



Business Cycles:

Where do I want to enter?

By Scott Balfour

Every business is born from a concept or...a great idea. Each business typically goes through 4 phases during its life cycle. These phases include the: *Start-up phase, Growth phase, Maturity phase, and Decline phase.* As a business Buyer, you need to consider which phase you are most comfortable entering into. Each has its own risks and rewards.

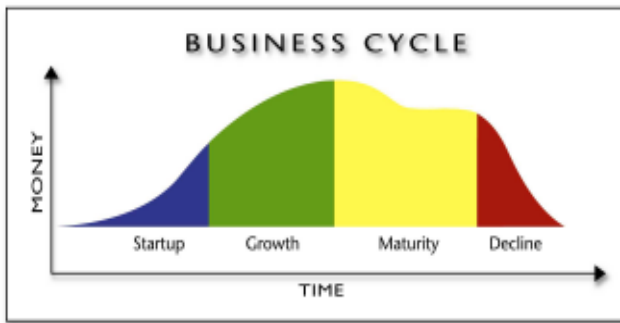
Start-up Phase:

True entrepreneurs and visionaries seem most comfortable in the start-up phase. They have an idea and want to do it their way. Typically in this segment of the business cycle, relatively speaking, they invest little money and lots of sweat equity. Decisions are often made emotionally vs. empirically. The business often requires the owner to go quite some time before any thought of taking any money out, even for a salary, can be considered. The risk is often high.

Government surveys report that 60 out of 100 start up businesses fail in the first three years.

Conversely, those that hit can provide great personal satisfaction and a high return on capital and energy invested.

Growth Phase: The next phase is the growth phase. This is at the point when the 'nut' has been made. (break-even), and the 'test of time' has proven it's a viable business. In this phase, sales and all aspects of the business are growing in relative proportion with one another. (number of



employees, physical space demands, equipment, perhaps profits etc.) This is a very exciting time in the development of a business and those with vast energy resources flourish. This is where the momentum for growth is set and the challenge is to see how high it can go. What is rewarding financially in this phase is that relative to investment the future return in equity build up is the greatest. The downside is that the growth often requires constant capital investment, both from internal sources and external. Reacting to, and creating change in this cycle is critical.

Maturity Phase: After a point business growth often flattens out or slows down. It seems to repeat the same performance year after year. This is often where great managers feel most comfortable. Their challenge is to tweak the business, to constantly look for ways to improve the business model and get the best bottom line. The business at this point typically can pay a healthy salary to the owner and produce a profit. Not only do managers have the opportunity to look forward, as they did in the start-up and growth phase, but they also have the benefit of looking

backwards with plenty of experience, data and past performance. At this point some say 'if it ain't broke, don't fix it.' Others find this a comfortable platform to build from. Either way this is a good entry phase for those who want to avoid the high risk attached to start ups and/or need the predictable immediate salary not always obtainable in growth businesses.

Decline Phase: After a point many businesses just don't seem to perform as well as they have in the past. This can happen for many reasons.

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Cost Segregation

How to get a larger up front tax deduction...

In real estate investment there are four components that make up a return: Cash Flow, Equity Build-Up, Appreciation, and favorable Tax Treatment. In this article we are going to talk about the tax component.

Primarily there are two tax considerations. One capital gains, the other depreciation.

Capital gains: On the federal level when you sell your gains, if the property is held for over a year, under current tax rates, you will be taxed at 15% vs. your marginal rate, say perhaps 35%. On a \$200,000 gain that's a \$40,000 difference! And even then that tax may be deferred if you opt for a tax-free exchange. (See article Volume 1 on our web site www.balfourcommercial.com).

Depreciation: It comes as no surprise that every year you have to pay taxes on your real estate investments. You have to report all your rents. Subtract all your expenses. Then pay the appropriate tax. The tax benefit is that in addition to your cash expenses you get to deduct a non-cash expense called depreciation. This is a pre-determined amount prescribed by the IRS and greatly reduces your net operating income and thus your tax. In effect some of your cash flow is not taxed in the current year. In the example below, a \$500,000 commercial property consisting of \$100,000 of land and \$400,000 building improvements the traditional depreciation prescribed is \$10,256. At a 35% tax rate that provides a \$3,590 tax savings.

COST SEGREGATION - FIRST YEAR SAVINGS

	<u>Traditional</u>		<u>Cost Segregation</u>		
	Value	Dep.	Value	Dep.	
Valuation	500,000		500,000		
Land	<u>100,000</u>		<u>100,000</u>		No depreciation on land
Building	400,000	10,256	300,000	7,692	Commercial buildings - 39 yrs, Apartments 27.5
			30,000	20,000	3yr personal property, double declining
			25,000	10,000	5yr personal property, double declining
			45,000	4,500	15 yr personal property, 150 declining balance
		<u>\$10,256</u>	vs.	<u>\$ 42,192</u>	Depreciable amount
					35% tax rate
		\$3,590	vs.	\$ 14,767	First Year Tax Savings

Cost Segregation. A more aggressive approach that could potentially give you \$42,192 in depreciation write-offs, thus a \$14,767 first year tax savings is through an approach called Cost Segregation. Here, with proper documentation, instead of just breaking down the property into two categories building and land, the IRS lets you further break down the building component into building and personal property. The benefits are two fold. First the property components are written off with much shorter depreciable lives (years). The second is that the depreciation deduction can be accelerated, in some cases up to double that of the straight-line amount.

It is true that the IRS will want you to adjust annually for the accelerated depreciation and the more you write off annually will increase your gain down the road when you sell. Even so you get the tax-free use of the money till then and capital gains treatment vs. ordinary income. We at Magnusson Balfour encourage you to ask your accountant how this may benefit you and would love to assist you in finding or selling your investment properties.

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Perhaps the owner has become complacent, there are technological advances that weren't kept up with, the industry has become saturated with competition, the management has risen to their point of incompetence (the Peter Principle), or some aspect of the business has not been paid attention to, marketing, finance, production, human resources, etc. This type of business is where the turn around specialist flourishes. They find the problem and fix it. They often tend not to care about leaving their personal mark and often don't particularly care what industry it is in. They are bottom line driven and like to use their business skills in producing new and quick results through the people and systems in place added to their business savvy and/or capital.

The title of this article is "*Business Cycles – Where do I want to enter?*" I'm hopeful you can now see why businesses for sale don't come in "one size fits all." Aside from the industry the business is in, it's different strokes for different folks. We at Magnusson Balfour would be pleased to discuss which phase would best fit your comfort level.

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know."

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