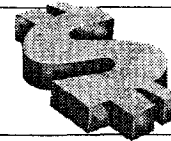


FINANCIAL PERSPECTIVE



Understanding the ups and downs of minority interest

By David J. Mayotte

In a previous column, the article focused on succession planning and the need to make sure that the plan reflects the current wants, needs and desires of the business owner. This article will discuss a business valuation term: minority interest.

First off, what is a minority interest? According to the *International Glossary of Business Valuation Terms*, minority interest is defined as an ownership interest less than 50 percent of the voting interest in a business enterprise. With an ownership interest of less than 50 percent, the shareholder(s) cannot exhibit control. Control is having the power to direct the management and the policies of a business enterprise.

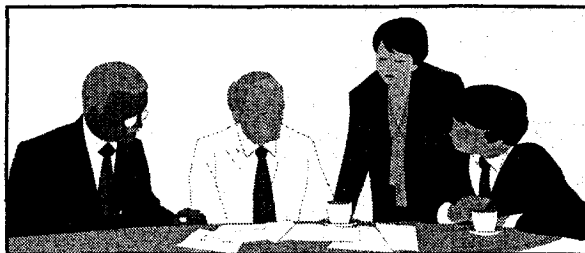
Control shareholders have rights that minority shareholders do not have. It is the ability of exercising those rights that causes the minority shareholder's ownership interest to be worth less on a per share basis compared to a control shareholder's ownership interest.

For instance, a control owner can decide the compensation or directors' fees for officers, directors and employees; decide whether to pay dividends and, if so, how much; buy or sell any or all of the company's assets; amend the articles of incorporation or bylaws; decide whom to do business with including contracts with related parties; select directors, officers and employees; and a control owner can block any of the above items mentioned. These are all items that a minority interest owner cannot affect.

Consider the following: Two people own a business enterprise that makes fandangles. One person owns 55 percent of the voting stock and the other person owns 45 percent of the voting stock. They are making a nice profit making fandangles. The first person should be happy with 55 percent of the compa-

ny's profits but he is not. He wants more. He comes to work on Monday and he informs the other person that he is increasing his own salary by \$100,000 and his wife will be joining the company as his executive assistant with a starting salary of \$150,000.

Immediately, the second person objects but the first person controls the business enterprise because he owns a controlling interest (with 55 percent) and the second person only owns a minority interest with (45 percent). This does not seem fair, does it? Of course not, but this is why a minority interest in a business enterprise is worth less per share than a controlling interest.



Many states have laws that limit or curb these "perks" of control through dissenting shareholders and/or minority oppression statutes. However, each case is judged on a case-by-case basis and a minority interest shareholder might not get relief here.

Of course, if a dissenting shareholder and/or minority oppression statute is brought to court, there will be legal fees incurred. It appears that even if there is help in the courts, the time, effort and legal fees incurred will serve as further proof that a minority interest is worth less per share than a controlling interest.

While it might appear that a minority interest in a business enterprise is undesirable, there are times when a minority interest is good and here's why. If, for estate/gift tax purposes, one wants to reduce his/her estate, there is possibly no better way than to gift an interest in the business enterprise to family members. By gifting a minority interest to the family members, the owner still retains control of the enterprise.

In addition, by gifting a minority interest in the enterprise, the fair market value per share of the enterprise is worth less than the fair market value per share of a controlling interest.

By gifting minority interests in business enterprises, the owners can better utilize their lifetime gift tax exemptions. For 2004, one can annually give \$11,000 (\$22,000 with consenting spouse) away before "eating into" the lifetime gift tax exemption. This could mean large savings on gift taxes for the owners.

After the gift tax exemption is used up (\$1,000,000 in 2004), the tax rate can be as high as 48 percent. With the establishment of an annual gifting program, minority interests in the enterprise could be gifted over a number of years and the enterprise could be entirely gifted over a certain number of years. This result could be more favorable than gifting the entire enterprise away in a single year for three reasons.

By giving minority interests away, the fair market value per share would be less than the fair market value per share of a controlling interest. The second important item would be that fact that one can annually give \$11,000 (this number is inflation adjusted on an annual basis) away before the lifetime gift tax exemption is ever used. Why give the enterprise away in one year when you could give it away in 10? If gifted over one year, \$11,000 could be gifted before using the lifetime gift tax exemption. If gifted over 10 years, \$110,000 (prior to inflation adjustment) could be gifted before using the lifetime gift tax exemption (this doubles when spouse consents). The potential gift tax savings by establishing an annual gifting program could be tremendous.

Lastly, by gifting minority interests, the owner can still retain control.

The value of the gift and the associated minority discount need to be determined by an independent business valuation conducted in accordance with recognized standards and methods. Failure to adequately support the value and the discount could cause the assets to be included in the estate.

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