We've recently been analyzing the pending changes to long term capital gains tax and the implications for sale of private businesses. The results surprised even us. While we typically only send out communications on a monthly basis, we thought it was important to share our results with you right away.

Massive Tax Increases Coming on Sale of Your Business after 2010

Upcoming tax changes make 2010 a very special year to sell a business. For the last several years, we've enjoyed a federal long term capital gains rate of 15%. When blended with the current Illinois tax rate the total is 17.55%. If your business sale qualifies for long term capital gains treatment, you get to keep 82.45% of the proceeds. On January 1, when you kiss a loved one and say, "Happy New Year!" the party is really going to be over. The largest tax increases in many years are just around the corner.

Our country has spent more than a trillion dollars to stimulate the economy and bail out troubled financial institutions and automakers. With increasing concern about financing Social Security and Medicare and now, our new health care law; tax increases seem inevitable. In addition, attention is now turning to the unprecedented level of national debt. Some combination of tax increases and spending cuts will be required to reduce this debt to a manageable level. Many of the coming tax increases are already passed into law. The rest are being worked on and will be likely become effective for 2011 and beyond.

Individual components of various tax increase plans are being debated in congress. Increases under consideration could almost double the rate for next year and it's likely to go even higher in 2012 and 2013. Our most likely scenario will see the 2011 tax burden including a variety of different taxes applicable to capital gains at close to 30%.

Many business owners believe that 2010 is not the best year to sell. The economy is starting to turn around. Wouldn't it make more sense to wait a year or two until things improve? Understanding the coming tax changes suggests that 2010 may be the best opportunity to sell for years to come. All of the gains in value that you may achieve in the next few years will likely go the government.

The Different Taxes Being Considered

The Bush tax cuts expire on December 31, 2010 and the federal long term capital gains tax rate will revert to 20% (or a 33% increase) next year and talk continues that the Reagan era tax rate of 28% could come back. Congress continues to explore a Federal Surtax of as much as 5.4% on high income taxpayers to bail out Medicare and Social Security and the health care law tax will add 3.8% on higher income taxpayers beginning no later than 2013. After the fall elections we expect see significant movement on the tax increases including the acceleration of the health care law costs that require more tax revenue. If you wait until this time to market and sell your business, you will be unable to avoid what is looking to be a 50% to 60 % tax increase in 2011 alone.

It is certain that most business sales will put the seller in a high income tax bracket in the year of the sale. It's also likely that Illinois, like many other states struggling financially, will increase the state tax rates by at least 1% or 33%. In the aggregate, tax on business sales in excess of $500,000 that qualify for long term capital gains treatment may well increase by 89% by 2013 when the Affordable Health Care Act is fully implemented.

A Case Study

Business owners who are thinking about waiting for earnings to rise in a better economic climate would do well to consider how much additional sales volume and bottom line profit is going to be needed to get to the same sale proceeds on an after-tax basis. Consider the following example: Stanford Precision Molding has been a Sub S corporation for more than 10 years and will therefore qualify for long term capital gains tax treatment. Stanford's earnings for 2009 were down to $4MM. They were $5MM in 2007. Stanford is beginning to see signs that the economy is picking up. The owner, Mel Stanford, who would like to retire, believes that in 2010 or 2011, earnings will be back to 2007 levels. He plans to wait until EBITDA reaches $5MM and then put the company on the market.

What Mel doesn't realize is that all of the hard work that he's planning to do will just result in more taxes with no additional after tax proceeds. The table below illustrates the problem:

Stanford Precision Molding			
	2010	No Improvement New Tax Rates	Sales needed to get back to 2010 after tax gain
Sales	20,000,000	20,000,000	24,000,000
Adjusted EBITDA	4,000,000	4,000,000	4,879,000
Valuation	20,000,000	20,000,000	24,394,000
Federal Capital Gains Tax	15.00%	20.00%	20.00%
Illinois Capital Gains Tax	2.55%	3.20%	3.20%
Federal Surtax	0.00%	5.40%	5.40%
Health Care Tax	0.00%	3.80%	3.80%
Total Tax Rate	17.55%	32.40%	32.40%
After Tax Proceeds	16,490,000	13,520,000	16,490,000

In our example, Mel is better off to avoid betting on future results when he can get nearly the same after-tax result today.

Paying Today's Tax Rate on Future Compensation

During the past few years, M&A transactions have increasingly relied on seller financing. Normally when a seller agrees to defer some of the compensation to later years, it almost always makes sense to elect installment sale treatment so that the taxes would be paid on the seller note when the money is ultimately received. However, the unique tax situation we are faced with suggests that sellers will want to seriously consider paying capital gain taxes in 2010, even on sales proceeds which will be received later on.

Many sellers don't realize deferring tax by electing to consider the transaction to be an installment sale has always been the seller's option. In some cases, there may even be a way to structure the sale this year, so that the seller can benefit from increased earnings in the next few years but still pay 2010 tax rates.

What about businesses that won't qualify for long term capital gains rates, such as C corps selling assets? In most instances, the seller is able to convert a major portion of the proceeds as a qualifying dividend that is taxed today at the long term capital gain rates. Congress is working on legislation to tax all dividends at income tax rates which will revert to 39.6% in 2011. This is another scenario in which a sale in 2010 will make a major difference in after-tax proceeds.

Summary

Will we see long term capital gains rates as low as today at any time in the foreseeable future? It seems highly unlikely. Even if you believe that politicians seeking to reduce taxes it's also important to recognize that the national debt is at an unprecedented level. It's unlikely that the country can ensure our long term stability with spending cuts alone even if the lawmakers agree to spending cuts. It's prudent to assume that it will be many years before we again see a 17.55% blended federal and state tax rate.

Every business owner who is thinking of selling in the next few years should seriously examine the tax consequences of waiting beyond year end to consummate a transaction.

Of course there are many factors to consider when selling your business, for a no obligation confidential analysis, contact your Focus Capital professional today by phone at 630-795-1495 or by email.

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