



Watch Out for the Key Person Discount

If you own a small business, have you looked closely at the depth of your management team? Do you have a management succession plan in place? If the answer is no, you are not alone. Most small business owners look at one thing — the company's management ability. It may be worth your time to look at both.

Unlike most major corporations with diverse management responsibilities, the success of many small businesses is largely dependent on a single, key person. This key person could be the CEO, who makes strategic decisions based on his business experience, or a salesperson, who has established great relationships with the company's largest customers. No matter which scenario, this person has shown great success when it comes to growing the business, and as a result, stores a vast amount of intellectual capital. The loss of such a person, for any reason, could have a devastating effect on the ongoing cash flow potential of the business. This loss is also likely to reduce the company's value in the eyes of investors or potential investors. As a result, most business appraisers or valuation professionals apply what is called a key person discount when placing a going-concern value on such a business for investment, taxation and/or other purposes.

Key person discounts may have an extremely negative effect on the value of any business. Valuation professionals often apply hefty discounts based on experience factors with little or no other supporting documentation. The Tax Court allowed a twenty-five percent (25%) key person discount in the settlement of one estate tax case. Recent studies indicate a range of discounts between 5% and 10%.

According to Revenue Ruling 59-60, the loss of a key person "may have a depressing effect on the value of the [company's] stock." In addition, this ruling instructs valuers to consider what effect losing a key person would have on "the future expectancy of the business," and "the absence of management-succession potentialities." Key person discounts may or may not apply to small and mid-sized businesses depending on a number of factors, including:

- **Management Composition:** Discounts become less likely as management becomes more diversified in that both strategic and tactical decision making authority is spread to additional persons. Comprehensive management succession plans coupled with appropriate training programs can also reduce the key person discount.
- **Specializations or Operational Complexity:** Some businesses may require a professional designation to conduct business while others may necessitate a great deal of technical know-how to operate efficiently. If a single person possesses such expertise, a key person discount may be applicable if a suitable replacement is unavailable.
- **Sensitivity to Change:** Businesses in cyclical and highly competitive industries have historically been more sensitive to operational changes and more likely to incur financial declines with the loss of a key person. A business that has a high degree of sensitivity to change requires a higher key person discount.

Offsetting factors which may reduce or eliminate the need for the key person discount in valuing a business include:

- **Insurance:** Proceeds from a company-owned life or disability policy on the key person could serve to offset any projected decrease in future cash flows resulting from the loss of the key person.
- **Net Cost Savings:** As a general rule of thumb, the key person's compensation and benefits are commensurate with his/her value and tenure with the business. In all likelihood, any replacement would require less compensation.
- **Non-compete Agreements:** This type of agreement is designed to protect the small business in the event that the key person submits his/her resignation. By implementing a non-compete agreement, the key person may not go into direct competition with the business he or she left.

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Our mission is to provide information and strategies to business owners and managers for improvement in the effectiveness of its business management so that key objectives can be realized.

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Watch Out for the Key Person Discount (cont.)

Is your small business prepared to handle the unexpected? Are you thinking of stepping aside and relinquishing control to someone else? Are you contemplating the sale of your business? In any case, watch out for the consequences of the key person discount. A lack of planning on this important issue may result in severe consequences not only for you, but for your investors, or worst of all, your heirs.

We can help you avoid this issue. You can make intelligent decisions, which make your company systems dependent rather than people dependent. Give us a call today to talk about your unique situation.