Preferred Stock Recapitalization

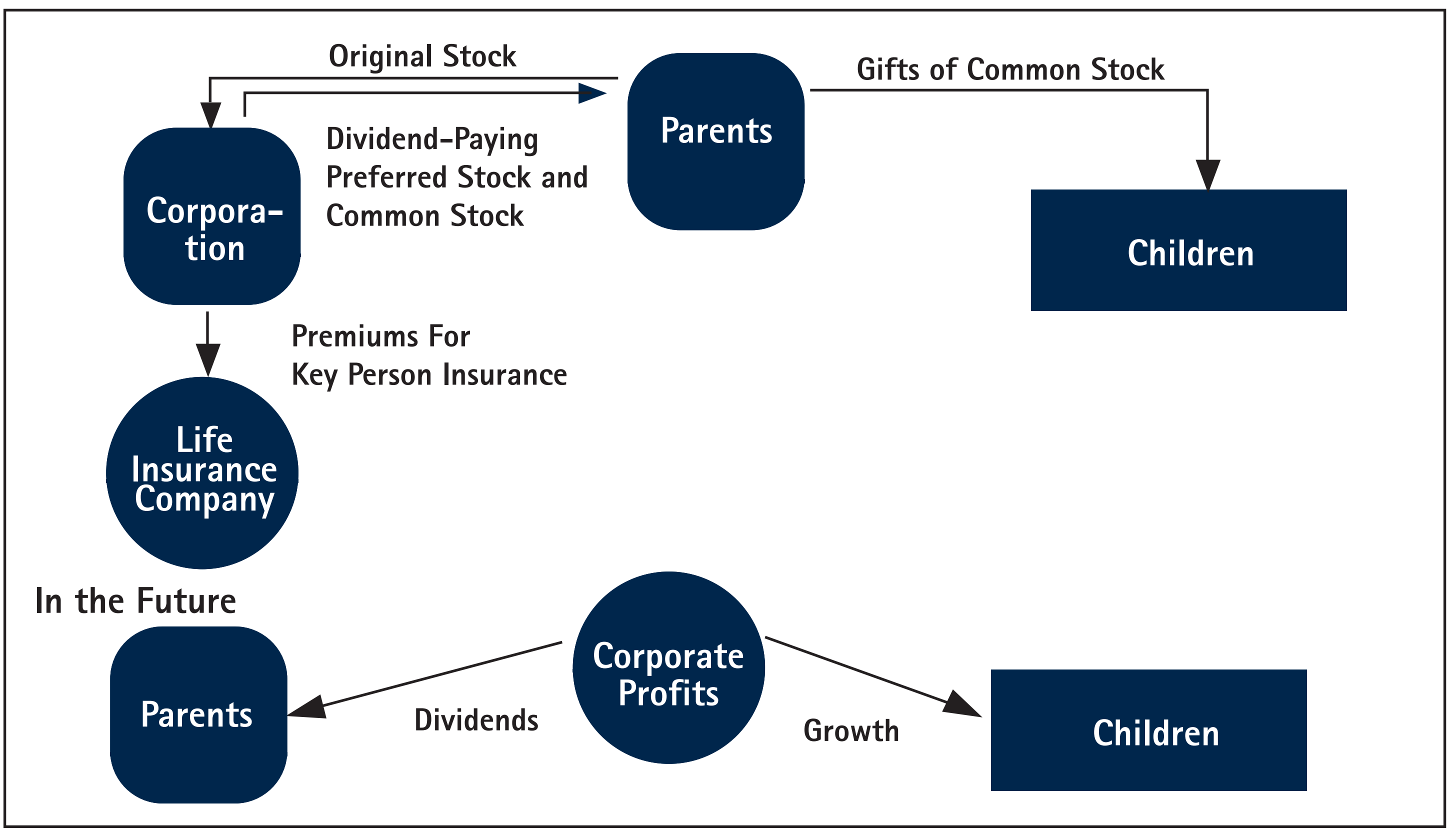
SUMMARY:

A preferred stock recapitalization is a form of estate freeze designed to keep control of the family business in the hands of the older generation while shifting future appreciation of the business to the children. In one popular design, the parents exchange all their common stock in the family corporation for a combination of voting preferred stock and non-voting common stock. The parents retain the preferred stock and gift or sell the common stock to the children. Cumulative preferred stock pays a fixed dividend and its value does not increase. On the other hand, the common stocks value may appreciate with the success of the business. Thus the value of the parents' business interest is "frozen" for estate tax purposes.

To pay for the taxes due on the estate retained by the parents, the adult children purchase a life insurance policy on the lives of their parents. An Irrevocable Life Insurance Trust can also provide liquidity to the beneficiaries or an inheritance to children not involved in the business.

Key person insurance offers important protection for any business. However, in a company planning a preferred stock recapitalization, the obligation to pay dividends on preferred stock can be disastrous if a key person dies. The corporation is the owner and beneficiary of policies on the lives of employees essential to the profitability of the business.

HOW IT WORKS:



Note: Specific tax and legal questions should be referred to your tax adviser or legal counsel.

CONSIDERATIONS:

- Shifts future appreciation of the business to the children.
- Keeps control of the business in the parents' hands.
- Freezes the value of the parents' ownership interest for estate tax purposes.
- Provides income to the parents.
- Facilitates transfer of the business at the parents' death.
  - The value of the common stock for gift tax purposes is the value of all the stock less the value of the preferred stock. The value of the preferred stock with cumulative dividend rights is the present value of future dividends. The larger the preferred stock's dividends, the lower the value of the common stock. Certain privileges such as voting rights must be assigned a value of zero.
- Unpaid dividends will increase the value of the parents' estate.

TAX CONSIDERATIONS:

- Unless the parents exchange all their stock for stock of a different class, the receipt of preferred stock is considered Section 306 stock. Proceeds from a future sale of this stock will not qualify for capital gain taxation.
- Chapter 14 special valuation rules must be followed:
  - The common stick must be given a value of at least 10 percent of the corporation.
  - Cumulative dividends must actually be paid.

HOW TO IMPLEMENT:

- The business owner obtains an independent business valuation.
- The attorney restructures the corporation's capital.
- The parents exchange their common stock for voting preferred stock and non-voting common stock.
- The parents gift their non-voting common stock to their children.
- The corporation pays a fixed dividend to the parents.
- The business purchases key person insurance to protect future profitability and the ability to pay future preferred stock dividends.

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