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FAIR VALUE™

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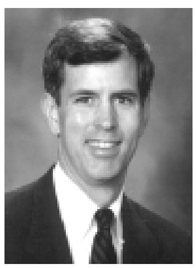
Voting/Non-Voting Recapitalizations In Subchapter S Corporations

By: George B. Hawkins, ASA, CFA

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.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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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