Legacy M&A Advisors LLC

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Business Owners: Important Tax Laws Set to Expire

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Introduction

There were 66 million babies born between 1945 and 1964. The era was known as the "Baby-Boom" and the "Boomers" are reaching retirement age. In fact, the oldest are now turning sixty-seven and the youngest are embarking on their forties and fifties. As such, many of these people have worked hard throughout their lives and have built businesses from the ground up and purchased houses. A very considerable amount of wealth has been created and those owners are now looking to retire or move on from their businesses.

Currently, in 2012, we have favorable tax rates which allow you and your company to pay fewer taxes on the sale of a business as opposed to waiting until 2013. There are also favorable laws on the books regarding estate planning and home foreclosures. For the past decade, both capital gains and dividend tax rates were decreased to 15%. Those tax cuts are now set to expire December 31, 2012. The rates coming in 2013 will be 20% for capital gains and the ordinary tax rate for dividends can be as high as 35%.

Capital Gains

The capital gains rates are currently 0% and 15%. Historically, the capital gains rates have been as high as 20%. This means that capital gains will be taxed at 0% if the combined Adjusted Gross Income of the selling taxpayer (including capital gains) is at or below the two lowest tax brackets. The amount of capital gains earned by a taxpayer that is at or over the 25% bracket is currently taxed at 15%. These new rates produce much more favorable tax consequences than in past years.

For example, if a company is sold and capital gains are determined to be $1,000,000, in this tax year, the seller of the company would pay $150,000 in capital gains taxes as opposed to $200,000 in a future year. The result is a tax savings of $50,000 just given the fact that the sale happened this year as opposed to next year.

Unless Congress acts to the contrary, the capital gains tax will go up in the next year. If you fail to take gains this year, they will be taxed at a higher rate next year.

Dividends

If you own stock in a C Corporation you most assuredly have had, at one time or another, dividends distributed to you. Currently, and for the good part of the past decade, dividends have been taxed at 15%. No matter what income level you were at, dividends received a preferential rate making the C Corporation a good buy and a good business entity for tax purposes. The laws giving rise to the preferential treatment are now coming to an end as of December 31, 2012. On January 1,

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A CASE STUDY

A sole member of a Limited Liability Company (LLC) was held personally liable for the LLC's unpaid employment taxes by the Tax Court. The LLC was disregarded as a separate entity under the check-the-box regulations for federal income tax purposes. Although the taxpayer filed all the required returns, he failed to pay part of the liabilities reported on those returns. The issuance of a separate EIN number for the LLC does not necessarily indicate the existence of a distinct taxpayer. With regard to the EIN, the Tax Court stated the taxpayer could not "frustrate the principle that a disregarded entity's employment tax liability is the liability of the LLC's sole member."

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2013, dividends will be taxed at the ordinary income tax rate of the taxpayer.

The significance is that 2012 is a very opportune time to cash in corporate retained earnings. This is sometimes done during business sales to cash out the retained earnings, lessening the tax burden. If this is done in 2012, the tax rate will be 15%. Next year, dividends are taxed at a maximum rate of 39.6%, as the ordinary income tax rate regains its old position as well.

To illustrate the point, a taxpayer in 2012 who cashes out retained earnings of $1,000,000 will pay $150,000 in taxes. Next year, the same taxpayer could pay up to $396,000, well over double the 2012 tax consequence. This is a difference of $246,000 for the same amount of dividends distributed to the same person.

Further, if your S Corporation has retained earnings from years operating as a C Corporation, the above applies as well. It is recommended that all C Corporation earnings in subchapter S Corporations be removed by the end of 2012.

Estate Planning

Yet another area of concern in tax practice is that of estate planning. Since 2000, the estate tax exemption amounts have steadily increased, yet the threat of sudden reduction in the exemption amount has been ever present. In 2011, the exemption amount was $5,000,000. In 2012, it was adjusted for inflation to $5,120,000. On January 1, 2013, the amount reverts back to $1,000,000, inadvertently trapping many middle class households within its grip. Those with businesses and considerable estates are advised to plan for this change.

Mortgage Indebtedness Forgiveness

This is being mentioned last in this article because it could be the most important. Normally, when a loan debt is forgiven in a charge off or a foreclosure, the amount written off is considered income to the party losing their home or possessions. For calendar years 2007 through 2012, the Federal government allowed those who have had their homes foreclosed to not include the forgiveness of indebtedness in their income.

It seems trivial to most, but to the afflicted it is very serious. Taxes affecting items of income are an annoyance (you are splitting part of your gains); on the other hand items affecting the treatment of forgiven debt can be absolutely detrimental (you are being taxed on what you lost). Imagine losing your home, and then opening a letter in your mail on January 31 of the next year stating you have an addition to your income in the amount of your mortgage on a home you lost! A typical mortgage is $250,000 in this country. Having to pay 30% of that to the IRS is $75,000, not pocket change for many. Bottom line, if your home is in foreclosure it is time to start planning for consequences that will result if this law expires on December 31, 2012. The consequences can be serious.

Conclusion

With a potential loss of certain tax provisions including an increase in the capital gains tax and the dividend tax rates, owners of closely-held businesses are well advised to sell their businesses this year as opposed to next in order to take advantage of the lower tax rates. If you are interested in discussing your succession or exit plan, please contact The Center at (618) 997-3436.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **Currently, in 2012, we have favorable tax rates which allow you and your company to pay fewer taxes on the sale of a business as opposed to waiting until 2013.**
- **For calendar years 2007 through 2012, the Federal government allowed those who have had their homes foreclosed to not include the forgiveness of indebtedness in their income.**
- **If your home is in foreclosure it is time to start planning for consequences that will result if this law expires on December 31, 2012.**

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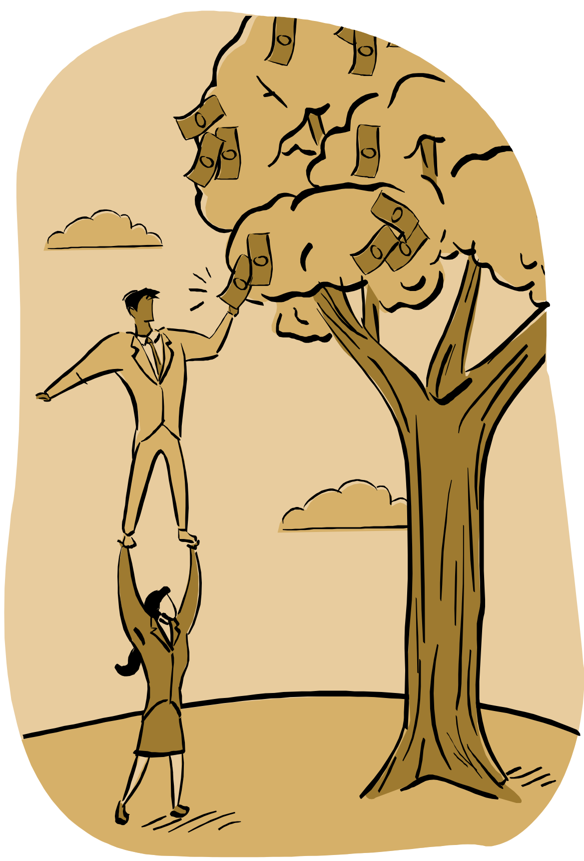
A CASE STUDY CONTINUED:

Editor's Comment: This case involves employment tax liability from tax years 2006 and 2007. It is important to note that since January 1, 2009 a disregarded entity is treated as a corporation for purposes of employment tax reporting and liability. In order for the IRS to hold a sole member liable it must make a separate responsible person penalty assessment under Internal Revenue Code Section 6672. In addition to federal and state income tax returns for your business, the professionals at The Center can assist you with your employment tax returns.

Remember, just because you create an LLC, does not mean you will not be held personally liable for payroll taxes.



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Is This the Right Time to Sell Your Business?

It seems that more and more business owners are asking me that question these days. Given the recent "perfect storm" of collapsing financial markets, tighter credit, growing unemployment and a worsening economic recession, it's a very fair question.

My answer is generally in two parts. First, for most business owners, determining the right time to sell your business depends upon a great many factors, including your health, your spouse's health, your retirement plans and retirement savings, your management succession plan, the current financial health of your business and its immediate prospects for the future, and last but not least, the state of the overall economy, just to mention the most obvious factors. Clearly, this is not a question that can be answered without a careful analysis of many, interrelated factors. Equally clearly, there is no one time that is right for every company and owner.

The second part of my answer goes something like this: Now that the economy has started growing again – albeit more slowly than many would like – and now that credit lines for business acquisitions are more available - and still at historically low interest rates - this could be a particularly good time to sell your company.

While there is almost always a market for a really well run company with a proven track record of generating above average cash flows, and with bright prospects for continued future growth, most companies sales and cash flows have nearly returned to the high levels they achieved just before the Great Recession.

Strategic buyers and private equity groups both seem to be in a strong position to fund their deals and are actively looking to source new deals to add-on to their existing platforms and to form new platforms.

In view of the above, a better question might be: What can I be doing now to maximize the value of my company when I'm really ready to sell it?

We've addressed some specific strategies to maximize business value in previous articles; my point here is that this may be an <u>ideal</u> time, when the business is not yet stretched to its limits, to invest in actually implementing those value improvement ideas. As the economy continues to improve, most business owners will once again be so busy trying to keep up with the growing demand for their products and services that they will quickly complain that they simply don't have the time to make needed improvements. This time around, commit to yourself that you won't fall into that mental trap.

If you know of someone who's thinking of selling or buying a business and who might benefit from a free, <u>confidential</u>, consultation with us, have them contact me at: mertel@legacymandaadvisors.com.

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Frequently Asked Questions…

Q: What is the capital gains tax rate for stocks that I sell in 2012?

A: If the stock was held for less than one year, the capital gains rate is generally the same rate as the taxpayer's ordinary rate. On the other hand if the stock has been held for one year or longer, the capital gains rate is 15%. Usually it is better to hold gain stocks longer than one year in order to get a beneficial tax rate.

Q: My business has operated at a loss for the past 3 years according to the tax return. How can I get a mortgage?

A: The answer to this is not necessarily easy and cannot be completely answered within a paragraph. Generally, if a person has had negative income for each of the past three years, obtaining loans tends to become hard, but not impossible. It would be wise to have the tax returns examined by an accountant or professional and see why the person had negative income. Sometimes, the financial statements can be restated and shown to cast a more accurate and better picture regarding credit.

Q: I operate a small business. At what point should I turn to professionals to do my accounting / taxes?

A: Usually it depends on the nature of the business, but once revenues hit $5000, it is not a bad idea to turn to professional tax preparation. Further, if any business operates above $40,000 in revenues or 1099 earnings, they should absolutely be under the due care of a professional.