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GUIDEPOST

Recapitalizations: An Often Neglected Estate Planning Tool

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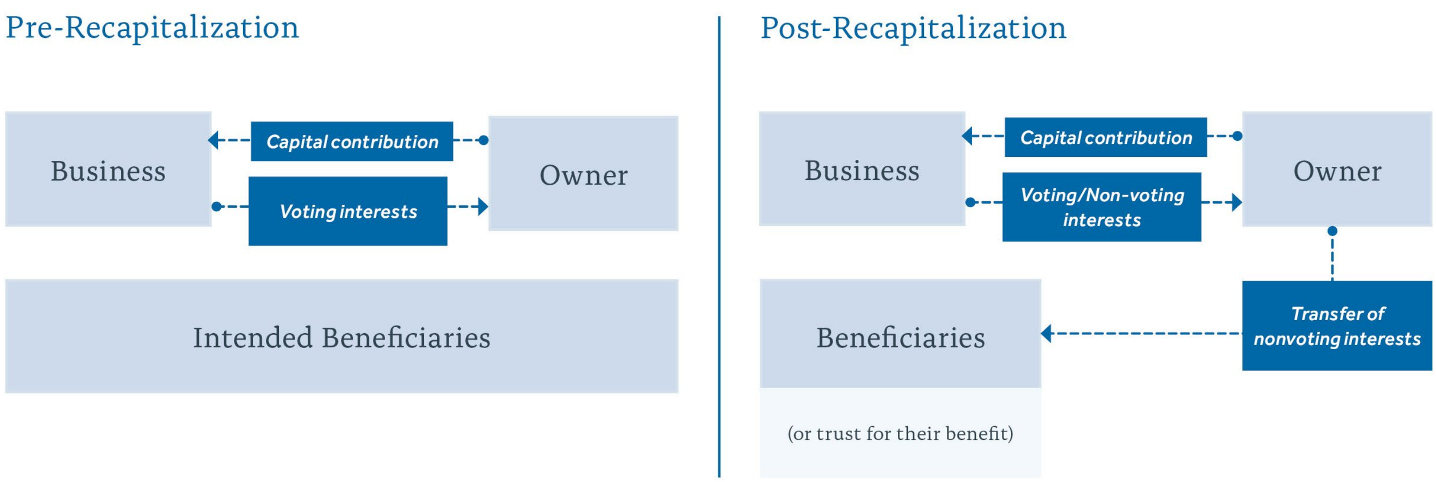
When contemplating estate and gift planning, clients who own closely held businesses often want continued control over the business with flexibility to change any plan. These points are particularly important in the current tax environment, which appears to be in flux. The Tax Cuts and Jobs Act passed in December 2017 provides taxpayers who want to transfer assets (including interests in a closely held business) free of gift tax an exclusion amount of $13.99 million (in 2025).

A technique that can enable clients to have flexibility in transferring closely held businesses to the next generation, but still retain control, is called a recapitalization ("recap" for short). Recapitalization is nothing more than the rearrangement of the capital from within an existing business organization. Further, recapitalization can be an important strategy to professionals who advise clients on business succession and estate planning. For corporations, including S corporations, this involves issuing nonvoting stock; for a limited liability company or partnership, this involves issuing nonvoting membership units or partnership interests.

Design of recapitalization

A recapitalization simply involves amending the articles of incorporation, membership agreement (for an LLC), or partnership agreement, and then issuing nonvoting stock, units, or interests. Each existing voting share, voting unit, or voting interest is exchanged for some number of Class A voting shares and some number of Class B nonvoting shares. This recap then allows any shareholder or member of an LLC or partner of a partnership to transfer all or part of the nonvoting ownership interest to the next generation. There are several options available to transfer the nonvoting stock or units to the next generation, including strategies such as the use of one or more trusts or family limited partnerships. The final objective determines the strategy employed.



Generally, recapitalizations are treated as tax-free reorganizations, meaning the gain realized in the exchange is not recognized and taxed because the substance and value of the corporation has not changed. To qualify for this treatment, however, the fair market value of the stock received in the exchange generally must equal the fair market value of the stock relinquished. In an arm's-length transaction, it is assumed that the parties will exchange property of approximate equal value.

In the case of a recapitalization where related parties are involved, the Internal Revenue Service will review property exchanges of different values, and the transaction substantively could be refashioned as a value-for-value exchange, accounting for any difference in value by characterizing that difference as a taxable transaction. Depending on the specific circumstances, if an exchanging taxpayer receives new stock having a fair market value in excess of the fair market value of the stock surrendered, the amount of the excess may be treated as a combination of compensation, a gift, a payment to satisfy an obligation, or something else factually supportable; any excess amount will not be eligible for non-recognition treatment.

Planning tip

A recapitalization can provide a framework for several advanced planning techniques. For example, recapitalization should be considered prior to any transaction with an intentionally defective irrevocable trust (IDIT). The recapitalization enables a transfer of only the nonvoting interest to the IDIT, while control is retained through the voting stock.

Valuation discounts

When properly implemented, recapitalization triggers valuation discounts of which there are several. Also, discounts are not mutually exclusive; the use of one does not preclude the use of all (if conceivably all discounts were to apply). For example, the lack of marketability discount and minority interest discount are often applied together.

Lack of marketability discount

A reduction to the value of an asset transferred is often allowed if the asset transferred has an inherent lack of marketability; think of a farm or collectible. An ownership interest in a closely held business or partnership interest might also be short of marketability as they are often more difficult to sell than other interests, such as stocks and bonds (which have a ready market for sale) and open-end mutual funds (which have redemption rights at the fund family).

Minority interest discount

If a transferred asset represents a minority interest in a business, then a reduction to the value of the asset is typically allowed. Characteristics of the minority interest discount include:

- No voting control interest in a corporation or partnership.
- Minority owners do not manage the business.
- Minority owners cannot initiate a sale or liquidation of the business.
- Purchasers typically will pay less for minority interest versus a controlling or majority interest.

The minority interest discount and the lack of marketability discount are often applied together.

> **Example:** Lisa gave her son Jack a 2% interest in her closely held business. The business has a value of $1,000,000 and Lisa applied to her gift both a minority interest discount and a lack of marketability discount that a qualified appraiser determined to be 25%. What is the value of the gift?
>
> Answer: $15,000. Lisa would not have to file a gift tax return (U.S. Form 709) since the amount falls within the per donee annual exclusion. [($1,000,000 x 0.02) x (1 - 0.25)].

Key person discount

A discount typically is allowed for a business in which a key person has died or becomes disabled. The rationale behind this discount is that the closely held business may experience an interruption in production, decline in stock price and change of management if a key person (such as the founder) died or becomes substantially disabled or unable to return to the business.

In many cases, life insurance is purchased on the life of a key employee or person (payable to the corporation) to give the business some additional capital to help locate a suitable replacement in the event of death of the key employee or person. The discount may be reduced if such insurance is in force, then the discount may be reduced or even eliminated.

Block discount

A substantial block (or amount) of listed stock (that is, corporate stock listed on a public stock exchange), may be part of a decedent's taxable estate. If this occurs, the stock may be somewhat difficult to sell due to the size of the block and the current trading volume of the stock in the company.

Why discount a large block of stock?

- A large volume is more difficult to sell than a small volume.
- A large block often must be sold over several trading days.
- Market price will be lower for a large block compared to a small order.
- A discount would be based on the decrease in the realizable price below the current market price for the stock.

Additional valuation concerns

Corporate recapitalizations have become much less attractive as an estate freeze technique since the enactment of Internal Revenue Code (IRC) §§2701 and 2704. IRC §2701 places a statutory monetary value of zero on the interest retained by the owner, causing the gift of common stock to be valued at its full fair market value. IRC §2704 ignores the lapsing rights associated with the owner's retained interest for purposes of valuing these retained interests for estate tax purposes.

There are still situations, however, where a recapitalization can be structured so that neither §2701 nor §2704 applies. First, a recapitalization can be structured so that the retained interest held by the owner has value, thus reducing the amount of the gift. This can be achieved, for example, when any preferred shares retained are entitled to a cumulative, fixed dividend. In such a case, the preferred shares retained by the owner are not valued at zero, and 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 kind may allow the owner to retain control of the corporation while gifting away the common stock (plus any of its future appreciation) to family members.

Second, a recapitalization can be structured so that IRC §2704 will not apply. For example, if rapid and substantial appreciation is anticipated, transferring nonvoting common to younger family members while retaining voting preferred (or voting common if corporation has made a Subchapter S election) having no lapsing provisions may make sense. The transferring owner may have to pay gift tax on the value of the common stock when transferred, but that anticipated rapid and substantial appreciation will occur in the estates of those younger family members.

Tax considerations

Income tax

As stated previously, generally there is no income tax liability upon a recapitalization. By transferring post-recapitalization nonvoting interests to family members (typically of the next generation), income tax liability can be shifted and dispersed among those family members. Items of income, gain, loss, deductions, credits, and other tax items that may flow from such ownership interest in the form of dividends, guaranteed payments, S corporation distributions and the like, become the reporting responsibility of the new owner.

Gift and estate tax

Business owners often decide to recap their businesses to pass wealth onto family members of a younger generation. Typically, owners will transfer by gift nonvoting interests tax-free to other individuals up to the basic exclusion amount. For 2025, this amount is $13.99 million per donor. When calculating the gift tax value, the value of an asset transferred is the fair market value at the time of the gift.

A major advantage to utilizing the recapitalization technique is that an owner may be able to transfer nonvoting interests at one or more valuation discounts (as described above) to the fair market value of a proportionate share of the entire business asset. To the extent the current basic exclusion amount "sunsets," as is scheduled to occur on December 31, 2025, it may be prudent for high-net-worth individuals to utilize the temporarily increased lifetime exclusion through lifetime asset shifting techniques, such as a gifting nonvoting business interests.

Generation-skipping transfer (GST) tax

GST exemption may be allocated to any nonvoting interests upon the initial transfer of such assets. Any appreciation to the value to such assets would also remain GST exempt, thereby leveraging the GST exemption.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to $13.99 million per person ($27.98 million for a married couple), effective in 2025. For assets transfers greater than the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies.   These materials are prepared by The Nautilus Group®, a service of New York Life Insurance Company, and are made available to all Nautilus Group member agents, and as a courtesy, to select agents of New York Life Insurance Company. SMRU 5018355 Exp. 12/31/2025