Spring 2003

Swing Vote Premium Hinges on Circumstances

Recent political history illustrates the importance of the swing vote concept. When Sen. Jim Jeffords of Vermont left the Republican party in May 2000 to become an independent, he represented only 1 percent of the voting power in the U.S. Senate. Yet his decision shifted control of the body from the Republicans to the Democrats. Sometimes less is more.

When you apply the swing vote concept to minority interests within a company, the same argument can apply. By forming alliances with other minority interests, a minority interest may have power disproportionate to its size. Should, therefore, a premium be attached to these interests?

IRS Gets Involved

The Internal Revenue Service (IRS) raised the swing vote premium issue in a 1994 technical advice memorandum (TAM 9436005) regarding gifts from the sole owner of a corporation to his children and spouse. The owner gave each of his three children a 30 percent interest in the corporation and his wife a 5 percent interest. He claimed lack of marketability and lack of control discounts totaling 25 percent of the gifts.

In the TAM, the IRS emphasized the potential for the minority interest holders to band together to gain control of the company. The IRS also claimed that the same argument would hold even if the gifts had not been made simultaneously. As soon as gifts that could aggregate to a controlling interest were made, then each gift had swing-vote potential, and a swing-vote premium would be appropriate.

It is worth noting that the IRS raised the swing vote issue in a TAM regarding intrafamily gifts shortly after losing its long-running battle against minority interest discounts in family businesses. The IRS has not indicated, however, that its position on swing vote premiums is driven by family ownership.

A variety of arguments can be made against the IRS position on the swing vote question. First, there is the concept of fair market value itself.

Hypothetically, No Premium

The IRS definition of fair market value hinges on the price that a willing buyer

would pay a willing seller, where neither is compelled to act and both have reasonable knowledge of relevant facts.

In May, 2001, the Ninth Circuit Federal Appeals Court amended that definition. In *Simplot v. Commissioner*, the appeals court ruled that fair market value was set by "a purely hypothetical willing buyer and seller," not by "specific individuals or entities."

Since any premium on the value of a swing vote minority interest depends entirely on the specific circumstances surrounding that interest, this narrower definition of fair market value seems to preclude a swing vote premium, no matter what the circumstances. As with many valuation questions, however, there is more than one answer.

Some valuation professionals feel that swing vote premiums can be appropriate if driven by specific events that could affect the value of the interest.

For example, suppose a company's bylaws state that 60 percent of its shareholders must approve a sale of the business. The company has a 51 percent majority owner, and two minority owners, one holding 24 percent, the other 25 percent.

The majority owner is in favor of the sale, but needs one of the two minority owners to agree as well before the sale can be completed. This set of circumstances clearly enhances the power of the minority owners and argues for a swing vote premium.

Company bylaws also may require specific majorities for other actions, such as replacing directors. Again, in specific circumstances, swing vote premiums could be appropriate.

In either case, though, remember that the swing vote value is ephemeral. When the circumstances that create the swing vote value change, then the premium disappears.

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