Legacy ADVISORS GROUP

M & A UPDATE®

July 2010 Volume 6, Issue 7

Selling in 2010 Makes Good Tax Sense

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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-six and the youngest are embarking on their forties. As such, many of these people have worked hard throughout their lives and have built businesses from the ground up. 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 2010, we have favorable tax rates which allow you and your company to pay less taxes on the sale of the business as opposed to waiting until 2011. During the Bush administration, both capital gains and dividend tax rates were decreased to 15%. Those tax cuts are now set to expire December 31, 2010. The rates coming in 2011 will be 20% for capital gains and the ordinary tax rate for dividends can be as high as 39.6%.

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 are at or over the 25% bracket are 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 harsher next year.

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A CASE STUDY

The Tax Court only allowed doctors who donated stock in their practice to a newly formed tax-exempt professional services corporation (PSC) a small portion of the charitable contribution deduction they had original claimed. The Court found that the value of the donated stock to be too high and should not have been valued because it was going to be consolidated into the PSC. The Court also assessed a 40% accuracy penalty to each taxpayer because they did not act in good faith when valuing the stock. While the taxpayers claimed that they relied on professional appraisers and advisors, the Court found that they were educated and should have known of problems in valuing the stock so high when the medical group was not likely to continue operating.

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Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy Advisors Group, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy Advisors Group, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

Cover Story

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 were 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, 2010 as well. On January 1, 2011, dividends will be taxed at the ordinary income tax rate of the taxpayer.

Here, the significance is that this year 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 2010, 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 2010 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 2010 tax consequence. This is a difference of $246,000 for the same amount of dividends distributed to the same person.

Conclusion

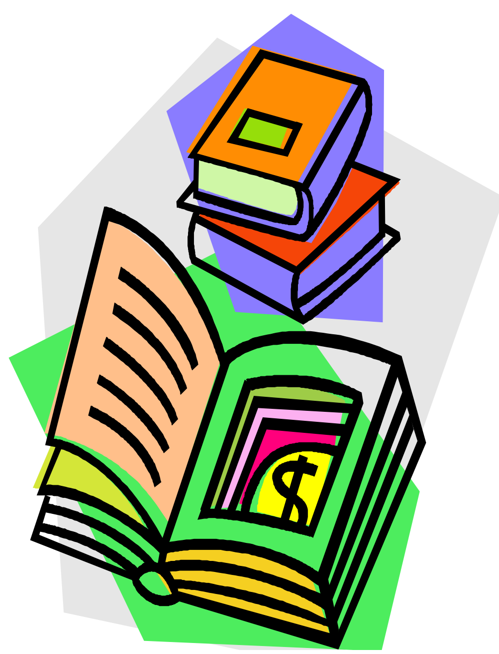
With the imminent increase in the capital gains tax and the dividend tax rates, owners of closely-held businesses are well advised to sell their businesses this year as opposed to next in order to take advantage of the lower tax rates. Your business sale this year resulting in a $3,000,000 gain is a mere $450,000 in tax. Next year, a $3,000,000 gain could result in $600,000 due. The difference in taxes between the two years is considerable. If you are interested in discussing your succession or exit plan, contact The Center at (618) 997-3436 to speak to one of our professionals.

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.

A CASE STUDY CONTINUED:

Editor's Comment: This case demonstrates the expensive consequences of improperly valuing stock. It is important to always act in good faith in disclosing information to the IRS. While the taxpayers in this case were trying to save money by overstating a charitable contribution deduction, it ended up costing them more in the long run when they were ultimately assessed with a 40% penalty.

Remember, the valuation of stock in a private company should not be left to general predictions and/or individuals who are not independent of the operation. It's important to retain valuation professionals that are knowledgeable about the industry that the business is in. Contact the valuation professionals at The Center for an analysis of your company's worth.



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Points of Interest

- **A very considerable amount of wealth has been created and those owners are now looking to retire or move on from their businesses.**
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FUNDING A BUSINESS ACQUISITION WITH A SELF-DIRECTED IRA

Mike Ertel, CBI/ M&AMI/ CM&AA

The ability to access IRA or other retirement account assets to fund the acquisition of a business, whether it's an on going business or a start-up, has been available since IRAs were created in 1974. However, it has only been in the last ten years or so that many aspiring business owners really became aware of the option.

Self-directed IRAs are an enormous source of capital for prospective business owners, currently totaling $4.2 trillion and growing at $200+ billion per year, largely due to the increased number of pension plans rollovers into IRAs as the "baby boomers" retire.

A word of caution is in order, as IRAs and other retirement accounts are designed to encourage individuals to put money away to fund their own ultimate retirement, and as such, they should not be squandered on foolish and ill-conceived ventures. Failure rates for business startups are quite high, with less than 1 in 7 startups surviving until their 5th anniversary. Failure rates for new franchised businesses are substantially higher, with 95% still in business after 5 years, and survival rates for an ongoing business are better still.

While the purchase price of an ongoing business with a proven cash flow will likely be substantially higher than a start-up, the premium paid for a much, much higher probability of long tern success may be well worth it.

Self-directed IRAs for business acquisitions can be funded solely by new contributions, or by rollovers from pension plans like 401(k) plans of former employers. Rollover assets can be particularly useful as they are generally larger in dollar value than single year contribution limits and can be used for a more substantial investment. There are rules when using these funds, but with the help of experienced professionals who understand the rules, using these funds can significantly open up opportunities for private equity investments.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at mertel@legacyadvisorsgroup.com

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Frequently Asked Questions…

Q: I just opened a business and formed it as a Limited Liability Company under my state's laws. For federal tax purposes, how do I classify my LLC?

A: An LLC may be classified for federal tax purposes as a sole proprietorship, a partnership, or a corporation. If the LLC has only one owner, the LLC will automatically be treated as a sole proprietorship unless another election is made by the owner. On the other hand, if the LLC has two or more owners, it will be classified as a partnership unless an election is made. The election is made on IRS Form 8832. Unless the election is made, the classification will be the default classifications.

Q: I am selling rental property which I have owned for many years. However, I have not taken a depreciation deduction for the property during the time I have owned it. What will my taxes be on this exchange?

A: When selling depreciable property, you are required to recapture and pay ordinary income taxes as required by law on depreciation taken or allowable. This means that even though you may have not claimed a depreciation deduction (thus paying higher taxes), you must still pay ordinary taxes to some extent in addition to the capital gains taxes due. To solve the dilemma, the IRS allows you to amend your tax return for up to 3 previous tax years. If you have not taken depreciation beyond 3 years, taxpayers can file for a change of accounting method to adjust for not taking depreciation on the rental asset.

Q: I would like to set up a Subchapter S Corporation. How do I do this?

A: You must first file articles of incorporation with your respective state. Once this is done, IRS Form 2553 must be filled out to make the Subchapter S election.