

The Tax Man Cometh

By Brian Deveaux, Leaders LLC

Many of you probably remember the old Midas commercials where the mechanic says to a distraught looking customer, “You can pay me now ... or you can pay me later;” suggesting to the customer that deferring the current repairs will result in a much larger repair bill at a later date. With potentially significant tax increases on the horizon, it occurred to me that this is an appropriate adage for business owners who might be considering selling their businesses any time in the next several years.

Those of you that have read prior articles I’ve written for *CryoGas International* (see www.cryogas.com, search “deveaux”) know that when I advise business owners regarding the sale of their businesses, I urge them not to focus too much on the purchase price, but rather to focus on the after-tax proceeds they will receive from the transaction. In my last article, “M&A — Opportunity in the Midst of a Mess” (*CGI, January 2009*), I alluded to the possibility that future increases in tax rates could effectively negate any potential increases in the value of businesses for many years to come. With some of these potential tax increases seeming more certain, and the timing of certain specific tax increases looming at the end of 2010, this seems like a good time to expand on this subject.

There are many factors that come into play when determining the taxes that will become due as a result of the sale of a business, including: what type of legal entity the business is (C-Corp., S-Corp., LLC, Partnership); whether the stock or assets are sold; what the tax basis is in the stock or assets; how the purchase price is allocated; the tax basis of each individual shareholder; what, if any, state taxes are applicable; if there is a built-in gain from C-Corporation earnings; and if there is corporate debt that must be paid off.

Each of these factors (and many more) impact the amount of the purchase price

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that is taxable, the type of tax that applies (i.e., capital gains, dividend, or ordinary income) and the applicable tax rate. For the purpose of presenting an oversimplified example in this article, initially I will focus on the one factor that has the most significant impact in most sale transactions — capital gains tax rates.

President Obama has publicly stated that one of the Bush era tax cuts that he will allow to “sunset” at the end of 2010 is the reduction in the top federal capital gains tax rate. At best, this means that the top federal capital gains rate will increase from 15 percent to 20 percent; however, many economists expect it to increase further. In this article, I will illustrate how this one change could potentially impact a hypothetical business owner who is considering selling his business any time in the next several years. To illustrate this potential impact, I will compare hypothetical sale transactions under two potential future tax scenarios against a hypothetical baseline transaction that occurs in 2010 under the current tax rates.

2010 BASELINE TRANSACTION

For purposes of this comparison, the 2010 Baseline Transaction is a hypothetical transaction that occurs in 2010 involving the purchase and sale of the stock of an S Corporation, whose shareholders have a zero basis in their stock (not an unusual occurrence in our industry). Furthermore, the company has no bank debt and resides in a state with no state income or capital gains taxes, and thus the only liabilities that must be paid from the purchase price are federal taxes. The purchase price for the stock is \$10,000,000. In most cases, the taxable gain from a sale of stock would be treated as a cap-

ital gain and thus at the current federal rate of 15 percent, the total taxes due from the shareholders would be \$1,500,000, resulting in after-tax proceeds of \$8,500,000.

To compare the Baseline Transaction to future hypothetical scenarios under different tax rates, I made the following additional assumptions about the company:

- The market value of the company increases at a rate of 7 percent annually. (Note: this is an aggressive assumption given current expectations regarding the speed of an economic recovery.)
- The “time value of money” is 4.5 percent annually. In other words, a dollar in hand today is worth 4.5 percent more than a dollar received next year, which is worth 4.5 percent more than a dollar received the year after that.

Scenario 1: Capital gains rate increases from 15 to 20 percent

The scenarios presented in Figure 1 illustrate the impact of an increase in the top federal capital gains rate from 15 to 20 percent on the present value of the after-tax proceeds from a sale in the six years following the 2010 Baseline Transaction.

Notice that while the market value (i.e., the Purchase Price) of the company increases each year on a compounded basis, the increase in the tax rate, coupled with the impact of time, reduces the present value of the after-tax proceeds for several years. Even based on this conservative set of assumptions, the shareholders would have to wait until 2013 to sell the company in order to achieve the equivalent \$8,500,000 in after-tax proceeds generated by the 2010 Baseline Transaction.

Scenario 1: Capital Gains Rate Increases from 15–20 Percent

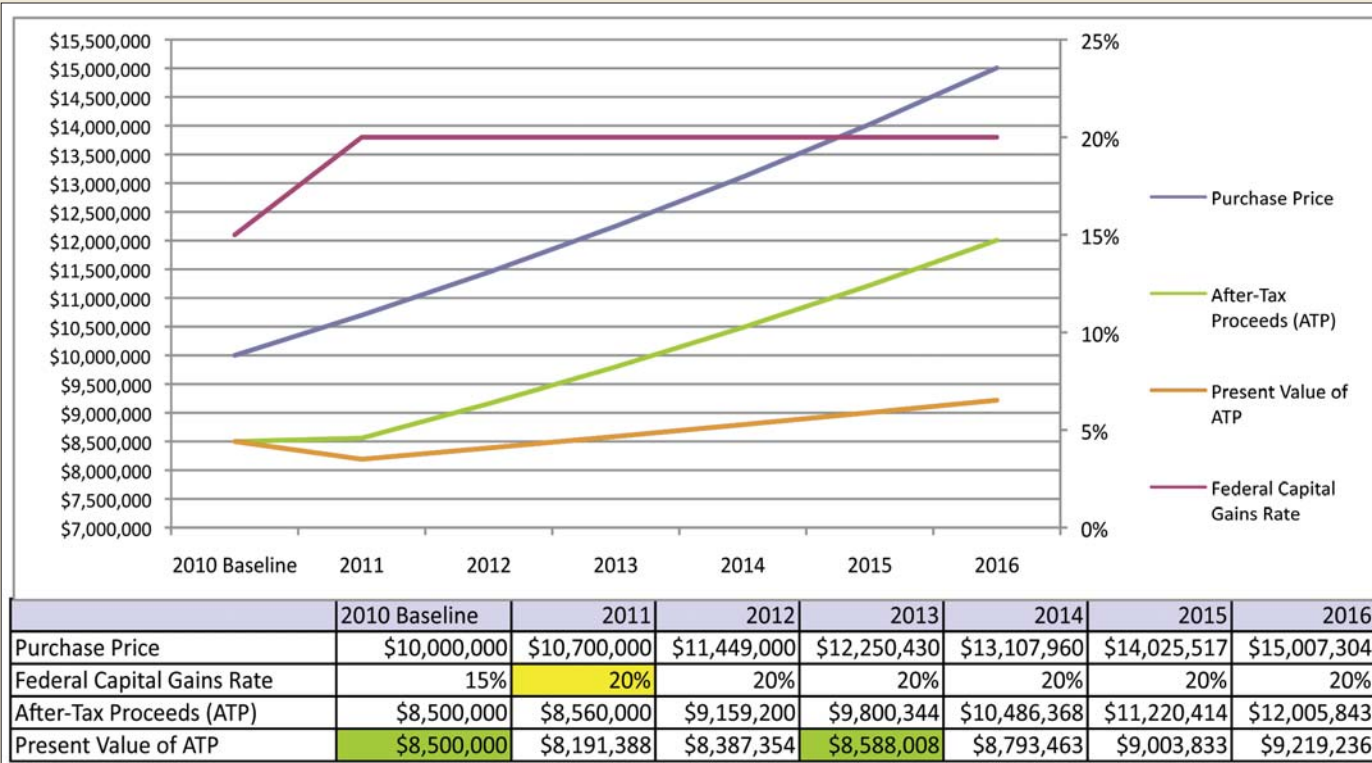


Figure 1

Scenario 2: Capital Gains Rate Increases from 15–25 Percent

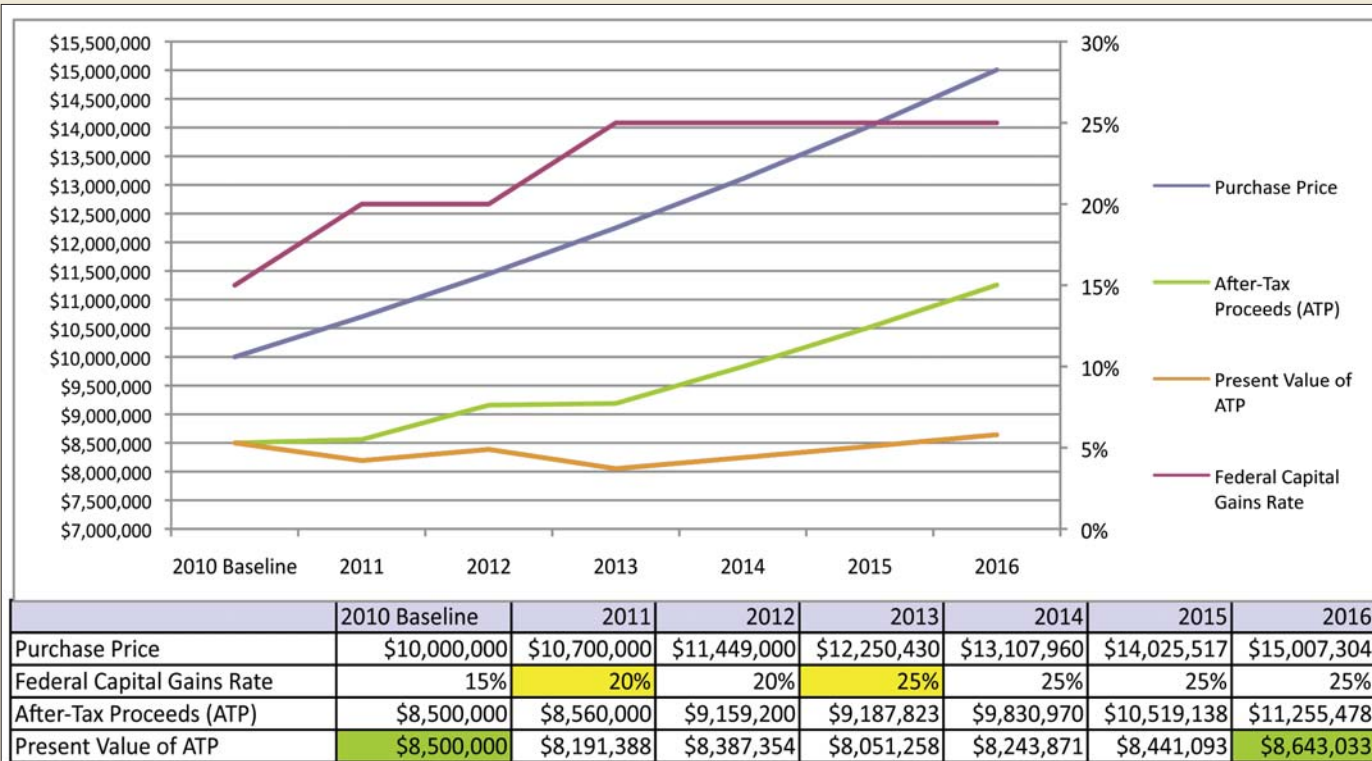


Figure 2

Scenario 3: Baseline Proceeds Analysis

	2010 Baseline	Comment/Explanation
Purchase Price	\$10,000,000	
Tax Basis in Assets Sold	\$5,000,000	
Taxable Gain (Corporate)	\$5,000,000	Purchase Price minus Tax Basis
Federal & State Income Tax Rate	40%	35% Federal plus 5% State
Corporate Income Tax	\$2,000,000	40% of Taxable Gain
Amount Distributed to Shareholders	\$8,000,000	Purchase Price minus Corporate Tax
Federal & State Dividend Tax Rate	20%	15% Federal plus 5% State
Dividend Tax	\$1,600,000	20% of Amount Distributed
After-Tax Proceeds (ATP)	\$6,400,000	Amount Distributed minus Dividend Tax
Present Value of ATP	\$6,400,000	

Figure 3

Scenario 2: Capital gains rate increases from 15 to 25 percent

The scenarios presented in Figure 2, on page 47, illustrate the impact of a two-stage increase in the federal capital gains rate (from 15 to 20 percent in 2011 and from 20 to 25 percent in 2013) on the present value of the after-tax proceeds from a sale in the six years following the 2010 Baseline Transaction.

In Scenario 2, the value of the company in 2016 has increased by more than 50 percent,

yet the present value of the after-tax proceeds has barely reached the equivalent \$8,500,000 in after-tax proceeds generated by the 2010 Baseline Transaction.

Scenario 3: A more severe (but by no means unrealistic) example

The examples presented in Scenarios 1 and 2 demonstrate the significant impact of just one tax change, a change in the top federal capital gains rate, on the after-tax proceeds from a

sale. To further illustrate the potential impact that tax increases could have on the after-tax proceeds, Scenario 3 presents a similar comparison, only this time involving a purchase and sale of the assets of a C Corporation in a state that does have income and capital gains taxes. The sale of assets from a C Corporation triggers two levels of taxes — first at the corporate level and then at the shareholder level when the proceeds from the sale are distributed. For the purposes of Scenario 3, the 2010 Baseline Transaction proceeds analysis is shown in Figure 3.

In Scenario 3, let's assume the top federal income tax rate returns to its pre-2001 level of 39.6 percent (which is what the President has proposed in his budget). Furthermore, let's assume that the budget-challenged state within which the business resides increases its top income tax bracket from 5 to 6 percent. Finally, let's assume the dividend tax increases along with the capital gains tax from 15 to 20 percent (note: some economists believe that dividends could revert to being treated as ordinary income thereby increasing the top dividend

Scenario 3: Impact of Combination of Tax Increases

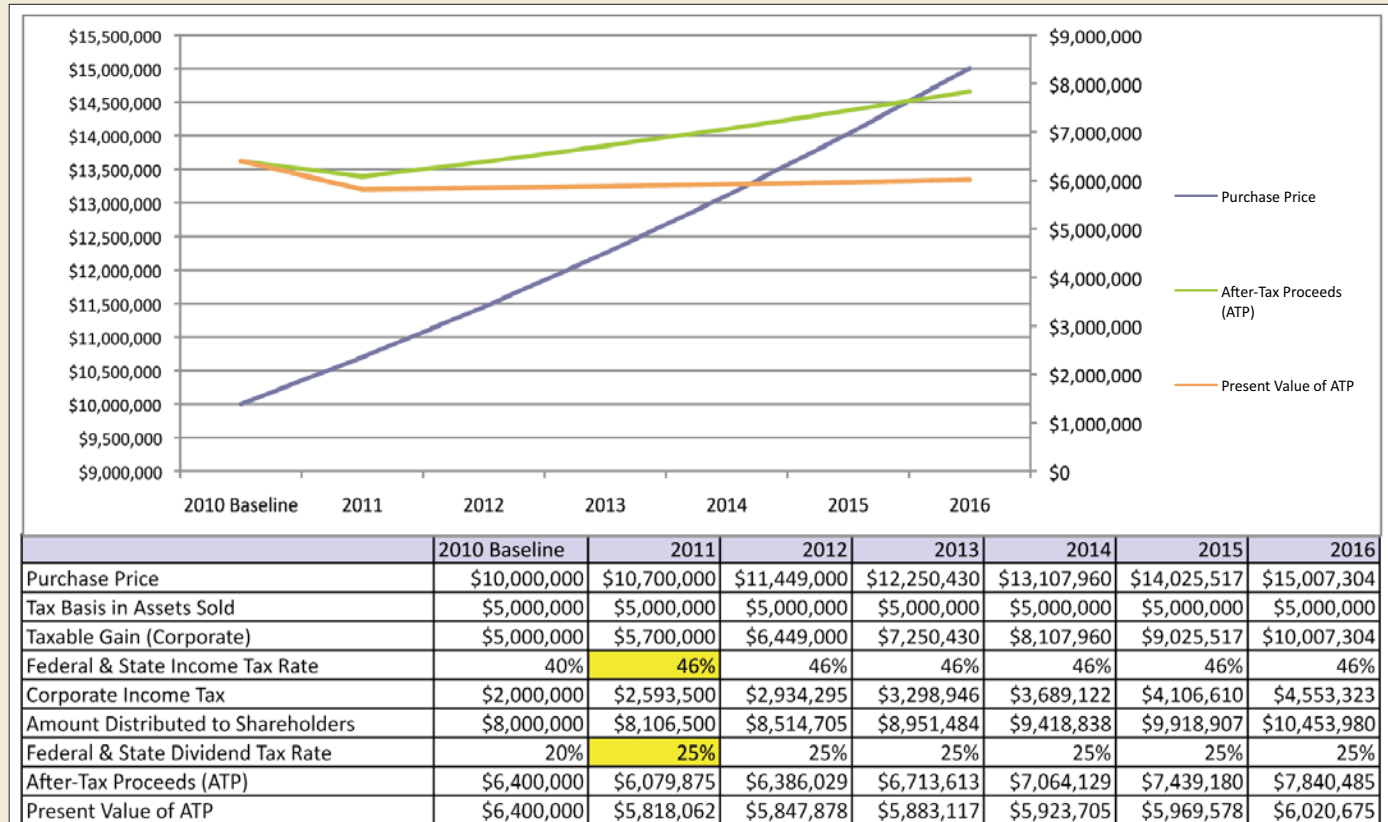


Figure 4

rate to 39.6 percent which would make this example even more extreme). The scenarios presented in Figure 4 illustrate the impact of this combination of tax increases on the present value of the after-tax proceeds from a sale in the six years following the 2010 Baseline Transaction.

Based on this set of assumptions, even after six years the present value of the after-tax proceeds to the shareholders is still not equal to the proceeds generated from the 2010 Baseline Transaction. In order to make up for the increase in taxes by 2015, the market value of the company would have to increase by nine percent annually — a challenge even in good economic times.

While this may seem like an extreme example, our experience tells us that asset purchases occur as frequently, if not more frequently than stock purchases. Furthermore our experience tells us that many private businesses, particularly in the industrial, medical, and specialty gases industry, are still C Corporations. Thus this extreme example is not so extreme for many prospective sellers in our industry.

CONCLUSION

My purpose in writing this article is not to cause alarm or to cause readers to become agitated about paying taxes. It is simply to try to get business owners to think proactively about planning for the sale of their businesses. While it is true that business values, for the most part, are down from where they were a few years ago, I would argue that the fact that historic values are down is irrelevant. What matters now is how current values compare to expected future values on an after-tax, present value basis.

Clearly no one knows for certain how and when tax rates will change, or how the economy will impact business values. What does seem certain, however, is that tax rates will not be as “good” as they are right now any time in the foreseeable future. So, should you pay them now ... or pay them later?

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