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Items to Consider in Determining Whether to Sell Your Business in 2010 - Part 1 of 4

Tax Rates are Rising! This alert highlights the imminent changes to the tax laws in 2011 (e.g., the sunset of the Bush era tax cuts) and the changes that will arise in later tax years (e.g., tax provisions contained in certain parts of the recently enacted health care legislation) that may affect a decision to sell your business this year. When business owners contemplate the sale of their business, typical initial questions include where to start, what types of activities are required, and how to negotiate the sale process. This client alert is the first in a series of four. This first alert explores various tax issues that will drive some business owners to sell their businesses in 2010 as opposed to selling in later years. The remaining three alerts describe many of the steps a business owner should consider to prepare his or her business for sale. These include the sale process, the evaluation of a purchase offer, the importance of a confidentiality agreement, the role of a letter of intent, structuring a transaction, and the sale documents that "close" a transaction. Because every transaction is different, the general principles provided in these alerts must be adapted for your particular business and industry.

LOW TAX RATES – ALMOST A THING OF THE PAST

Capital Gains Rates. In 2010, long-term capital gains are generally taxed at a 15 percent rate. This 15 percent rate is set to expire on December 31, 2010 and, after that, long-term capital gains will revert to a rate of 20 percent. If a seller closes a transaction in 2011 instead of 2010, the seller will generally pay at least 33 percent more in capital gains taxes due to this tax increase. Some people even believe that Congress may seek to impose a retroactive tax increase in an effort to capture sales in 2010. While no one can predict the future, business owners who are debating whether to sell the stock, limited liability company membership interests, or partnership interests of their business may conclude it is better to consummate a sale sooner rather than later.

Ordinary Rates. In an asset sale transaction (as distinguished from a sale of stock), the gains from the sale may, at least in part, be taxed at ordinary income tax rates. Ordinary income is currently taxed at a maximum rate of 35 percent. However, on December 31, 2010, this rate will also expire and rise to a maximum rate of 39.6 percent.

S Corp. Issues. In addition to the items mentioned above, business owners holding assets in an S-corporation have another potential tax advantage if they sell their business assets in 2010. Generally, owners of an S-corporation, who previously converted their S-corporation from a C-corporation, have to hold the assets of that business for a 10-year period in order to avoid a tax on any built-in gain in the assets of the business that existed at the time of conversion. (Essentially, if the owner of an S-corporation sells the assets of their business before the end of the 10-year holding period, their ability to take advantage of a single level tax at the shareholder level (as opposed to a tax at the corporate level and the shareholder level – the so-called double tax) is hampered.) In 2010, the 10-year holding period is shortened to a 7-year holding period, but the asset sale must be closed by December 31, 2010 in order to take advantage of this shortened holding period.

Future Taxes. Other new taxes come into effect over the next several years as a part of the recently enacted health care legislation. The newly enacted Medicare tax on unearned income (which is effective January 1, 2013), imposes a 3.8 percent tax on the lesser of (i) net investment income or (ii) the excess of modified adjusted gross income over $250,000 (for joint filers). This new tax may pick up all or part of the proceeds of a stock or asset transaction (depending on an individual's tax situation) and increases the effective tax rate by 3.8 percent (on top of the higher effective tax rates that will take effect on January 1, 2011). The exact application of this new tax will be

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dependent on the form a transaction takes, the type of business entity, and the taxpayer's other sources of income in the tax year in which the sale occurs. Although this new Medicare tax does not take effect until 2013, the upcoming increase in taxes and new regulations imposed by the recently enacted health care legislation (e.g., penalties for not providing minimum health coverage, excise taxes on high-cost, employer sponsored health care plans, and new reporting requirements) provide additional reasons for considering closing a sale transaction by December 31, 2010 – not only will taxes increase in 2011, but taxes will go up even further in the following years.

The next alert in this series will focus on (i) many of the steps a business owner should take in order to prepare the business for sale, (ii) the sale process, and (iii) several key factors to consider in the sale process in an effort to maximize the benefits to the owners of the business and to help ensure a smooth sales process.

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