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Minority Shareholder Discount vs. Lack of Marketability Discount

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.

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

Some confusion results between the two types of discounts noted above when analysts arrive at discounts for control and marketability. Minority ownership interest discounts relate to the control the subject has in relation to the business. Marketability, on the other hand, deals with the potential to liquidate the company and how quickly and easily the company can be reduced to cash based upon external forces. Contact The Center's professionals who routinely prepare valuations involving discounts. **1-10**

Dr. Basi's Recently Published Articles:

Secured Transactions, MHEDA, 4th Quarter 2009

The Family Limited Partnership, Services: Legal Update, Sept./Oct. 2009

Dr. Basi's Speaking Schedule:

**February 1 & 2 – Las Vegas, Nevada
Speaking at Surfaces & World of Concrete**

Basi, Basi & Associates at The Center for Financial, Legal & Tax Planning, Inc.

- Mergers & Acquisitions
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- Tax Aspects of Business Decisions
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SERVICES OF THE CENTER FOR FINANCIAL, LEGAL AND TAX PLANNING, INC.

Stockholders (owners) of closely-held business corporations should focus their attention on business planning, direction, and related tax matters at least once a year. Inevitably, the following questions should be addressed:

- Am I provided with timely and relevant information in making my business decisions?
- What steps should be taken for year-end income tax planning?
- How do the recent tax law changes impact my current plans for my company?
- Is the asset composition of my company structured to derive maximum tax advantages?
- What is my business really worth?
- Will I, as an owner, be able to enjoy retirement without incurring unnecessary expenses?
- Do I really know where my cash comes from and where it goes?
- Do I have a business plan and is it current?

The Center for Financial, Legal and Tax Planning, Inc. has the expertise that enables its personnel to respond quickly and effectively to these and other business questions. Our objective is to help with the important decisions necessary to enable you to make the best use of your business resources.

Expertise exists in each of the following ten areas:

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|--------------------------|---------------------------------------|
| 1. Accounting Services | 6. Investment Analysis |
| 2. Budgeting & Cash Flow | 7. Mergers & Acquisitions |
| 3. Business Succession | 8. Retirement & Estate Planning |
| 4. Business Valuation | 9. Strategic Planning |
| 5. Income Tax Planning | 10. Tax Aspects of Business Decisions |

The Center's broad experience in solving problems of the closely-held company and its owners includes the ability to formulate a complete financial plan as well as provide financial tax planning services. The Center is a leader in financial and tax planning for the closely-held business and has developed the expertise necessary to respond to client needs. The Center can coordinate this multi-faceted process for you in an unbiased fashion. Personnel do not sell investments. Advice is offered because it is right for you, not because a product needs to be sold. All advice of The Center is independent and objective of any product bias.

If you would like to receive the Financial, Legal & Tax Advisory by email, please send an email to trish@taxplanning.com.

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