrangement

Owner decides upon a tax-free method of recapitalization, whereby preferred stock would be issued in exchange for some of the company's common stock.

Accordingly, he provided for the issuance of 2,000 shares of $1,000 par value preferred stock (which could include cumulative or non-cumulative dividend features) after which 40 percent of his common shares were swapped for 2,000 shares of the preferred.

Resides reducing his common stock ownership, this action transferred retained earnings to the preferred stock and reduced the common stock to a low fair-market value.

Field and Inside were each then able to purchase 20 percent of the total amount of outstanding...
common at a price of $10,000. Together, they will now share in the company's future earnings to the extent of 40 percent. On the other hand, Owner will receive 60 percent of such earnings, and also holds approximately $2-million of preferred stock, which, of course, pays dividends.

Additionally, there are several beneficial estate planning options open to Owner, including gifts of preferred stock, or, even more significantly, gifts of common stock whose current low fair-market value would result in minimal tax liability.

**Family Estate Planning**

Let's now examine a second hypothetical situation whereby a 60-year-old widower and his 30-year-old son are the principals of a construction company started many years ago by the Father. The only other sibling is a daughter, who chooses not to play a role in company affairs.

Given the same financial conditions as the company described above, how can the Father structure an estate plan so that the two children will share equally in his estate while, at the same time, the son becomes the only active shareholder?

Recapitalized stock is the answer. With a view toward recapitalizing his company, the father provided for the issuance of four types of stock: Preferred Class A (cumulative voting), Preferred Class B (noncumulative, non-voting), Class A Common (voting) and Class B Common (nonvoting).

The Class B Common was accorded some degree of preference over the Class A Common in the event of liquidation, to compensate for its lack of voting rights.

The father then exchanged half of his common stock for $1-million of Preferred Class A and $1-million of Preferred Class B. The remaining common, which then had little current value, was swapped for shares of Class A and Class B Common.

Subsequently, gifts were made of Class A Common to the son and Class B Common to the daughter. Also, the father provided in his will that the Preferred Class A shares pass to the son, and the Preferred Class B to the daughter.

As a result of these moves, all future increments in corporate equity ensure equally to the son and to the daughter. Moreover, no further benefits will accrue to the father's estate from corporate sources.

Of course, in each of the above cases a ruling should be obtained from the Internal Revenue Service to ensure that the transactions will be tax free.

In addition to providing excellent tax and business planning advantages, these recapitalization methods will, when bonding is necessary, obviate the need for the contractor to abruptly commit retained earnings to a permanent investment through increased capital stock, as is often required by surety underwriters.