Innovative liquidity solution for SME's.:

True business heroes

Small business owners are the true heroes of any economy. Unlike publicly traded firms, private firms have to earn their capital – no public stock issues for them. The injustice is that when small business owners (SBO) try to get their capital out of the business when they exit, they have to compete with publicly traded firms.

The SBO has for many years been contending with competitors across town or across the state. At the exit point this competition continues and is compounded by the realization that there will be an additional contest with publicly traded capital markets.

For example, let us assume that an SBO has managed to generate C-corp after-tax profits of $200,000 per year for five years. At a handsome premium multiple of, let us say, 5 times, the privately owned business can be valued on paper at $1 million at least.

The problem is that the SBO will be extremely lucky to get $1 million for the shares of the business. That's because an investor will look to large dividend-paying publicly traded stocks as a first choice. These investments offer instant liquidity, capital guarantees with options, the best management that money can buy, no employees to manage, no worker's compensation forms to fill in, and no tussles with the IRS over deductible operating expenses at tax time. Look closely and you can see the annual increase in shareholder value rising at about 15% (including dividends) year after year for decades for large blue chip companies. Shareholders demand such increases from management to offset risk, so CEOs deliver earnings that reflect the demand. These large firms saw the price of their stocks plunge during the recent financial crisis, but once the recovery is in full swing they will revert to their long-term mean. That's one explanation for Berkshire-Hathaway's buying spree in the last 18 months.

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SBOs get frustrated when they look at offers for their shares. Quite often they have return on sales, equity, assets and capital that would make the CEO of a publicly traded firm envious. Yet small businesses are not attractive because they are not liquid. As a result, many SBOs put off making plans for an exit until it is too late.

A few SBOs do manage to accumulate sizeable cash balances and accompanying retained earnings accounts. Yet even these sustain a tax hit from the IRS. Tax-paid capital on the balance sheet, when the retained earnings are paid out, becomes income, taxable at the prevailing dividend tax rates.

However, extracting a large, one-time cash balance is tough for any business. Successful SBOs have long-standing relationships with their suppliers, lenders and, most importantly, their employees. In addition, SBOs have usually not made maximum contributions to 401Ks and other personal pension schemes; as a result, they are in conflict at retirement with their own needs and the needs of the business as an entity for the benefit of customers, employees, lenders and suppliers.

A small fraction of SBOs will be bought out by publicly traded firms or perhaps even go public. But this is not the norm for SBOs. If a cash payment at five times earnings is not likely, then perhaps a junior but promising employee could be enticed to take over the reins and ownership by means of a “buy out”?

This appears to be an appealing prospect. The junior person will likely know the business very well, have lots of drive and a good technical business education. However, when the junior executive consults his personal CPA, he will find that on average, the total after-tax cash flow required to execute a buyout over 10 years at 6% and current corporate tax rates will amount to approximately twice today’s asking price of, for example, $1 million.

The junior executive will have to generate sales revenue, pay tax on the profits, pay interest on the debt and, of course, pay the principal. The misfortune in this case is that the junior executive will have to have earned about $2 million in cash to make the transaction work, and he will be ten years older and won’t have created any wealth for himself.

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Not many junior executives with today's level of education would sign on to such a deal. So if this type of exit is not viable and public markets create an overwhelming arbitrage situation that militates against a buyout commensurate with the true value of the business, other solutions are required.

One possible solution is to move after-tax cash profits as dividends to a holding company owned by the SBO. Once there, they can be inserted into a life insurance policy for tax-sheltered accumulation. A long-term cash accumulation of about 5% is possible even with the cost of insurance factored into the policy.

As for liquidity, instead of withdrawing cash from the policy, the shares of the corporation can be assigned to a bank for a series of capitalized loan payments or CLPs. These are similar to reverse mortgages.

Such capitalized loans will grow well into the future. The life insurance company will pay off the loans, and the balance of the life insurance proceeds can go to the holding company from which it can eventually be dispensed to shareholders – one of which will be an estate.

The principles of this strategy are straightforward: the present value of tax paid on dividends withdrawn from a corporation today is much greater than the accumulating future value of the interest capitalized by a lender.

The tax collectors still get their tax on stated earnings from the lender and from the life insurance company on earnings from operations. In effect, the SBO has uploaded his tax payable today to organizations with the resources to pay it.

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