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Selling Your Business In The 21ST Century

How many businessowners will transition their business ownership in the next 10 years? Based on the tsunami of Baby Boomers – quite a few. Baby boomers have dramatically impacted markets as they have aged. First it was baby gear, then overcrowding of schools. There was an impact on housing, the stock market and ultimately, consumer spending which is keeping the economy afloat. As these Boomers near retirement, this tidal wave of humanity is going to impact social security, health care and retirement homes. What impact will they have on the sale of a business?

Based on past history, there will be a lot of businesses being put into play. – but will there be enough buyers? Based upon simple economics - the Law of Supply and Demand – it is likely a large number of businesses for sale will impact the sale value. The price of businesses could fall precipitously as more and more businessowners try to sell into this buyer's market.

Every businessowner shares one problem in common. They eventually want to capitalize on the value they have created. They want a liquidity event. As retirement nears, they will want to convert their equity into passive income. It often comes as a shock that their capital can't produce the same income they were earning from the business. But that is the subject of another paper.

This liquidity event can only occur when the seller turns their business over to a new owner. For most businesses, there are essentially only three prospective buyers – a family member, an inside buyer or an outside buyer. The impact of these factors is unpredictable, but there are two things which are certain – (1) owners of businesses should secure a buyer as soon as possible and (2) they should carefully consider any expansion plans.

Finding a Buyer

Let's look at finding a buyer. Our experience has been that most sellers either sell to a family member or a key employee(s). When the seller rejects these options, then they start to look outside the business. The most common reason a family sale or internal sale fails to happen is the cost. These buyers can't afford the price or the terms are unacceptable to the seller. When this happens, the seller seeks a business broker and begins a search for the "elusive" outside buyer.

Occasionally, the seller will discover their business is worth far less on the open market than they had hoped. All of the warts and moles of the company are only too apparent to a professional buyer. The cost of doing a makeover is too much to consider, leaving the internal sale as the only good option.

Expansion Plans

Most entrepreneurs have been successful because they take risks. It is their nature. They usually don't possess strong management or business skills. We have found there are two types of owners – the risk takers and the managers. The bridge between risk and management is delegation.

The risk taker is constantly expanding, looking for new markets and trying to find ways to grow the value of their business. Often there is no eye towards an exit strategy. They believe someone will always be willing to step in and buy the business. This ultimate buyer is their escape route, yet they are often very cavalier in their planning for this event.

Should our intrepid risk taker expand into a buyer's market. The Babyboomer entrepreneur who is 50 – 55 may be thinking they can double or triple the value of their business in the next ten years and really capitalize on the value they have worked so hard to build. While this may be true, there is every likelihood they will see very little of that value in a buyer's market. Maybe they should take some of the chips off the table and start planning now for their exit.

A Basic Business Rule

There is one basic rule that governs every business transition. Understanding this simple rule makes all the difference between a successful and unsuccessful transaction. Here is the rule – "**There is no such thing as new money**." It's a simple rule really – it means that every businessowner eventually will buy themselves out of their own business with ***their own money***. At first blush, this may seem ridiculous. Why would they ever do this? The buyer writes a check for the value of the business. Whether it is a cash sale or a term note, it is the buyer's money.

While this is true, to a point, don't be fooled by the idea it is the buyer's money. They may front the money, but they would never purchase this business unless they thought they were going to get it back, plus a handsome profit. Initially, this is a difficult concept for most businessowners to grasp. In fact, it is often puzzling to their advisors. But once this important concept sinks in, it becomes the key to planning a successful transition. Again, it is important for the seller to understand it is always their money that buys them out of their business with their own money. Why?

The Basics of a Transaction

Let's look at the basic factors of a transaction to understand the interplay between buyer and seller.

When an outside buyer purchases the business – what money do they use to pay for the purchase? They either borrow from a lender (seller financing or a bank) or they liquidate their own assets, but ultimately they are going to look to the business income stream to repay their investment. Most buyers want a 20-25% return – this equates to payback in 4-5 years.

If our seller had never sold the business, he would have kept the income for himself. Once the sale is completed, his income goes to the new buyers – along with the risk, the headaches and the liabilities. So then, whose money bought the business? It's the seller's money. As a result, if it is his own money – why not have the buyer start planning his exit now.

In order to truly understand the implications of No New Money, every businessowner and advisor needs to understand the tax principles in a business transition – we call it "The $1.82 Story." Most people don't know this, but the sale of a business is often the most ***heavily taxed transaction*** in the tax code.

The tax can approach 110% of the <u>sale price of the business</u>.

Let me repeat that – 110% of the **SALE PRICE**. If the FMV of the business is $1,000,000, the taxes paid could be $1,100,000. Why? Let me show you. Suppose you sell your business for $1x – how much will you net from the sale? If we assume it is a capital gains transaction – the maximum capital gains tax rate in many states will be between approximately 25- 28%.

Let's assume the tax is 28% for our purposes. This means our **businessowner** will pay $.24 in tax(state and federal) and net $.76 for his efforts. We call that the Seller's tax and most people are familiar with those. But what about the buyer? What taxes did the buyer have to pay? Buyer's tax? Come on, the Buyer doesn't pay a tax, does he?

Is there a Buyer's Tax?

Whether I am working with a buyer or a seller - I always ask this question – "Does the Buyer have to pay a tax?" This is where it gets interesting because virtually everyone will say – "No – how could there be a buyer's tax?"

So, how would you answer? Most will say the same thing – "Buyers don't pay tax." And while this is absolutely true – in theory - it is ***<u>not</u>*** true in operation. Here is why.

How Does the Buyer Repay or Replenish their Capital?

When the buyer writes a check – where does the money come from to pay the seller? Remember, the money came from either a loan or the liquidation of other investments. The purchase price either comes from accumulated capital or from financing. In either case, the buyer purchases the business using an earnings multiplier. Remember, they are expecting to recover their investment in 5 years (a 20% return). Does this happen by magic? Of course not, they recover their investment from taxable business income.

Focus on this – ***<u>taxable</u>*** business income. In a 45% corporate tax bracket - how much income does the business have to earn to net $1.00 to the owners? (So they can recover their $1.00 of capital) Most say, 45% tax bracket – it must be $1.45. But is it?

Let's look and see. If you earn $1.45, and pay a 45% tax, the tax is $.65 and you net $.80 - but $.80 is not $1.00. So how much do you have to earn to net $1.00? You have to earn

$1.82. That’s why we call it “The $1.82 Story.” You pay $.82 of tax and net $1.00 income.

Why is this important? Remember I mentioned the purchase of a business is the most heavily taxed transaction in the code? Look at the taxes. The seller had to pay $.28 and then the buyer has to pay $.82 – so, add them up – that’s $1.10 total taxes to transition a business worth $1.00. This is truly double taxation. The IRS taxes the income from the business and then taxes the purchase price of the stock.

Businessowners must understand the pricetag of this transaction. Business decisions are all about pricetags **AND** alternatives. The pricetag of a business transaction is - $1.10.

How to Reduce the Tax Cost

We can reduce the pricetag of the transaction by restructuring the financial statement of the business. To do this, we must convert Capital gains to ordinary income. What? Convert capital gains to ordinary income, that is ridiculous. But is it? Most would say- why? That is intuitively impossible to accept. Yet, by doing so, we dramatically impact the cost of the sale to the buyer. The FMV of a company is usually determined by the book value plus any goodwill. By converting goodwill to tax deductible compensation, we convert double tax dollars to tax deductible dollars. Be careful, a lot of accountants have never thought about doing this – and may balk at the idea. Business brokers are often not interested in adding any complication to the transaction and will fight against doing this.

The key to selling a business is tax efficiency. It has to be good for both the buyer and the seller. So, you might still be thinking – “Why, would we ever convert capital gains to ordinary income?” By doing so, we are able to deduct a significant portion of the selling price. “But this causes the seller to pay more tax.” Right, but if the seller NETS the ***same*** amount, what does it matter if he paid more tax? – especially since the overall transaction cost will be significantly less.

Here is the fact - most sellers find it difficult to sell their business for top dollar. Professional buyers always out negotiate amateur sellers. Sellers usually are selling for the first time. Professional buyers make an art out of buyer low. But by restructuring the capitalization of the company, you can make the ultimate cost to the buyer less which can result in the seller getting MORE.

Selling to the Inside Buyer

In most situations, the sale should be to an inside buyer. So, why doesn’t this happen more often? For one reason, the inside buyer has no MONEY. The Seller has to finance the purchase with additional salary to the inside buyer. The seller increases the insider buyer’s compensation so the inside buyer can pay income taxes on the additional income and then turn around and pay it back to the seller as taxable capital gains. This is what we call the “double tax buysell.”

"Mr. Jones – if I could show you how to sell your business to your key man for top dollar and avoid the "double tax buysell" – would you be interested?" This can be done by restructuring the Seller's compensation instead of the Buyer's.

If the Seller takes cash from the business as compensation – he would have to pay tax on it anyway. By setting up a deferred compensation plan – for himself or for the inside buyer - to offset the goodwill – he does two things. First he establishes a substantial wealth accumulation program from himself. But equally important – he ties the inside buyer to the business.

Remember the rule – sellers are always bought out with their own money. By showing Sellers how to make some or most of the business tax deductible and at the same time - tie the inside buyer to the business in order to increase the value of the business over time, the Seller assures himself of the price he requires. In the final analysis, the Buyer will purchase the business for a significantly lower cost than if he borrows from the bank or liquidates other money.

In the coming years, Sellers will be looking to find unique ways to fund the purchase of their business. The $1.82 story or "selling your business in the 21st century", is a story they must hear if they are going to make the most of this transaction.