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SHIFTING CONTROL WITHOUT SELLING THE BUSINESS INTEREST*

G. Charles Scharfy

Frequently family tax planning on the part of the owner of a small business necessitates a change in the character of his holdings and a change in the degree of his control of the business without a sale. Such a change may be effected by a tax-free recapitalization, or the issuance of a preferred stock dividend. The desired result may also be obtained by the issuance of new stock to key employees or by means of the stock option. The family or business objectives to be obtained will generally determine the method that is to be adopted.

RECAPITALIZATIONS BY ISSUANCE OF PREFERRED STOCK

Perhaps the most important of these avenues of approach are the "recapitalizations," which have as their primary objective the shifting of control of the business to relatives of the owner who are in the business or to key employees, but at the same time allowing the former "boss" to retain a substantial financial stake in the continuing enterprise. Under section 112(b)(3) of the 1939 Internal Revenue Code the courts bestowed judicial blessing upon recapitalizations, even though such recapitalizations effected a complete realignment of powers and rights among the shareholders inter se. The courts did, of course, require a "business purpose" in these recapitalizations. However, the "business purpose" of these cases involved merely the desirability of transferring control of the companies to experienced or capable executive personnel, and away from older, retiring, or inexperienced persons who might otherwise have retained control to the ultimate detriment of the business entity.

This article is intended to update and summarize certain problems covered in the 1958 Tax Institute. Calkins, et al., Tax Problems of Close Corporations: A Survey, 10 WEST. RES. L. REV. 9 (1959). See particularly the discussion on Leverage Stock by Barring Coughlin. Id. at 98. It should also be noted that the present article describes the methods by which the owner of a family business may give up control and maintain a financial interest. Thus the planning purpose discussed in this article is contrary to that discussed in two previous articles where the purpose was to give up a financial interest in the business without necessarily giving up control.

1. INT. REV. CODE OF 1954, § 368(a)(1)(E) [hereinafter cited as CODE §], defines "reorganization" to include "recapitalization." CODE § 354(a)(1) provides that an exchange pursuant to a plan of reorganization of stock or securities by a party to the reorganization is tax free.

2. CODE § 421.

Meanwhile, a somewhat parallel line of decisions under the 1939 Code provisions permitted the removal of a substantial portion of a shareholder's financial stake in the business, through the device which is familiarly known as the "preferred stock bail-out." This device consists of a distribution of pro rata dividends of preferred stock to holders of common shares. These dividends were held to be non-taxable.\(^4\) The subsequent sale of the preferred stock was held to result in a capital gain to the shareholder.\(^5\)

The advantages accompanying "realignments" of stock interests through recapitalizations and accompanying preferred stock bail-outs led to such an enthusiastic reception by taxpayers that Congress, in its 1954 reanalysis of the revenue structure, decided to insert some checkreins in this area. Accordingly, section 306 of the 1954 Code was enacted. Although it continued the tax-free nature of the immediate transaction, that is, the recapitalization and the stock dividend, it provided in effect that certain shareholders must take the "bitter with the sweet" by imposing possible tax penalties upon subsequent dispositions of their "non-common" stock holdings.\(^6\) In other words, gain on subsequent resale by shareholders was to be taxed as income, not as capital gains.

Section 306, which covers the recapitalization and the preferred stock bail-out areas,\(^7\) has already received extensive analysis and treatment by tax authors,\(^8\) and the purpose of our discussion here is to consider only certain aspects of this section's applicability to the "family business" situation.

First, the owner of the business should keep in mind the fact that the receipt and subsequent possession of section 306 stock does not always involve ordinary income tax consequences. For example, a sale or re-
demption of section 306 stock which completely terminates the owner's stock interest in the company will not give rise to ordinary income, nor will distributions in partial or full liquidation of the company. Again, if the owner plans to make gifts to charity, he can utilize section 306 stock without realizing income at all. In addition, if the owner wishes to retain his stake in the business until he dies, any section 306 stock owned by him will lose its "taint" upon his death.

Second, the owner of the business should recognize that by the receipt of section 306 stock, he will achieve certain affirmative advantages for his family and estate and for the business itself. He will have obtained the increased protection of a preferred position of ownership, the security of a steadier and more assured income, and the elimination, or at least minimization, of estate valuation problems. In addition, the owner will have enhanced the probability of the continued successful operation of the business by having afforded an incentive to the younger executives who will replace him, since the growth of the company and the attendant increased valuation of ownership will be reflected in the common or ultimate equity interest which the "new" owners will have.

**SHIFTING CONTROL BY ISSUANCE OF STOCK TO EMPLOYEES**

*Direct Issuance of Stock*

Up to this point we have considered shifting control by recapitalization and by the issuance of stock dividends. Another method of achieving the same result is by diluting the owner's interest through the issuance of additional stock to key employees. The key employee or group of employees who will have ultimate control may be issued stock by the company as additional compensation. The principal deterrent to this avenue is the high tax-cost to the recipient of the stock, since the receipt of the stock will be treated as ordinary income. It should be noted that the employee will also receive adverse tax consequences if his additional compensation is in the form of cash to purchase the stock, for this too will be treated as ordinary income. By either method this tax may well be prohibitive if the employee has worked his way up into a fairly high income tax bracket. No problem, however, arises in this situation if control is wielded by a bare majority, because a shift of control may be effected by a purchase of a small amount of stock.

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9. **Code §§ 306(b) (1), (2).** Note that the attribution rules of Code section 318 are applicable in determining whether complete termination has been achieved.

10. **Rev. Rul. 57-328, 1957-2 CUM. BULL. 229.**


12. If the employee's additional compensation is in the form of cash, he will, at least, be able to pay the increased tax. On the other hand, if he is issued stock, he may not have the available cash to pay the increased tax. The solution to this dilemma may be a combination of cash and stock given to the designated employee.
Assuming that the prospective new owner is not now financially able either to purchase the shares which will give control, or to pay the income tax thereon if such shares are distributed to him as compensation, the groundwork can be laid for future steps in this direction through the issuance of stock options. The options may either be "restricted stock options" as that term is defined and used in section 421 of the Internal Revenue Code, or they may be "unrestricted."

It is not our purpose in this brief article to go into the intricacies of restricted stock options under section 421. Suffice it to say that if the requirements of that section are complied with,13 the key employee may purchase shares, pursuant to such options, without adverse tax consequences when the options are issued or subsequently exercised.

On the other hand, if the key employee receives an option which does not qualify as a "restricted stock option," he may indeed have tax troubles. In this connection it should be remembered that it may be very difficult to qualify an option as a "restricted stock option" in a small family corporation where the valuation of the stock is never definite. Because of the valuation problem, the validity of the option may be rendered uncertain.14 The tax troubles that will be encountered under an unrestricted stock option are defined by the Commissioner in a Regulation15 based upon two United States Supreme Court cases.16 These cases held that ordinary income will be realized when the option is exercised and when there are no restrictions upon the right to receive the stock.

The courts have also adopted a liberal interpretation of the option procedure that may well result in adverse tax consequences for the taxpayer. In Joseph Kane,17 the court held that an option granted by the chief stockholder of a company to an employee's wife was intended as

13.Code § 421(d). In general, the requirements of a restricted stock option are as follows: (1) the option must be granted in connection with the grantee's employment by a corporation; (2) the option price must be at least eighty-five per cent of the fair market value of the stock at the time such option is granted; (3) the option must not be transferable except at death and must be exercisable, during the optionee's lifetime, only by him; (4) the option must not run for more than ten years; and (5) if the optionee already owns more than ten per cent of the company's stock, the option price must be 110 per cent of the stock's value and the option period five years or less.

14. For a discussion of the problems that hinder the use of a restricted stock option in a closely-held family corporation and a discussion of the applicability of a non-restricted option on restricted stock in this situation, see Hawkins, Tax Factors in Balancing the Interests of Investor-Shareholders and Officer-Shareholders, 12 West. Res. L. Rev. 218-23 (1961).


17. 25 T.C. 1112 (1956), aff'd per curiam, 338 F.2d 624 (2d Cir. 1965), cert. denied, 353 U.S. 931 (1957); cf. Wanda V. Van Dusen, 8 T.C. 388 (1947), aff'd, 166 F.2d 647 (9th Cir. 1948).