Legacy ADVISORS GROUP

M & A UPDATE®

January 2010 Volume 6, Issue 1

Minority Shareholder Discount vs. Lack of Marketability Discount

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Introduction

The Center recently received a call regarding situations involving minority share stocks and lack of marketability. When businesses are valued, whether that reason is for a business sale, exit planning, or another reason, generally the owner likes to see the highest value possible for the business. After all, it is human nature to desire the most wealth and security as possible for yourself and your family. On the other hand, imagine the same business owner that is going through a divorce or is otherwise being forced to buy out a partner through a dissolution proceeding. It is quite a different scenario for the business person to go through.

Situations do exist where a business owner desires a low value to be attached to their business. Such situations include estate planning, divorce, and when a potential buyer desires to purchase a business (i.e. acquisition or takeover). Legitimate avenues do exist to accurately reflect the reduction of value of any given business when appropriate. Discounts determined for lack of control and lack of marketability are legitimate and even common in business valuations.

The Discounts

1) People generally prefer to have controlling power as opposed to being controlled. The lack of control or minority shareholder discount in closely-held and small companies is calculated to reflect the detrimental effect of not having control over business decisions. While a minority interest in a publicly traded company is not subject to a lack of control discount, in private companies, lack of control means the minority owner is subject to the whim of majority shareholders. Such detrimental decisions to minority shareholders can include: determination of management compensation, declaration of dividends and disbursements, setting the course of the business, and decisions to liquidate or sell business interests. Lack of control discounts can range from 35 to 50 percent, and even higher in some cases when compared to publicly traded stocks. Readers should be aware that the state of Florida has recently passed a law making the minority discount illegal whenever a company that has ten or fewer owners is valued.

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A CASE STUDY

The Tax Court has ruled that a son's work and aid in a business owned by his parents did not result in taxable compensation, but were instead construed to be a gift. The taxpayer in question worked and aided his parents in the operation of a business belonging to his parents.

His parents gave him money. The IRS contended that the money was remuneration for work done in the family business and was therefore taxable wages. The taxpayer countered and won, contending the money was a gift as part of a larger estate plan.

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2) The lack of marketability discount applies to many small businesses as well. Owners prefer to have assets that are more liquid as opposed to less liquid. It is with this preference that those businesses that can be bought and sold quickly are worth more. Businesses that are hard to liquidate or are generally unmarketable, are worth less than publicly traded companies. Because of this lack of marketability, certain businesses are given a discount to reflect the detriment of the ability to sell the company. Lack of marketability discounts can range in the area of 20 to 50 percent when compared to their publicly traded counterparts.

The Difference

Often there is confusion between the two discounts among practitioners. As mentioned above, minority shareholders lack certain controls. Imagine being so suppressed by a majority shareholder that holding the interest in the business makes the stock, not only worthless, but also a legal liability. Would this minority stock (already subject to minority shareholder discount) be very marketable (subject to lack of marketability discount as well)? The answer, quite simply is NO!!! The minority stock in this company would not be marketable.

The minority shareholder discount simply applies when the shareholder holds a share in the company of less than 50%. This is an internal, mathematical calculation. Lack of marketability, on the other hand, applies when external influences limit the attractiveness of a company to be sold in the market place.

For example, imagine a situation where a service company has exclusive rights in the state of New York to replace every light bulb in public buildings. There would be no need for a lack of marketability discount because the lack of a competitive environment would result in a gold mine to whoever owns it. Now imagine, the same service company, but 50 other companies have the right to change light bulbs. In this case, external, competitive forces, no matter how successful the vendor is, limit the marketability of the company. Why? Quite simply, an investor with $50,000 to invest would be repulsed by the external forces. The investor, given the competitive environment, would be more likely to invest his or her money in Kimberly Clark stock or another publicly traded company instead of a service company in an extremely competitive market.

Conclusion

Minority ownership interest discounts relate to the control the subject has in relation to the business. Marketability deals with the potential to liquidate the company and how quickly and easily the company can be reduced to cash based upon external forces.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

A CASE STUDY CONTINUED:

Editor's Comment: Generally, any money given for an effort expended is taxable compensation. The taxpayer was very fortunate to win the case. From the facts as presented, the son did work in the business because his parents were not well. However, the son did not have to work, was not told what to do, and was able to prove that he was just helping his parents. Thus the Tax Court said that the money given to the son was just the parents' way of saying "thank you", i.e. a gift to their son.

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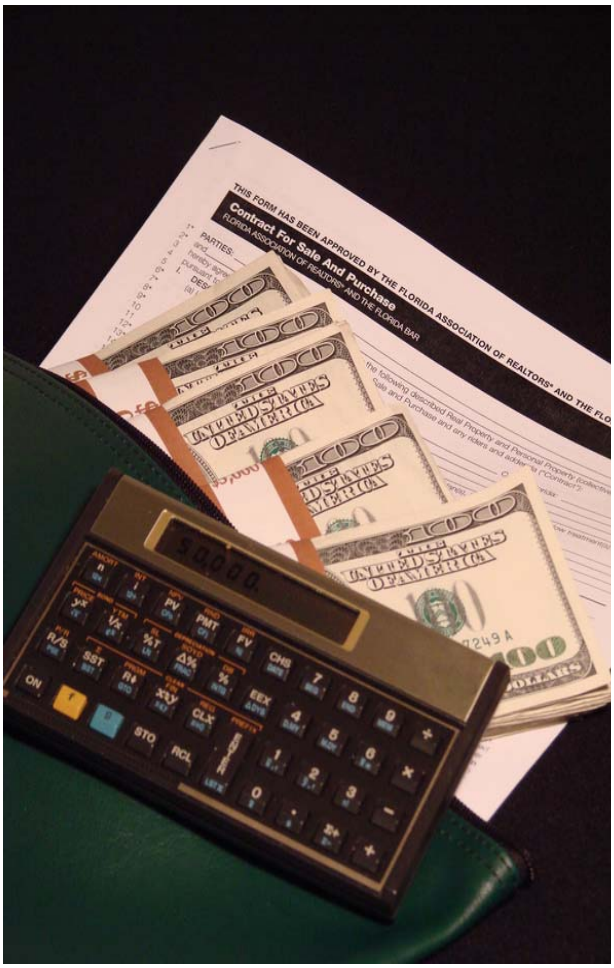
Points of Interest

- **It is human nature to desire the most wealth and security as possible for yourself and your family.**
- **Situations do exist where a business owner desires a low value to be attached to their business.**
- **Legitimate avenues do exist to accurately reflect the reduction of value of any given business when appropriate.**



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VALUE DRIVERS TO MAXIMIZE THE SELLING PRICE OF YOUR BUSINESS – PART 4

Mike Ertel, CBI/ M&AMI/ CM&AA

This is the fourth in a series of articles outlining the steps any business owner can take to maximize the value of his/her business when it comes time to sell. If you'd like to see previous articles in this series, visit our website at www.legacyadvisorsgroup.com. If you'd like a copy of the complete list of value drives, e-mail me directly at mertel@legacyadvisorsgroup.com and request the Value Drivers list.

11. Be Prepared to Hang a Lantern on Your Problem

No business is completely flawless, but the mistake many business owners make is assuming that if they hide their flaws perhaps the buyer won't discover or notice them. This almost never happens, and when the buyer suspects that he/she was deliberately deceived, this can undo months of confidence and rapport building between the seller and the buyer. It frequently leads to an 11th hour reduction in the buyer's offer, and not infrequently kills the whole deal.

In my experience, a much better approach is to take charge of the disclosure of these aspects of your business right up front, or at least very early in the process. Several advantages accrue to the seller when you do it this way. First, right out of the gate you establish a reputation of being a straight shooter who has nothing to hide. Second, you control the news, and have an opportunity to put it in perspective, and explain what steps you're already taking to remedy/minimize it. For example, "When I started the company I sold and serviced most of our larger accounts myself. However, I recently hired a VP of Sales and started taking more time off. Now when our customers need something, they call him."

12. Last, but not least, a Clean, Well-Ordered Workplace

This last point may seem trivial and unimportant, or it may seem so obvious as to go without saying; however, in my experience there's no denying the positive impact that a clean, well ordered workplace has on a buyer. First, it creates/promotes an environment of pride, quality and efficiency. Second, it creates floor space/counterspace/ storage space which translates to more capacity. Lastly, all other things being equal, what owner or employee wouldn't prefer to come to work in a clean, well-ordered workplace?

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at mertel@legacyadvisorsgroup.com

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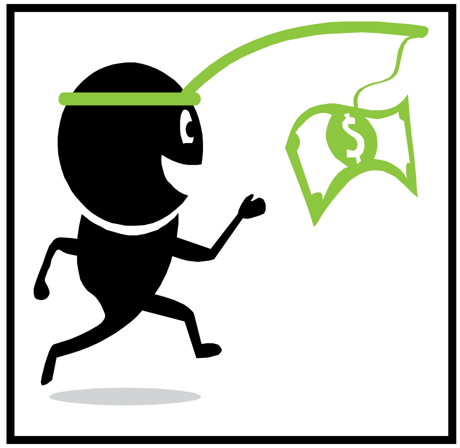

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Frequently Asked Questions…

Q: I just opened a business and formed it as a limited liability company (LLC) under my state's laws. For federal tax purposes, how do I classify my LLC?

A: An LLC may be classified for federal tax purposes as a sole proprietorship, a partnership, or a corporation. If the LLC has only one owner, the LLC will automatically be treated as a sole proprietorship unless another election is made by the owner. On the other hand, if the LLC has two or more owners, it will be classified as a partnership unless an election is made. The election is made on IRS Form 8832. Unless the election is made, the classification will be the default classifications.

Q: Where is the best place to store estate plan documents?

A: The best place to store estate plan documents is in a location where others a) know of, b) can get into when the time arises, and c) is secure. Storing the documents in a safe deposit box that a friend knows of can be a good place as long as that friend knows where to get the key at. The location would be known, able to be opened, and secure. Hiding documents in a book or in a safe that nobody knows of or does not have the combination renders the documents useless to both you and those that are trying to help you.

Q: Is an S Corporation required to make quarterly tax payments?

A: Yes. Subchapter S corporations must make estimated tax payments if the amount of taxes required to be paid exceeds the amount specified in the law. Taxes due from an S Corporation can arise from capital gains, passive activity, built in gains, and depreciation recapture.