The Exit Strategies Newsletter

New Tax Law Changes and Their Impact on your Exit Planning

When planning an exit from your business, it is important to know how much of what you 'get' for cashing in your business you will actually keep. Equally important for many owners is knowing how that wealth will transfer to their heirs and future generations whose lives will be impacted by your business success. How well you plan for all of this will have both short-term and long-term impacts on your business. And, because taxes play such a critical role in all of these assessments, it is important to understand how the recent compromised agreement in Washington, D.C. – titled the American Taxpayer Relief Act of 2012 (or ATRA) - may impact your business exit. Therefore, this newsletter covers the salient points of the new legislation that will likely impact your exit transaction and your future financial legacy.

Income Tax Rates increase for those making $450,000 or more

The negotiations in Congress concluded with the following compromise on Ordinary Income Tax Rates:

Ordinary Income Tax Rates	
2012 Law	10%, 15%, 25%, 28%, 33%, and 35%
2013 ATRA	10%, 15%, 25%, 28%, 33%, 35%, and 39.6%

The 39.6% tax rate applies to income over $400,000 for singles and $450,000 for married filing jointly.

Now, many owners of businesses who are thinking about an exit are running companies that are 'flow-through' entities, such as S corporations or LLC's. It is important to know what 'income' would push you into the higher tax brackets where these changes will impact your 'take-home' pay. It is likely that you have a combination of W-2 (payroll) income that you take from the business each year as well as profit distributions. It is also likely that you have a number of personal expenses that run through the business.

So, with the new highest tax rate of 39.6% (as opposed to 35%) it is important to know what 'income' is going to push you into that next level of taxation and seek guidance from your personal tax professional for specifics relating to your situation. Specifically related to your exit planning, it would be very helpful to know your projected income (and associated tax rate) post-exit so that you can accurately forecast your taxes and 'net income' when you complete your exit so that you can meet your post-exit, financial lifestyle goals.

[Long-term] Capital Gains and other Investment Income

When a business sells via a 'stock' sale (not an asset sale) that exchange has the opportunity to be characterized as a 'capital gain transaction'. Over the past decade, those who have bought and sold securities have enjoyed the benefit of the low capital gains tax rate of 15%. [NOTE: the long-term capital gains tax rate applies to holdings of more than 12 months.]

Heading into the recent negotiations in Congress, there was a lot of speculation as to where this low capital gains tax rate would settle – some even speculated that it could go away all together with future [otherwise] capital gains transactions simply being taxed at ordinary income rates. The 'sunset' provision that was in place would have raised the rate from 15% to 20%. In fact, that raise did happen but, again, only for incomes exceeding $450,000. The former and current rates are listed below:

Capital Gains and other Investment Income	
2012 Law	0% and 15% rate
2013 ATRA	0% and 15% and A 20% rate on income over $ 400,000 for singles and $ 450,000 for married filing jointly

As mentioned, the sale of your business will likely be characterized as a capital gain transaction if you are able to sell the stock. [NOTE that many smaller transactions (i.e. under $10 million in transaction value) are often structured not as 'stock' purchases, but as 'asset' purchases – again, consult with your tax professional to determine the applicability of these characterizations to your current or future transaction].

Let's also look at another 'tax increase' that went into effect in January of 2013 which was not a part of ATRA but will, nonetheless most likely impact your 'exit proceeds'.

The Affordable Care Act tax on 'investment income' of 3.8 percent

The sale of your business will likely be characterized as 'investment income' and be subject to this additional tax. So, if you are considering cashing in your business, you want to consult with your tax professional to determine whether or not you'll pay an additional 3.8% on your 'investment income', which will further reduce your net proceeds from the exit transaction.

Gift and Estate Tax Limits

A topic of large change and debate had been the gift and estate tax limits. We now have clarity around these limits. There is a $5.25 million limit, per person, for estate tax purposes. Although there had been a lot of talk about a limit of $3.5 million surprisingly, the $5.25 million estate limit was maintained (adjusted for inflation). Further, a $5.25 million gift limit was also maintained (with adjustments for inflation), allowing families / owners to transfer as much during their lifetime, without tax, as they would otherwise do at death. The gift limit was a surprise as most expected this limit to revert to $1 million.

Year	Estate Tax Exemption	Max. Estate Tax Rate	Max. Gift Tax Credit	Max. Gift Tax
2012	$5.12 million	35%	$5.12 million	35%
2013	$5.25 million	40%	$5.25 million	40%

Note that state level taxes should always be observed for your complete analysis.

So, for example, business owners who want to transition a portion of their business to their children can do so at the new higher levels, reducing the overall gift taxation on the estate.

Concluding Thoughts

In the final assessment, the American Taxpayer Relief Act of 2012 fulfilled the expectation that taxes would be going higher. The upside is that we now have some level of certainty as to where the rates will be in the near future so that we can continue some of our modeling and longer-term planning and assessments. And, if you are a business owner who is considering an exit transaction and cashing in your business, we encourage you to seek the counsel of your tax and legal professionals to see how these new rates will impact the 'net' proceeds that you will receive.

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