Pacific-West Fastener Association
10842 Noel Street #107, Los Alamitos, CA 90720
Phone (714) 484-4747 or (877) 606-5232 • Fax (562) 684-0695 or (877) 607-5232
www.pac-west.org info@pac-west.org

Conditions Favorable:

Consider Selling Your Business Now

July 2011

By:

Bart A. Basi

Dr. Bart A. Basi is an expert on closely held enterprises. He is an attorney, a Certified Public Accountant, and the President of the Center for Financial, Legal & Tax Planning, Inc. He is a member of the American Bar Association's Tax Committees on Closely-Held Businesses and Business Planning.

and

Marcus S. Renwick

Marcus Renwick is an attorney and the Director of Research and Publications with the firm.

Introduction

The time is ripe to sell your business. In the past couple of decades business owners faced high interest rates, high taxes, and at times tough economic conditions. Today, three major factors exist to provide you with a substantial value for your business.

The three factors are the tax rules, interest rates, and the economic environment. The current favorable tax structure allow you to sell your business for a lower price and carry away the same amount of money you would have, had you sold in another year at a lower price. Interest rates provide a similar relief. When interest rates are down, buyers can afford to finance more. Last, but not least, the economy is in an upswing. When the economy is in an upswing, business values arise concurrently. When all three factors are together, they provide for an optimal environment to sell a business.

Tax Consequences of a Business Sale

The first major factor in selling a business are the tax rules. The tax consequences of a business sale are as important as the selling price itself. When selling a business, it is important to know there are two types of sales. One type of sale is known as a stock sale. In a stock sale, stock is sold and the result is a low tax rate. The gain in this scenario is taxed only once to the shareholders in both the sale of C Corporations and all other incorporated entities.

The other type of sale is known as an asset sale. In an asset sale, the assets of a company are sold. As such, the sellers must pay what is known as "recapture" to the extent depreciation has been taken. Recapture is taxed at ordinary tax rates. Beyond that, capital gains taxes are assessed for the difference. If a C Corporation is selling its assets, they are taxed not only at the corporate level at ordinary tax rates, but also at the shareholder level as capital gains.

Though not a sale, but yet a business transformation, mergers and acquisitions are another way to change ownership of your business. In a merger or acquisition, one business is taken into another business or combined into another business. The result is a tax free transformation of the business for the seller. Though there are tax ramifications, it is possible for both the buyer and seller to get tax free benefits.

The importance of taxes is even more important to sales involving small businesses. Often the owners of small businesses are not considered wealthy. When tax consequences on a business sale are large, the effect is felt disproportionately. A $300,000 tax burden will be felt more in a $1,000,000 sale (where the owner walks away with $700,000 and cannot retire) as opposed to a $3,000,000 tax burden where the owner walks away with $7,000,000 and is able to retire. The current tax and financial conditions combined together make for a more optimistic selling environment. Therefore, it is more likely a seller will get a higher price for a business. The following explains why conditions are favorable to sell a business at the present time.

Low Capital Gains Rates

The capital gains rates are currently 5% and 15%. Historically, the capital gains rates have been as high as 20%. This means that capital gains will be taxed at 5% 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 at or over the 25% bracket will be 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 past year. The result is a tax savings of $50,000 just given the fact that the sale happened this year as opposed to a past year.

Capital gains can be recorded in installment sales (i.e. over a period of years). In an installment sale, gain is recognized when money comes through the door. This means the capital gains can be reported over time. However a capital gain is dependent on the rate of tax in the year for capital gains. If it fluctuates, capital gains could go up. That is why it is important to consider selling a business now. The capital gains rates will more than likely not go up in the new few years and you will be able to use the lower rates effectively in an installment sale.

Low Ordinary Tax Rates

Ordinary tax rates are also some of the lowest they have been in recent times. Since ordinary taxes usually result in business sales of assets, sellers are at an advantage this year to sell their companies as opposed to waiting for a future year when ordinary tax rates go up.

For example, the top ordinary tax rate has been around 40%; now the top tax rate is 35%. Given a taxpayer has $100,000 in ordinary gains, the taxpayer will pay $5,000 less in taxes for selling this year as opposed to a higher tax year. Remember, taxes can go just so low before Congress has to raise them or increase our debt.

Low Interest Rates

The low interest rates of today are a bit of an anomaly in today's market. Generally, buyers finance the amount of principal they can with the prevalent interest rate. This can best be seen in the housing market. Before the interest rates went down, housing prices were still generally low. An average American might have been able to afford $1000 per month with his or her income. This would have financed roughly a $125,000 house. Since the interest rates went down, that same monthly payment can finance approximately a $200,000 house.

The same is generally true for business sales. When a buyer can finance more, sellers will get more for their business. The best results can be obtained by selling now before interest rates go back up.

Special Consideration for C Corporation Asset Sales

The taxes at the C corporation level are slightly less than they have been in the past. Additionally, it is a longstanding fact that corporations do not benefit from the low capital gains rates from which individuals benefit. Even though this might make a sale of a C Corporation seem bleak as far as tax consequences are concerned, such is not the case. In the recent past, the concept of "Personal Goodwill" has been developed.

Personal Goodwill results when the owner of a business develops goodwill outside of the company. This type of goodwill is taxed only at the shareholder level and not at the corporate level. The result is favorable tax treatment at personal capital gains rates. However, since this concept is new, it may change. Therefore, C Corporations still face high taxes to operate their business, but may face low taxes to sell their business. C Corporation owners are advised to take advantage of this concept before it is changed or modified.

Subchapter S corporations are taxed at the personal level. Thus, with the personal rates decreasing and capital gains rates of 15% applying, now is the time to consider selling your Subchapter S Corporation as well.

Future Tax Changes

Now that President Bush has been reelected there will be changes. During his first term, the Administration and Congress changed the tax code five times in four years favoring taxpayers, both businesses and individuals alike. Being that he is a president who wants to alter the tax code, it is inevitable the tax code will be changed during the next few years. Many of the current tax changes expire during the next four years. The president has or has promised to extend these low tax rates through 2007. Then, what happens is up to Congress!

However, President Bush is determined not to leave the White House without cutting the nation’s deficit. To do this, he will have to either cut spending, raise taxes or both. This leaves the future of tax rates uncertain for the remainder of his term. The President is straddling the possibility of changing the entire tax structure. This possibility has been expressed in many major newspaper articles. Being that this uncertainty exists in the tax laws; it is advisable to begin your business succession plan now and not wait.

Conclusion

From a tax, financial, and economic perspective, now is a great time to sell your business if you are thinking about retiring. The tax rates are at low levels, interest rates have started to increase and the economy is on the upswing. Anyone planning to sell a business should do so now as long as taxes, finances, and the economy are factors in the decision process.