Dividends or redemptions?

Which liquidity plan is best for your family business?

By François de Visscher

In the early years of a family business, families typically provide liquidity to shareholders by distributing dividends. One advantage of dividends is that they are easy to understand as well as to implement.

Traditionally, dividends have been an ongoing reward to shareholders and a key component of the overall return on their investment. In first-generation companies, founders often trade off dividends with salaries and bonuses. In partnerships, the board finds out what family shareholders need, looks at how much cash the business has and pays out as much as possible. But in later-generation family businesses, dividends can create several problems, because the various shareholders' liquidity needs evolve differently.

A dividend policy can't accommodate disparities in shareholders' financial and social lifestyles. It considers everyone equally and inevitably reaches for the highest common denominator of liquidity needs. That can get very expensive for the business. Another problem is flexibility. In theory, dividends are flexible in the early years of a company. But that flexibility flags in later generations, as inactive shareholders come to expect a certain level of dividends and, in some cases, may depend on their distributions to support their lifestyle.

This may lead to the classic liquidity spiral, which has destroyed the value of many family companies. As more dividends support liquidity needs of a growing shareholder base, less capital is available to reinvest in the business, resulting in less value creation and less cash flow available for future distributions. So shareholders must choose: Sell the business at a highly diminished value, milk whatever value is remaining or, worse, face insolvency with outside creditors. The board of directors can avoid this problem by establishing strict and objective dividend policies that properly balance the financial return to the shareholders with ongoing capital needs of the business. Objective benchmarks in the form of payout ratios and yields comparable to those of public companies enable the board to provide shareholders a fair current return on their investment.

But there are alternative ways to provide shareholder liquidity. Stock redemptions, for instance, come in several different forms to help family companies adequately match distributions to shareholders' specific liquidity needs. Redemptions need not fully replace a dividend policy but can complement dividends to satisfy the overall needs of shareholders and balance them with the capital needs of the business.

Here are three types of redemptions for family businesses:

• **An annual redemption fund program** allows shareholders each year to sell shares to the company or to other shareholders at a predetermined valuation, subject to certain cash limitations. Shareholders who want to buy shares from other shareholders create an annual liquidity market. With a very large and diverse group of shareholders, this program enables the company to expand liquidity funds only to those who so desire.

• **An internal recapitalization** enables the company to differentiate among shareholders. For example, a preferred stock recapitalization creates a new class of preferred stock with a fixed dividend rate. Shareholders with high liquidity demands can exchange their common stock for dividend-paying preferred shares, which they can then redeem over a short time, say five to ten years. The common stock, where most of the future value will accrue, will be concentrated in the hands of those shareholders who have the smallest liquidity needs and a long-term interest in the future value of the company.

The internal recapitalization offers a great deal of flexibility. I am seeing some complex family systems create two, three and sometimes five classes of preferred stock, each with different dividends and redemption periods.

Consider a $30 million company with three shareholders; two active and one inactive. They each own one-third of the company. The active shareholders earn a nice salary and don't have much need for dividends. But the inactive shareholder has been living off the income from the stock. If this company pays a dividend of $1 per share, $2 of every $3 it pays goes to people who don't need it. The company is basing its dividend policy on satisfying the neediest shareholder.

Instead, the company can redeem the inactive shareholder's shares by converting them into preferred redeemable shares. This shareholder's $10 million of common stock transforms into $10 million of preferred stock that will pay a set dividend. But now dividends go just to the shareholder who needs them. If the preferred shares are redeemable over ten years, then each year the company will also buy back $1 million worth of those shares.

Over time, this redemption plan will increase the ownership of the other two shareholders. Initially they each owned one-third of the company—$10 million apiece. After ten years, they will each own 50%—$15 million apiece (or half of whatever the presumably appreciated value of the company is by then).

This plan changes the balance in the ownership structure of the family. This can be a good thing, especially for families who want to concentrate the power among certain relatives (e.g., those who run the business). But some families may view this as a drawback, to the extent that the new ownership structure concentrates control with some branches and not with others.

• **Limited-liability company redemptions** or other corporate reorganization models allow the operating company to distribute a percentage of its cash flow to an LLC or other a family entity, sufficient to pay any taxes due and provide for that year's liquidity demands of shareholders. In turn, the family entity distributes cash to shareholders who so desire by way of redemptions of their shares in the entity.

For example, you can capitalize the LLC with voting and non-voting shares and can even add preferred shares to the mix. The voting shares are not redeemed, so the balance of control doesn't necessarily change. The company can provide liquidity without affecting control.

What about the tax consequences? Under the recent tax changes, both capital gains and dividends are taxed at the same 15% rate. Therefore, if the tax basis of shares sold in the redemption is minimal, as is the case in many family companies, the tax consequences of distributions on dividends or redemption will be similar.

But redemptions may have some significant tax consequences even to shareholders who are not selling any shares. Redemptions fall into a very dangerous tax area called "imputed dividends." Because redemptions often increase the ownership of shareholders who have not sold, the IRS takes the position that this increase in ownership is a taxable event—even if no cash was distributed to those shareholders. I urge any family businesses contemplating redemptions to consult with tax advisers to plan carefully around this complicated and contested area of the tax code.

	Dividends	**Redemptions**
PROS	• Easy to understand and implement. • Equal treatment of all shareholders. • Flexibility at the discretion of the board. • No sale of stock or change of control.	• Targets liquidity to the specific needs of individual shareholders. • Properly balances control, liquidity and capital needs. • Can save money by providing liquidity only to those who most need it.
CONS	• Does not distinguish between shareholders with different liquidity needs. • Creates expectations. • Can be very expensive; always reaches for the highest level of liquidity needs.	• Can create imbalances in ownership and control. • Can result in punitive tax consequences if not properly structured.

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