TAKING CHIPS OFF THE TABLE

(Cash out some of your business equity and stay in the game)

If you are a typical entrepreneur, your largest investment is your business. This is a natural phenomenon, since we initially perceive that our best chance of controlling our destiny is through managing our own business – and we continue to up the ante – reinvesting our earnings, and letting them ride to fund growth. So, we take the risks (including personal guarantees on business debt) with most of our personal resources being 'in the game' and subject to substantial risks every day of our business lives.

There comes a time, however, when prudence dictates that we balance our estates and 'take some chips off the table'. This can be done in a variety of ways. Traditionally, the ultimate exit strategy was to sell the business and cash in. This strategy has always required some planning, and some good fortune, to time the exit so as to maximize the proceeds from a sale. Many businesses have followed the general trend of the economy in recent years and consequently have experienced some temporary downturns in business. And, while most are now starting to return to normal growth in sales and profitability, a business which is sold before a full recovery might not command its full value in the marketplace. So, it seems that an entrepreneur is forced to wait a little longer and continue taking large risks with the lion's share of personal wealth.

However, if you are interested in decreasing the risks of holding a business through uncertain times, and therefore are willing to consider a sale, there are several current considerations that you should take into account:

1. **U.S. Income Tax Rates** – There is a very attractive window open today for the sale of a business. Dividend rates are only 15% (for those with C-corps), and more importantly, your personal capital gain tax is generally 15%. There appears to be considerable risk that these rates will return to pre-Bush levels – generally 25% for capital gains and about 38% for dividends. There is even some risk that capital gain rates could exceed the 25% rates. If you were to sell your business now at a $1million gain, your federal tax rate would be at 15%; to net the same amount in the future with a 25% rate, you would need to sell for a gain of $1.135 million. Tax risks of AMT would apply in either case. If you agree that the rates will increase after the coming election, these matters are very compelling to you.

2. **Interest Rates** – Generally, there is a relationship between the cost of capital for a business acquisition and the price that can be paid; if rates are higher, debt service is higher and net cash flow is lower, therefore the price would normally be lower. Interest rates are currently very low. If you believe they will rise any time soon, there is a good chance the value of a financed business will decrease.

3. **Market Values** – There are many forces working on market values for businesses. Capitalization rates (the rate of return demanded by buyers) are very important. Cap rates are generally impacted most by interest rates as mentioned above. Demand is also a critical determinant of price. There is a great deal of money chasing a very few deals today, creating demand for businesses far in excess of supply, which tends to increase prices and improve terms for sellers.

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4. **Tax deferral** – Installment sales have been available for most business sales (with certain limitations such as recapture). However, installment reporting means you are financing the debt. Providing financing can be good based on the fact you receive returns on pretax income, possibly pay lower taxes when you do pay (AMT and other burdens may not apply if you don't have to recognize all income in one year) and you can often receive an interest rate superior to alternative investment opportunities. However, you are generally risking that you won't get paid – historically you would not be able to use installment reporting if money was escrowed or otherwise available to you, because it was considered 'constructively received'. There is currently an opportunity to use a highbred tool, a guaranteed structured installment sale, which will guarantee that you get your money but you will not be taxed until it is received (normal exposure to constructive receipt issues are eliminated).

5. **Recapitalization** – The term 'recapitalization' is often used in very broad and general contexts. In fact, an IPO, an outright sale, and a debt refinancing might all be called "recaps." However, I would like to draw your attention specifically to the use of private equity funds that participate in changing the capital structure of your company. There are many of these funds and they have substantial capital which they very much want to invest. Historically, these funds were mostly available only to larger transactions, often with minimum investments of $10 million. Today the funds are willing to invest in smaller companies, buying a percentage of ownership and bringing new senior debt to the table (eliminating the personal guarantees of the current shareholders). Many funds are willing to acquire a minority interest. In some cases, the fund will design a program involving part equity and part "patient debt." The huge benefit available through this mechanism is the opportunity to withdraw some but not all of your capital from your business. You can therefore better define part of your estate, diversify prudently and yet stay involved personally and financially in your business without risking all your business net worth and personal guarantees. There is no need for you to live in a "hold'em or fold'em" environment – all or nothing – with your business. In the event you expect your business to improve dramatically in the near future, but you don't want to stay fully at risk until that happens, a recap could be the perfect prescription for you.

So, if it is time for you to limit the risks of having your worth depend entirely on the continued success of your business, you don't necessarily have to wait for a total economic rebound to take action. It is quite possible that now is the most prudent time to take all or some of your chips off the table and remain a winner.

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