

Premium for Voting Stock in *Simplot*: A Reflection of the Real World?

(The Financial Peril of Dying with Voting Stock)

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A 1999 Tax Court case, *Estate of Richard R. Simplot v. Commissioner*,¹ illustrates the misapplication of a commonly accepted principle of business valuation with a result that defies common sense and logic. The *Simplot* case serves as a reminder that, at the end of the day, the valuation result derived needs to make sense from both the buyer's as well as the seller's perspective. It also illustrates the tremendous financial peril of dying with voting stock in a company that also has a nonvoting class of stock, at least if this view of valuation takes hold.

This frightening Tax Court opinion is required reading for all who deal with estate-planning issues. Also, a common estate-planning technique in recent years has been the recapitalization of subchapter S corporations into classes of voting and nonvoting stock. The parents typically give away the nonvoting stock, hoping to achieve additional valuation discounts due to the nonvoting status of the shares. Also, parents are often not ready to pass voting control to their children until it is clear their offspring have the maturity and the ability to run the business. By keeping all of the voting shares, even though the shares might constitute a minority interest, the parents could remain in control and "have their cake and eat it, too." If *Simplot* becomes the standard by which the voting shares are valued, that piece of cake will carry a very high price indeed.

Voting v. Nonvoting Stock

The *Simplot* case involves the situation where voting control of a company is concentrated in a very small number of shares. This can be a common occurrence in many closely held companies where there is a bifurcated class of stock. By establishing both voting and nonvoting stock, the company founders can pass a significant portion of the company to their descendants (through the gifting of nonvoting shares)

yet still effectively control the business through their retention of the voting shares.

Most business valuers would agree that, all else being equal, the voting shares are more valuable than the nonvoting shares due to the voting shares' potential to effect such corporate action as the payment of dividends, liquidating the company, etc. This is not always true, however, as in certain cases, a business valuator may find that voting and nonvoting shares are equal in value. One example of this is when the voting-share interest to be valued is such a small percentage of the overall voting-share total, that it is essentially like nonvoting stock because it is just too small to effect corporate action.

If the voting-share block is large enough to effect corporate action, however, how much more is it worth than the nonvoting shares? Could the voting shares ever be worth more than their pro-rata share of the 100% control value of the company? For example, if the company has a 100% controlling-interest value of \$10,000,000 and there are 10 voting and 19,990 nonvoting shares (20,000 total shares), could the voting shares be worth more than \$500 per share (\$10,000,000 value divided by 20,000 total shares outstanding)? If the voting shares voted to sell the company for its 100% control value of \$10,000,000, no voting share would receive more than \$500 per share. Would a reasonable buyer ever pay more than \$500 for a share of voting stock?

Swing Blocks

The voting-share scenario is very similar to the situation with a "swing block" of stock. A typical swing-block scenario is as follows. Assume a company has three shareholders. Shareholders A and B each own a 49% interest while shareholder C owns the remaining 2%. Assume the company bylaws and state law require a majority vote for all corporate action, including the payment of dividends and the ability to sell or liquidate the company. Normally, the 2% shareholder would be powerless to effect any corporate action. However, under the

ownership scenario described here, the 2% shareholder is critical as her combination with either one of the other 49% shareholders is enough to control the company.

Assume the company above is worth \$10,000,000 on a 100% controlling-interest basis. This implies that if a majority of the shareholders were to agree on the sale of the business, the two 49% shareholders would get \$4,900,000 each while the 2% shareholder received \$200,000. The \$200,000 value is the 2% shareholder's pro-rata share of the 100% value of the business. Assuming (for hypothetical purposes only) that the 2% block were not a swing vote, the 2% shareholder might be expected to take a total discount (minority and lack of marketability) as much as 50% or higher. The amount of the total discount depends on the specifics of each situation and will vary from case to case.

Can the Value per Share Be Greater Than the Control Value?

The potential power inherent in the 2% interest makes it very valuable to the other 49% shareholders. Assume that the two 49% shareholders are at loggerheads as to the direction of the company. Either one of the 49% shareholders would kill to have the 2% interest that would give them control over the company. Whereas a 2% shareholder under a normal situation would expect to take a minority and marketability discount when selling her interest, here the 2% may be so valuable that it is actually worth its pro-rata share of the 100% controlling-interest value of the company. Could this 2% swing-block interest be worth even *more* than its pro-rata share of the 100% controlling-interest value of the company? The *Simplot* court says an emphatic, "Yes—a lot more."

Simplot Analysis

Using the simplified hypothetical voting/nonvoting company above (\$10,000,000 total value with 10 voting shares and 19,990 nonvoting shares), the ruling in the *Simplot* case would be applied as follows. Given a \$10,000,000 value for a 100% interest in the company, assume (again for hypothetical purposes only) that the "minority-marketable" value of the company is \$8,000,000. A "minority-marketable value" means the preliminary value of the company on a minority basis, but it assumes full marketability of the shares. This is a common preliminary measure of value under such approaches as the capitalization of earnings, discounted cash flow (DCF), and guideline (public) company approach. The preliminary results under the capitalization and DCF measures are said to be minority-marketable values because they are derived from discount rates for very small (i.e., minority) share holdings of freely traded (i.e., marketable) stock. Likewise, the preliminary result under the guideline company method is a minority-marketable result because it is derived from trading multiples of very small (i.e., minority) share holdings of freely traded (i.e., marketable) stock.

Another way to look at the \$8,000,000 "minority-marketable" value versus the \$10,000,000, 100% controlling-interest value is

from a control premium perspective. If the hypothetical company above were publicly traded (i.e., fully marketable), minority shares of the company would be valued at \$400 per share (\$8,000,000 minority-marketable value divided by 20,000 total shares outstanding). Were a buyer to make a \$10,000,000 offer for the entire company, the company's shares would rise to the \$500 per share control value. This implies a control premium of 25% (calculated as \$8,000,000 times 1.25 equals \$10,000,000). If the liquidation preferences for the voting and nonvoting shares were identical, both voting and nonvoting shareholders would receive \$500 per share upon the sale of the company.

Simplot Findings Defy Logic and Economic Reality

Applying the *Simplot* case to the above scenario results in a situation that does not reflect economic or financial reality. Using the hypothetical facts above, the *Simplot* court found an \$8,000,000 minority-marketable value for the company at issue, or \$400 per share. The *Simplot* court then calculated a 3% "aggregate control premium" applicable to the voting shares only. The 3% aggregate control premium was calculated as the minority-marketable value of \$8,000,000 times 3% aggregate control premium equals \$240,000. This aggregate control premium was then applied to the voting shares only (calculated as \$240,000 aggregate control premium divided by 10 voting shares outstanding equals \$24,000 premium per voting share). Thus, the total value for the voting shares (before discount for lack of marketability) was \$24,400 (\$400 per share minority-marketable value plus \$24,000 per share aggregate control premium).

The *Simplot* court then applied a 35% discount for lack of marketability to the voting shares and a 40% discount for lack of marketability to the nonvoting shares to reach final values (under the hypothetical above) of \$15,860 for the voting shares and \$240 for the nonvoting shares. When the dust had settled in *Simplot*, the value for the voting shares represented more than a 6,000% premium to the nonvoting shares.

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On a common sense basis, the *Simplot* decision makes no sense. Assume Z has the chance to buy 6 of the 10 voting shares of the hypothetical company above, and this 60% holding of the voting stock gave Z the ability to liquidate the company. Under the *Simplot* holding, Z would pay a total of \$95,160 (\$15,860 per share times 6 shares) for his 60% control of the voting stock. Having voting control of the company, Z now decides to liquidate the business for its \$10,000,000 controlling-interest value. On a pro-rata basis, Z's 6 voting shares bring him total proceeds of \$3,000 (\$500 per share liquidation value times 6 shares). Congratulations to Z, he has just lost \$92,160 of his original \$95,160 and realized a loss of 96.8% of his original investment. Surely the line of sellers of voting stock would stretch

around the block, but are there any buyers out there for this one? One of the experts for the IRS suggested a 10% “aggregate control premium.” Under this scenario, Z would pay a total of \$313,560 for the right to receive \$3,000 in return, a loss of over 99%.

Granted, the result in the *Simplot* case is exaggerated due to the significant difference between the number of voting shares versus the number of nonvoting shares, but how many real-world buyers are going to pay the kind of premium derived by the *Simplot* court? The Tax Court in *Simplot* based its result on the IRS’s logic that “the investor would likely pay large premiums to induce the [voting stock] shareholders to relinquish control. Once a majority of the [voting stock] is obtained, the investor could force a merger into another company.” But, what joy is there in forcing a merger into another company at a cost such as that illustrated above?

In “Stock Price Premiums for Voting Rights Attributable to Minority Interests,”² a study of 43 public companies with voting and nonvoting shares (which were otherwise identical) found the average discount for nonvoting status to be 3.66%. After adjustments for certain outlying values, the study found the average implied discount for the remaining 33 companies to be approximately 2.34%. This is not to say that this discount (or its implied 2.4% premium) should be applied in every case. However, it is evidence of actual transactions in the real world. Although the *Simplot* situation is somewhat unique

due to the very small number of voting shares as a percentage of the total shares, the *Simplot* case is an example of where theory does not meet reality.

Discount for Built-In Capital Gains Affirmed Again

The *Simplot* case is also noteworthy in that experts for both the taxpayer and the IRS took a full discount for built-in capital gains, which the court allowed. Both experts used a 40% tax rate in calculating the capital gains that would have to be paid upon sale of the asset. This continues the trend begun in 1998 with the *Davis* and *Eisenberg* cases.³ However, in those earlier cases, only a partial discount for capital gains was allowed with the court pulling the discount out of the air in both cases.

Conclusion

The *Simplot* case raises an alarming new uncertainty in the valuation of voting stock where a class of nonvoting stock is also present. It will be interesting to see if the case is appealed, and if so, what the outcome will be. Until this is known, valuers will be trading in uncharted waters. ♦

END NOTES

¹ 112 TC, No. 13.

² *Business Valuation Review*, December 1991.

³ *Davis*, 110 TC 530, CCH Dec. 52,164;
Eisenberg, CA-2, 98-2 USTC ¶60,322, 155 F3d 50.