



The Exit Strategies Newsletter

HOW TO STRUCTURE YOUR EXIT TRANSACTION TO NAVIGATE A RISING TAX ENVIRONMENT

It should be no great secret to business owners that the United States has so much debt that it will need to raise its revenues. What other options do we have? We could grow our way out of this problem, but many have grown tired of waiting for growth through this tough recession. We could spend our way out of the problem, but the Taxed Enough Already (TEA) Party is a strong force in opposition of additional spending by the government. What's left then? Well, logic holds that the next conclusion is to tax our way out of this problem. And, as an owner who is considering their future exit plans, it is very important to give some thought as to how you may navigate this [inevitable] rising tax environment.

The Buffett Rule

One of the best indicators of rising taxes is the current 'Buffett Rule' proposal in Washington, D.C. President Obama has nick-named the proposal which will ensure that the wealthiest Americans pay at least 30 percent of their income in federal taxes. The "Buffett Rule", the name is, of course, derived from the very public complaint by the billionaire investor Warren E. Buffett that his secretary actually pays a higher effective federal tax rate than he does.

Under the current tax code, the highest tax rate for investment income is 15 percent versus the highest tax rate for wages of 35

percent. Under this code it is possible for someone who makes the majority of their income from income dividends, such as Warren Buffett, to pay a lower percentage in federal taxes than someone who is taxed only on the higher wage rate. Under the Buffett Rule, or a similar tax change, households earning over one million dollars a year will be required to pay a minimum tax rate of 30 percent.

This past April, republicans voted down the rule in a 51-45 vote leaving the rule just nine votes short of passing. The defeat this spring was certainly not the end of public support for the initiative and with the upcoming presidential election, along with the expiration of the Bush tax cuts at the end of this year, it is almost certain that taxes will go up for many American taxpayers. For those who are in the one million dollar 'target zone', they'll need to pay very close attention to potential changes. Many business owners who are considering a future plan for their exit either fall comfortably or plan to soon be in this category.

Keeping More of What you Get

If you are looking to sell something such as a business, your primary objective should be to keep the most of what you get. The old saying, 'volume is vanity, while profits is sanity' certainly applies here. Although it is nice to be able to boast of receiving a high selling price for your business, what good

will it do you when you only get to keep a relatively small amount? It is therefore a wise business decision to avoid looking at the offer price and how much you think you can get and rather to focus on the rising tax rates in order to figure out how much you are going to keep. This first step alone is one of the most important as a rising tax environment seems imminent and it will impact the net amount that you receive from your exit.

Focus on Your Form of Incorporation & Your Basis in Your Company

The first step in assessing your potential taxes is to review your form of incorporation. S corporations, C corporations, LLCs and other forms of corporate entities are all taxed differently at the time of exit so you need to know which one you have and how that will impact the taxes you pay. Also, when it comes to the sale of your business, remember that you are only taxed on the ‘gain’ in a transaction – i.e. the amount greater than your current ‘cost of investment’ or ‘basis.’ This is another often overlooked aspect of estimated taxes in an exit plan because owners are not focused on their ‘bottom line’ from the transaction. Talk to your CPA about both of these issues to estimate the future taxes you can expect to pay. For example, a conversion from a C corporation to an S corporation for a sale transaction in the future may save you an extraordinary amount of money down the line. These few pieces of advice may make the difference between a successful or an unsuccessful exit for you. And, this is particularly true when one assumes that today’s tax rates are quickly fading into oblivion as the country struggles to balance its books and becomes more and more interested in how much of your exit transaction the government can hold onto to pay its debts.

When and How you Receive ‘Income’ Matters

Another way to navigate a rising tax environment with your exit is to evaluate not only how much you may pay in taxes, but when you will receive the income. Assume that you have a choice from a buyer of your business as to whether you want to take income today or in the future and what form the income will arrive in (note that income can be received as an earn-out, continued salary, rental payments, deferred compensation, etc . . .). Remember that ‘after-tax’ proceeds from a sale transaction is where you’ll need to calculate how much you have to fund your post-exit goals. Therefore, in order to navigate a rising tax environment with your exit planning, you need to know when and how you will receive the ‘income’ from your sale transaction. Also note that seeking professional advice to help determine the most advantageous structure of your payout is critical.

Getting Taxes Out of the Way

Many owners today are also considering transactions that allow them to pay all of their taxes at today’s current tax rates, forecasting that rising tax rates will have them paying more in the future. Here’s a simple formula to consider:

A sale transaction occurs for your business in January of 2013 when the combined Federal Capital Gains tax rate and the tax on Investment Income relating to the healthcare legislation equals 23.8%. This is an 8.8% increase in taxes from the current (2012) rate of 15%. Now you need to ask yourself if

you are going to grow the value of your business by 8.8% between now and next January. That is the relative comparison because it is the 'net' amount of what you get that matters most. In light of this reality, many owners are choosing to take 'income' today and pay their taxes at the lower rates.

Concluding Thoughts

Taxes are one of the major concerns in a business transfer and, as time marches on, it is getting harder and harder to argue that tax rates are going to do anywhere but up in the future. So, given that you've worked hard to build a business that will, hopefully, finance your retirement and possibly a legacy for your family it makes sense that you consider the impact of taxes on your exit. Protecting your wealth from taxes takes heavy consideration and it may turn out to be a very long time before we see a return to the current levels of taxation. By planning for your exit today, you gain a higher degree of comfort around issues such as tax rates and their relative impact on your future exit transaction.

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