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Successful Transitions

# Waiting to Transition Your Business? It May Not Be Worth the Wait

In an ideal world, every business owner would be prepared for a business transition at any given time. Today there are many private business owners who are seeing their business profits return to levels that have not been seen since prior to the last recession. However, despite this increase in overall profitability in privately-held businesses, there are many owners still waiting to exit. This newsletter is written to provide a comparison to the benefits of waiting for an exit (perhaps with an expectation of further increases in profits) versus the drawbacks of being exposed to potentially higher capital gains tax rates, potentially higher ordinary income tax rates, a crowded marketplace of sellers, and continued exposure to private business risk.

**<u>President Obama's Proposed 2016 Budget</u>**

President Obama has submitted his proposed budget for 2016 and it includes an increase in the capital gains tax rate, increasing that rate from 20% to 24.2%. And, in the event that the net invested income tax of 3.8% applies to your business exit, your total federal capital gains tax rate will be 28%. Plus, you may also be subject to state capital gains tax rates, pushing your total capital gains tax to more than 30% of your sale proceeds. When compared to the capital gains tax rates of just a few years ago, this figure is almost double.

**<u>Example: The Cost of Waiting</u>**

In order to make a simple point of whether or not it is worthwhile to wait to exit your business, let's take a hypothetical example of a company with $2 million in cash flow which may sell in the current market for $10 million. At a 20% capital gains federal tax (and assuming a basis of $0 in the company), the exiting owner would pay $2,000,000 in federal capital gains taxes and net $8 million (not including state capital gains taxes, the net invested income tax, and assuming that the transaction receives capital gains tax treatment). If the capital gains tax increases to 24.2% there is an additional tax of $420,000.

Now, there are many owners today who expect an increase in their overall cash flow in the near future, a trend that has occurred for a few years now. These owners might argue that a mere increase of only $100,000 in cash flow, at a 5 multiple, would cover this additional tax. While this math would prove accurate, it is also raises a host of related issues regarding the risks of waiting to exit. Some of these additional risks include the risks to the business as well as to risk the changes in the marketplace of buyers and sellers, not to mention the risk that another recession will appear at some point in the future.

**The Current Marketplace and the Pending Retirement of Millions of Baby Boomers**

The leading baby boomers, those born between 1946 and 1964, turn 70 in 2016. Since a majority of businesses in the United States are owned by these boomers, there is an expected flood of sellers looking to cash in their businesses as they tire and age. If the marketplace of transitioning owners gets crowded because everyone is done waiting, you, the owner, may not fetch the same price as more selling baby boomers come into the marketplace. Moreover, it may be the case that you don't get a deal done at all because you are competing with so many other sellers.

Today, there is a 'seller's market' for profitable, transferable businesses. The future, however, is a bit uncertain with such large dynamics at work. Plus, there is the additional risk of interest rates increasing, making borrowing more expensive to finance transactions, thereby also lowering prices that a buyer can pay.

Finally, and not insignificantly, owners who wait to transition continue to assume the risks of running their businesses. These risks include company risks, i.e. something can happen to you, to your business, or to your industry, including changes to the overall marketplace. In addition, owners who wait to transition bear the opportunity risk of having liquid dollars today appreciate over the next few years if you were to cash in your company and gain that financial security from your otherwise illiquid business.

**Concluding Thoughts**

All owners' companies and their situations are different. Regardless of the specific application of these issues to you and your company, it is helpful to think in these terms so that you can make a fully informed decision about the future transition of your business. Tax issues are only one reason to consider a transition today. Beyond that there are many other compelling, possible scenarios that arise from delaying the sale of your business. Each owner needs to weigh the pros of holding onto their company against the risks of delaying. This newsletter sought to make the point that waiting may cost much more than one anticipates, particularly in light of the trend of the marketplace dynamics as well as tax rates and other factors. We hope that this newsletter accomplished the objective of getting you to think about your transition in a broad sense, considering all of these factors to help you arrive at clear decisions about the right time for you.