NEWLY PROPOSED TAX CHANGES AND HOW IRC 1042 JUST BECAME EVERYTHING FOR BUSINESS OWNERS

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INTRODUCTION

We recently published a blog on the Potential Impact of Proposed Tax Legislation Changes on Business Owners. The Biden administration's original proposal sought to raise the capital gains rate for people earning above $1 million from 20% to 39.6% in addition to the 3.8% surtax on investment income that pays for the Affordable Healthcare Act. The proposed terms are dynamically changing, however, as Congress is now actively working on tax legislation.

The House Ways and Means Committee (HWMC) recently proposed new counter legislation that would restore the top individual tax rate back to 39.6%, increase the capital gains tax rate for those with incomes above $400,000 from the current rate of 20% to 25%[1], and will include an additional 3% surtax[2] on taxable income of more than $5 million ($2.5 million for married filing separately and $100,000 for estates and trusts). That means an 8% increase in capital gains tax for many business owners who sell their company, pushing the combined capital gains tax rate to 31.8% plus state tax as most capital gains are also subject to the additional 3.8% tax (net investment income tax). The new proposal implies to us that significant negotiation is ongoing within Congress to gain consensus.

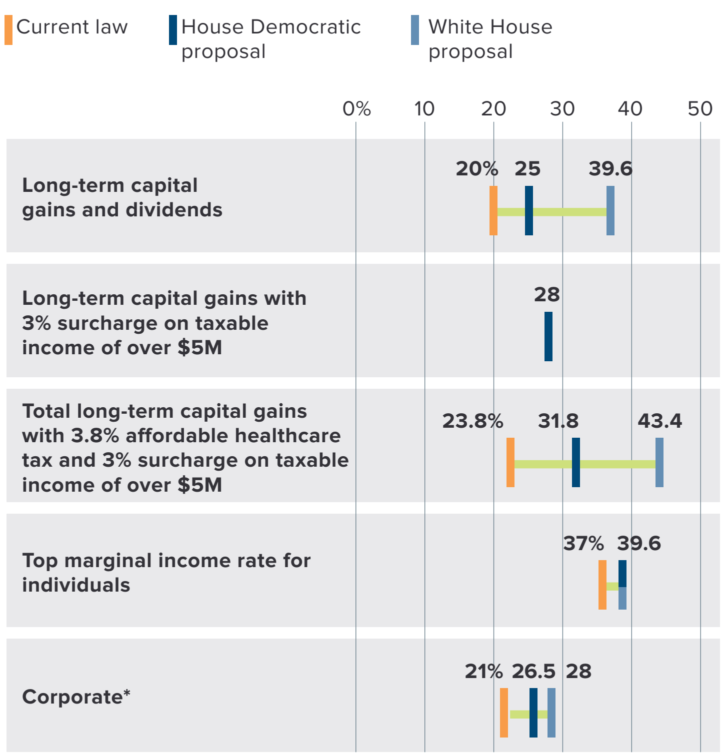
The HWMC is also proposing to replace the flat 21% corporate income tax rate with graduated rates of 18% on the first $400,000 of income, 21% on income of up to $5 million, and 26.5% on income greater than $5 million[3].

[1] This increase is proposed to take effect on September 14, 2021.
[2] This provision would be effective for tax years after December 31, 2021.
[3] These changes are expected to be enacted in November or December of this year but will retroactively apply to any sales that occurred after September 13, 2021.

Another notable component of the HWMC's proposed legislation includes reducing the exclusion from income of gain on the sale of qualified small business stock (QSBS), essentially eliminating the 75% and 100% gain exclusions for taxpayers with adjusted gross income of $400,000 or more, limiting said taxpayers to the 50% gain exclusion that currently applies to QSBS issued before February 18, 2009. These changes would increase the top effective rate on eligible gain from the sale of QSBS from 0% (for QSBS acquired after September 27, 2010) or 9.42% (for QSBS acquired after February 17, 2009, and before September 27, 2010) to 16.88%.

Additionally, the Section 199A 20% pass-through deduction would also be amended by setting the maximum allowable deduction at $500,000 for a joint return, $400,000 for individuals, $250,000 for a married individuals filing separately, and $10,000 for a trust or estate – for qualified business income (QBI) available to owners of sole proprietorships, partnerships, S corporations, and some trusts and estates engaged in qualified trades or businesses.

Current and Proposed Tax Rates



* Rate structure provides for a rate of 18 percent on the first $400,000 of income; 21 percent on income up to $5 million, and a rate of 26.5% on income thereafter. The elimination of step-up in basis is absent from the new HWMC proposal. Source: House Ways and Means Committee

HOW THESE CHANGES WOULD IMPACT SELLERS

Using a mean of 6.65% for state tax, the below chart illustrates the potential impact of capital gains tax changes on business owners who sell their company to a third party (a competitor or a financial buyer such as a private equity firm) for more than $5 million. This compares the current tax code to the Biden administration's proposed taxes and changes, and the proposal most recently set forth by the HWMC.

Current Tax Code	Tax	$mm
Business Sale		$100
Capital Gains Tax	20%	($20)
Affordable Care Tax	3.8%	($3.8)
State Tax (mean)	6.65%	($6.65)
Net Proceeds	*Total Tax %*	
less attorney, accountant & advisor fees	**30.45%**	**$69.55**
Biden Administrartion Prospoed Changes	**Tax**	**$mm**
Business Sale		$100
Capital Gains Tax	39.6%	($39.6)
Affordable Care Tax	3.8%	($3.8)
State Tax (mean)	6.65%	($6.65)
Net Proceeds	*Total Tax %*	
less attorney, accountant, and advisor fees	**50.05%**	**$49.95**
House Ways and Means Proposed Changes	**Tax**	**$mm**
Business Sale		$100
Capital Gains Tax	25%	($25)
Surcharge Sale of $5M+ (effective December 31, 2021)	3%	($3)
Affordable Care Tax	3.8%	($3.8)
State Tax (mean)	6.65%	($6.65)
Net Proceeds	*Total Tax %*	
less attorney, accountant & advisor fees	**38.45%**	**$61.55**

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Additionally, below we review scenarios, by state, of the total impact of capital gains tax changes proposed by the HWMC on business owners who sell their company to third-party for more than $5 million.

California: 13.3% **Minnesota: 9.85%** **New York: 8.82%** **Oregon: 9.9%**

You can find the full list of capital gains tax rates by state here.

Tax Changes Impact on Sellers	Tax	$mm
Business Sale **(California)**		$100
Capital Gains Tax	25%	($25)
Surcharge Sale of $5M+	3%	($3)
Affordable Care Tax	3.8%	($3.8)
State Tax	13.3	($13.3)
State Tax	*Total Tax %*	
less attorney, accountant & advisor fees	**45.10%**	**$54.9**
Business Sale **(New York)**		$100
Capital Gains Tax	25%	($25)
Surcharge Sale of $5M+	3%	($3)
Affordable Care Tax	3.8%	($3.8)
State Tax	8.82	($8.82)
Net Proceeds	*Total Tax %*	
less attorney, accountant, and advisor fees	**40.62%**	**$59.38**
Business Sale **(Minnesota)**		$100
Capital Gains Tax	25%	($25)
Surcharge Sale of $5M+	3%	($3)
Affordable Care Tax	3.8%	($3.8)
State Tax	9.85%	($9.85)
Net Proceeds	*Total Tax %*	
less attorney, accountant & advisor fees	**41.65%**	**$58.35**
Business Sale **(Oregon)**		$100
Capital Gains Tax	25%	($25)
Surcharge Sale of $5M+	3%	($3)
Affordable Care Tax	3.8%	($3.8)
State Tax	9.9%	($9.9)
Net Proceeds	*Total Tax %*	
less attorney, accountant, and advisor fees	**41.70%**	**$58.30**

As illustrated on previous page, if you're a business owner thinking about succession planning or considering a sale to a third party, the capital gains tax changes that will likely take effect shortly will have a significant impact on your total proceeds from a sale. Selling your business is one of the biggest decisions in your lifetime, and owners should understand all their options. One alternative to a third-party sale is an employee stock ownership plan (ESOP), which offers significant tax advantages to sellers compared to a sale to a third party.

In addition to the significant income tax implications, the proposed legislation also contemplates a return to the pre-Tax Cuts and Jobs Act of 2017 exclusion amounts, $5,000,000, adjusted for inflation, for deaths and gifts after December 31, 2021. The current estate and gift tax exemption is $11,700,000 per person. Further, the proposal provides for a substantial overhaul of the existing grantor trust rules and the elimination of certain valuation discounts; grantor trusts and valuation discounts are important tools in pre-transaction estate planning.

WHAT IS AN ESOP AND HOW CAN IT PROVIDE ME WITH TAX ADVANTAGES?

An ESOP transaction is an alternative to selling to a third party where you instead sell your business to your employees. With an ESOP transaction, as long as an owner sells at least 30% of the company to the ESOP and reinvests the proceeds of the sale in qualified investments, they can defer any tax on the gain. The tax deferment is available through IRC 1042 election and reinvesting the sale proceeds in Qualified Replacement Property (QRP), which is a security issued by a domestic, taxable operating company. The securities can include stocks or bonds. Combine that with step-up in basis (which readjusts the value of an appreciated asset upon inheritance), and those assets can be passed tax free to your heirs.

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ESOPs have long been regarded as an attractive exit strategy for business owners who are looking to defer capital gains taxes, preserve their legacy, and incent employees through employee ownership. However, with new imminent tax changes in the works, ESOPs just became even more attractive for owners who are selling their businesses.

HOW DO I LEARN MORE ABOUT ESOPS OR OTHER SALE OPTIONS?

If you're considering a sale, one of the services we provide to business owners is our Feasibility Study Analysis. This free service helps sellers learn more about the structure and the results for shareholders as well as the potential outcome for management and employees if you were to sell your business to private equity, a strategic buyer, or into an ESOP structure. We use the analysis to help you and your team see what ifs, and the benefits associated with each transaction type.