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Reprinted from the Spring 1997 Issue

VOTING/Non-Voting Recapitalizations
In Subchapter S Corporations

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Introduction. The closely-held business
founder and owner who has built a sizable net worth in
his or her business often desires to achieve three goals:

1. “Keep it in the family.”
2. Retain control until the next generation is ready
   and capable to takeover. Also, if a child should
go through a divorce, enter
bankruptcy, or become the
subject of a lawsuit, the
founder does not want the
shares to fall into the wrong
hands and have to deal with
another voting shareholder.
3. Minimize potential estate and
gift transfer taxes as shares are
passed on to the next
generation, taking discounts for minority
ownership status and lack of marketability.

The potential estate planning techniques for S
corporations are more limited due to restrictions on the
numbers and types of shareholders. These owners see
their entrepreneurial friends all putting a variety of
assets into family limited partnerships, typically
remaining as general partners (in control), but
transferring limited partnership interests to their children
at discounted values, effectively moving wealth, but not
control, into the next generation.

Voting/Non-Voting Recapitalization. The
owner of an S corporation can transfer wealth but not
control by recapitalizing the company into two classes
of stock, voting and non-voting, both being identical
except with respect to voting rights. Then, the owner
gives away the non-voting shares over time to the next
generation, taking valuation discounts for minority
interest status, lack of voting rights, and lack of
marketability. At the same time the founder will remain
in control by holding some or all of the voting stock. As
the next generation progressively proves their meddle
over time, the founder can continue to give away voting
shares until at some point, majority voting control passes
and the founder remains with a minority interest in the
voting shares.

Triple the Discounts? When considering a
voting/non-voting recapitalization for the first time,
many estate planners make the incorrect assumption that
the valuation of non-voting stock will always confer
three large discounts as follows:

1. Minority Discount- Since the shares are a
   minority interest, they should be discounted for
   lack of control.
2. Non-Voting Discount- Since the shares do not
   have voting rights they must be worth far less
   than the equivalent voting shares.
3. Lack of Marketability Discount- Because the
   shares lack ready marketability (e.g., they are
   not traded on an exchange), this illiquidity
   should be reflected in a significant discount for
   lack of marketability.

While it is true that minority and lack of
marketability discounts can be sizable in certain
circumstances, this might not be true for a non-voting
discount. Typically what is being gifted in non-voting

form is a small minority interest. For valuation purposes, assume instead that a small voting minority interest (non-swing block) had been gifted. The fact that the small voting minority interest has voting rights does not in fact give it much more clout than the same small non-voting interest. Except in unusual circumstances (such as a swing block) the limited number of votes of the small voting share block means its holder can’t affect the outcome of a vote any more than can the holder of a small, non-voting interest. In reality there can and usually are discounts for non-voting shares. However, objective market-based data indicates that these discounts are generally limited as compared to the values for small voting minority interests.

**Conclusion.** Discounts generally do exist for non-voting stock, even if they are small compared to those for minority interest status and lack of marketability. They are simply icing on the cake for the primary goals accomplished by a voting/non-voting recapitalization- transferring wealth at discounted minority values to the next generation without the passing of voting rights or control until the appropriate time. A professional business valuation can assist the owner and estate planner in effectively undertaking a recapitalization to meet these important milestones.

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