

Favorable Tax Laws Expiring—Planning Opportunities to Consider by Year-End

Numerous favorable tax laws are set to expire at the end of 2012. Although some commentators have indicated a possible extension, it is uncertain whether Congress will enact legislation, especially prior to the presidential election this fall. It is further unlikely that any tax extensions or reform will result in rates and exemptions more favorable than those in effect right now. Business owners should consider taking steps now to take advantage of favorable tax laws before year-end.

Summary of Federal Tax Law Changes

- The top marginal tax rate for ordinary income will increase from 35% to 39.6%.
- The top tax rate on long-term capital gains will increase from 15% to 20%.
- The "qualified" dividend income tax rate will increase from 15% to ordinary income rates.
- A new 3.8% Medicare tax will be imposed on net investment income (including passive flow-through income from LLCs and S corporations) of high-income individuals.
- An additional 0.9% hospital insurance tax will be imposed on earned income of high-income individuals.
- The lifetime gift tax exemption will decrease from \$5.12 million to \$1 million, while the estate and gift tax rate will increase from 35% to 55%.

Tax Planning Opportunities

With the favorable tax environment scheduled to change in 2013, now is the time for business owners to take advantage of low rates and consider the following opportunities:

Sell Your Business. Business owners considering a sale of their business may benefit by closing the sale by year-end to take advantage of the long-term capital rates. Especially for owners with low tax basis, locking in at the 15% capital gain rates (and lower ordinary income rates on any depreciation recapture) can provide a significant tax advantage.

- Illustration.¹ An owner of a C corporation with basis in his stock of \$1 million is

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in negotiations to sell his stock for \$10 million. If the deal closes by year-end, the business owner will pay a 15% tax rate on the \$9 million of capital gain or \$1.35 million in federal income taxes. However, if the deal were to close in 2013, the business owner would pay a 20% tax rate on the gain, which increases the total federal income tax liability to \$1.8 million. Furthermore, assuming the new 3.8% tax on net investment income applies, the federal income tax liability increase to \$2.14 million. Thus, the net after-tax proceeds (without regard to state income tax) for a deal closing in 2013 would be \$7.86 million as opposed to \$8.65 million for a deal closing in 2012. Note that additional analysis would be required for S corporations subject to built-in gain tax.

Although taxes should not dictate when a business owner decides to exit the company, business owners anticipating a transaction in the near future should consider the impact of the tax law changes. A business seller who executes a Letter of Intent with an anticipated closing date after year-end should consider adding a clause to increase the purchase price in the event favorable tax rates expire without extension.

Dividend Recapitalization. Tax planning is also available for business owners not contemplating a sale. Recently some public companies have been engaging in dividend recapitalizations by borrowing funds to pay dividends to shareholders. Dividends paid by yearend should qualify for the 15% tax rate, but this rate is set to increase dramatically to ordinary income rates in 2013. Mid-market private companies may also consider taking advantage of this concept.

- **Illustration.** A mid-market private C corporation borrows cash to make a \$5 million dividend distribution to its shareholders. If the distribution is made by year-end, the shareholders incur federal income taxes at a rate of 15%, which results in \$750,000 of taxes. If, however, the distribution is made in 2013, the shareholders could pay up to \$1.98 million in federal income taxes, which assumes the highest marginal rate of 39.6%. Furthermore, assuming the new 3.8% tax on net investment income applies, the total federal income tax liability could exceed \$2.17 million. Thus, a dividend recapitalization occurring in 2012 nets the shareholders \$4.25 million while an identical dividend recapitalization occurring in 2013 nets the shareholders only \$2.83 million.

Even if an exit is not in the cards, business owners may wish to take advantage of what may be their last opportunity to take some of their chips off the table at low tax rates.

Remove Real Estate from C Corporations. Another opportunity to take advantage of the low tax rate on dividends is to distribute real estate from C corporations to its shareholders. Generally, it is advisable to hold real estate outside of a C corporation, and any distribution made by year-end may qualify for the 15% dividend tax rate.

Transfer Wealth through Gift Planning. The high lifetime gift tax exemption provides an incentive for succession planning by year-end. Wealthy individuals should consider utilizing the \$5.12 million exemption (or \$10.24 million for married couples) to reduce their estate by both the gifted amount and the appreciation of the gift over time.

- **Illustration.** A married couple gifts \$10.24 million in assets to their children. Assuming the gift occurs in 2012, the full amount of the gift falls within the lifetime gift-tax exemption. If the gift were to occur in 2013, only \$2 million of the gift would fall within the lifetime gift-tax exemption. With the top estate tax rate set to increase to 55% in 2013, making the transfers in 2012 as opposed to 2013 provides for approximately \$4.5 million in after-tax savings to the couple's descendants (assuming no depreciation prior to death and substantially greater after-tax savings if the gifted assets appreciate).

Accelerate Income. With ordinary income rates set to increase, it may be advantageous to accelerate income into tax year 2012. Companies should consider issuing cash bonuses or nonqualified stock options by year-end. Employees should consider exercising stock options or making a Code section 83(b) election upon receipt of restricted property in order to recognize ordinary income in 2012.

¹The tax consequences in these illustrations may be even greater as the limitation on itemized deductions (which was previously phased out) returns in 2013.

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