A Time to Sell?

With the economy in the midst of a significant recession many private business owners are waiting to sell; however, pending increases in the long-term capital gains tax rate may point to an earlier exit

By David Kidd, Managing Partner
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Most business owners begin the process of selling a business by asking, "How much?" Financial planners advise, however, that the more important question is, "Is it enough?" From this perspective, taxes are a critical consideration.

Today the long-term capital gains tax rate for most private business owners is 15%, the lowest it has been in the U.S. since 1933. This low rate is the result of Bush-administration tax cuts enacted in 2003. The current rate is scheduled to increase after December 31, 2010, when long-term capital gains are to be taxed at 20%, assuming the Obama-administration and the Democratic majorities in the House and Senate do not enact new legislation to increase the rate further.

If President Obama and the Democratic congress increase the long-term capital gains tax rate to 28%... a business owner will pay 87% more in taxes.

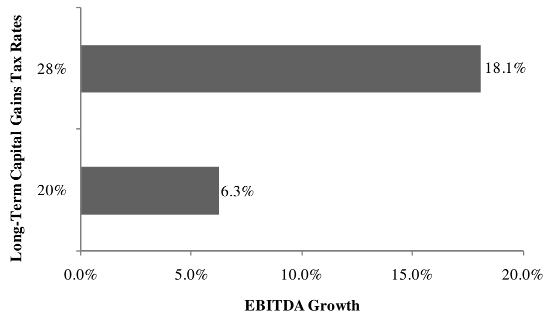
Many business owners considered selling their companies in the summer and fall of 2008 based on a belief that a newly elected Democratic President would increase long-term capital gains rates in 2009. However, with the economic downturn in September and October of 2008 many of these owners decided to wait until the economic outlook improved. The good news for those that waited is that President Obama has yet to modify the Bush-administration tax policies, giving business owners up to two more years to sell a business and take advantage of the historically low capital gains tax rate (assuming President Obama and Congress do not modify tax rates in 2010).

Implications for Business Owners

If a business owner is considering a sale over the next three or four years he or she should carefully review and understand the tax benefits of completing a transaction by the end of 2010. For example, assume a healthy business with no debt earning $2.5 million of EBITDA[1] is worth $10 to $12.5 million today based on a multiple range of 4x to 5x EBITDA. The long-term capital gains tax paid by the owner would be $1.5 to $1.875 million (not including state taxes), respectively. If the Bush-administration tax rates expire and the new long-term capital gains rate is 20%, the owner will pay $2 to $2.5 million in taxes, or 33% more, if the transaction closes in 2011 or later.

[1] EBITDA is Earnings Before Interest, Taxes, Depreciation, and Amortization; EBITDA is commonly used as a basis for business valuation and is an approximation for cash flow generated by a business.

Required Business Growth to Achieve Same Net Proceeds



However, if President Obama and the Democratic congress *increase* the long-term capital gains tax rate to 28%[2] or greater as has been speculated, the same business owner will pay 87% more in taxes, or $2.8 to $3.5 million. **When the capital gains tax rate increases to 20%, the business would need to grow EBITDA by 6%, or the market multiple for the business would need to increase by the same percentage, for the owner to net *the same* proceeds after the Bush tax cuts expire.** If the capital gains tax rate is increased to 28%, the business would need to increase EBITDA by 18% for the owner to net *the same* amount. Either way, the business owner must work hard to grow the business or rely on a market shift in order to get back to the same place. If he or she is considering retirement in conjunction with the sale, gearing up to grow the business and potentially working more hours, late nights, and/or weekends to make the same amount may not be an appealing proposition. There is also the added risk of holding a business for two or three years in the hope of a better economy: the economy or a specific industry may deteriorate, further lowering the value for the business.

The Bottom Line

Trying to time the sale of a business to maximize proceeds is more challenging and complicated than trying to time the ups and downs of the stock market, something the brightest minds on Wall Street regularly fail to do. Selling a business takes a minimum of three months and may last well over a year. An owner's energy and time may be better spent understanding what he or she needs to achieve from a sale in order to live his or her desired lifestyle. If the sale of a business can achieve an owner's goals today, he or she should consider selling the business to spend more time with family, on hobbies, or with charitable pursuits. The value of an early retirement, in conjunction with long-term capital gains tax benefits, may make a sale in today's market an attractive alternative.

About the Author

David Kidd is the Managing Partner and founder of Adirondack Growth Capital. Adirondack's sole mission is to build long-term value by acquiring and growing a privately held business. David earned an MBA from Stanford University, where he was an Arjay Miller Scholar, and holds a BS from the University of Illinois, graduating with Highest Honors and Bronze Tablet distinction. More information about the author and Adirondack can be found at www.AdirondackGrowthCapital.com.

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[2] 28% was the long-term capital gains tax rate in the late 1980's and early 1990's.