Tax Changes Could Help Fuel M&A Boom

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Deal-makers typically view taxes as just another economic cost that impacts their rate of return. But this year their impact could be far greater.

In the absence of new legislation, the tax rate reductions and special tax rates for dividends adopted during the Bush Administration will expire at the end of 2010. This anticipated increase in tax rates will create a strong incentive to accelerate recognition of capital gains and dividends in 2010 and will likely trigger a tax driven M&A boom before year end.

The long-term capital gains rate (gains from the sale of long term capital assets such as stock held for more than a year) for individuals is currently 15 percent. Assuming no change in law, beginning in 2011 the long-term capital gains rate will increase to 20 percent for individuals whose incomes fall within the two highest tax brackets. The highest individual marginal income tax rate will increase from 35 percent to 39.6 percent.

In addition, individuals are taxed currently on "qualified dividends" - dividends received on stock of U.S. corporations and certain qualified foreign corporations held for at least 60 days within the 120-day period surrounding the ex dividend date - at the 15 percent long-term capital gains rate for both regular and alternative minimum tax purposes. Assuming no change in law, beginning in 2011 the special treatment of qualified dividends will expire and individuals in the highest income bracket will be taxed at 39.6 percent on dividends. The taxation of long-term capital gains and qualified dividends at an identical 15 percent rate will end.

These changes relate to individual taxpayers. Therefore, the changes are relevant to flow-through entities such as partnerships, Subchapter S corporations, limited liability companies and certain trusts that pass dividends and capital gains through to their owners who are U.S. individuals. In particular, sponsors of private equity funds and hedge funds must be aware of these changes because they currently earn most of their income as capital gains and dividends. In contrast, corporations are generally taxed at the same rate on both capital gains and ordinary income and the top corporate tax rate will remain unchanged at 35 percent for 2011. In light of these likely changes, here is some tax advice for 2010.

1) Sell If An Exit Is On The Horizon

Due to the expected tax increases in 2011, individuals should seek to accelerate exit events and generate capital gains in 2010, assuming deferral will not materially increase the sales proceeds. For example, assume an individual owns corporate stock with a long-term holding period and an adjusted tax basis of $0 and expects to sell the stock for $100 (resulting in $100 of long-term capital gains). Assume further that the selling price after 2010 will not exceed $100 and no dividends will be paid on the stock in the interim holding period. The individual would pay $15 in federal capital gains tax if the stock is sold before year-end, but $20 in tax if sold in 2011 (or beyond). Thus, deferral will cost seller an additional $5 in tax (in addition to the economic return on the sale proceeds, or opportunity cost, during the deferral period).

Of course, individuals holding investments with built-in losses may want to wait until 2011 (or beyond) to harvest capital losses. Capital losses realized in 2011 can be used to offset capital gains subject to a 20 percent tax rate (up from 15 percent). Individuals may use any excess capital losses to offset up to $3,000 of ordinary income taxed at 39.6 percent (up from 35 percent), and may carry forward indefinitely any remaining unused capital losses to another taxable year.

2) Elect Out Of The Installment Method

An installment sale is a disposition of property (other than property that is traded on an established securities market) in which one or more payments are to be received after the close of the taxable year in which the disposition occurs. Installment sale gains are reported under the installment method: Sellers recognize a portion of their total gain on the sale, plus interest received on the installment note taxable as ordinary income, when they receive installment payments (rather than being taxed on the entire gain in the year of sale). Sellers are subject to the installment method unless they elect otherwise. By electing out of the installment method sellers recognize the entire gain in the year of sale. Sellers generally should elect out of the installment method this year because installment payments received after 2010 will be taxed at higher rates (the tax rate in effect for the year or years in which installment payments are received is what matters, not the year of sale).

Using the basic facts in the example above, assume the individual sells his stock in 2010 for an installment note with a principal amount of $100 payable in 2012. Presumably, the interest on the installment note will compensate seller for the foregone earnings on the sale proceeds (that is, the opportunity cost) for the interim period. Under the installment method, seller would recognize $100 of gain and pay $20 of tax (20 percent long-term capital gains rate) in 2012. If seller elects out of the installment method he would pay only $15 of tax in 2010. Of course, seller would not receive any cash proceeds (just the installment note) in the year of sale and, therefore, must deploy cash from other sources to pay the $15 tax. However, opting out of the installment method and paying tax this year is a productive use of the cash because it saves $5 in additional tax in 2012. Otherwise, seller must earn more than 15 percent over the next two years on the $15 in order to offset the additional $5 future tax liability. When significant short-term returns on cash are virtually non-existent, the best use of cash is to pay tax this year at a lower rate by electing out of the installment method.

It is important to note that the installment method applies not only to installment notes but other types of deferred payments as well. Thus, for deals closing this year sellers should minimize the amount of deferred purchase price to be received in 2011 (or beyond) in the form of earn-outs, working capital adjustments, or post-closing indemnification escrows.

3) Reconsider Tax-free Rollovers

Taxpayers often defer tax on a sale through the use of tax-free equity rollover transactions. By converting or rolling over their original investment into new equity in a taxfree exchange sellers can avoid recognizing gain until a future sale of the new equity. Thus, an individual holding a capital asset with a long-term holding period could roll over his

investment in a tax-free transaction this year and defer recognizing the gain until 2011 (or beyond). However, the increase in tax rates starting next year will add an additional cost to deferral.

Again using the basic facts of the example above, assume the individual rolls over the stock in 2010 for new equity. Should he structure the rollover transaction as taxable or tax-free? If the rollover is taxable in 2010 he would pay only $15 of tax but would have to use $15 in cash from other sources. If the rollover is tax-free and he sells his rollover equity in 2012 for $100 he would recognize $100 of gain and pay $20 of tax (20 percent long-term capital gains rate) in 2012. Structuring the rollover as taxable in 2010 and paying $15 in tax (using cash from other sources) saves $5 in additional tax in 2012, and thus is a prudent use of the $15 in cash. Otherwise, seller would have to earn a return in excess of 15 percent over the next two years on that cash to cover the additional $5 in tax payable in 2012. Of course, this example assumes no appreciation in the value of the rollover equity during the rollover period (i.e., a zero rate of return on the rollover equity). When tax rates are expected to increase during the deferral period, determining whether tax deferral is economically advantageous depends on the expected rate of return (i.e., the increase in value of the rollover equity) and holding period of the rollover investment. When current short-term returns on cash are historically low and future higher tax rates are certain, sometimes the best course of action is to recognize income currently on equity rollovers.

4) Consider Accelerating Sale Of Controlled Foreign Corporations

There is an even greater incentive for accelerating the sale of certain foreign corporations. A foreign corporation is a controlled foreign corporation (CFC) if more than 50 percent of the voting power or value of its stock is held by U.S. persons (each of which owns 10 percent or more of the voting power of such corporation). Under Internal Revenue Code Section 1248, the gain on the sale of CFC shares may be treated as a dividend, rather than capital gain, to the extent of the CFC's untaxed earnings during the shareholder's holding period. Under current law, the deemed dividend received by U.S. individuals may qualify for the preferential 15 percent rate applicable to qualified dividend income if either (i) the CFC is eligible for benefits of an U.S. income tax treaty, or (ii) the stock of the CFC is publicly traded on an established U.S. securities market.

In 2010 an individual seller of a CFC held for more than one year that qualifies under the rules described in (i) or (ii) above will pay typically 15 percent on the entire gain from the sale of the CFC. In 2011, the long-term capital gains rate for individuals will increase to 20 percent and the qualified dividend income provision may disappear. Therefore, in 2011 a seller will not only pay an additional 5 percent tax on its capital gains but will also potentially pay tax at the 39.6 percent ordinary income rate on Section 1248 deemed dividends.

In order for a CFC that does not benefit from a comprehensive income tax treaty with the U.S. to qualify for the preferential 15 percent rate on qualified dividends, the CFC may have to complete a public offering of its stock by the end of this year, a process which oftentimes takes many months to complete. Thus, an exit in 2010 for certain CFCs may require immediate action.

5) Consider Taking Dividends In 2010

In 2010, private equity funds should consider causing their portfolio companies to distribute current and accumulated earnings and profits in the form of dividends, assuming such companies are profitable, possess strong balance sheets and cash flow, are not overleveraged, and have available cash on-hand (or can borrow funds at low interest rates). Presently, U.S. individual investors are taxed at 15 percent on qualified dividends. Upon expiration of the Bush tax cuts in 2011, the preferential rate on qualified dividends will terminate and the applicable rate will rise to 39.6 percent. Of course, dividend income may not be ideal for private equity funds with foreign investors. Foreign investors in private equity funds incur a 30 percent U.S. withholding tax on dividend income from U.S. sources, unless they are eligible for a reduced rate of withholding under an applicable U.S.-income tax treaty.

By not acting this year individuals will lose the opportunity to extract earnings and profits from their portfolio companies at historically low rates. For example, an S corporation with accumulated earnings and profits from its prior life as a C corporation should file an election to treat its distributions in 2010 as made first from its accumulated earnings and profits and second from its accumulated adjustments account. The election will allow the distribution to be treated as a dividend (to the extent of the earnings and profits) taxed at the 15 percent preferential qualified dividend rate. Furthermore, the S corporation may be able to deplete its earnings and profits thereby freeing itself from the S corporation passive investment income rules.

The "extraordinary dividend" rules apply if a dividend equals or exceeds 10 percent of the taxpayer's adjusted basis in the stock. If an individual receives qualified dividend income (taxed at 15 percent) from an extraordinary dividend then any loss on the sale of the stock is treated as long-term capital loss to the extent of the extraordinary dividends, regardless of the individual's holding period of the stock. However, this holding period recharacterization rule will expire with the Bush tax cuts starting in 2011. Therefore, individuals holding stock with short-term (one-year or less) holding periods can receive extraordinary dividends in 2010 with respect to that stock and may still be able to recognize short-term capital loss on a sale of that stock in 2011.

Conclusion

Whether Congress enacts President Obama's proposals this year or does nothing and allows the Bush tax cuts to expire, at least one thing is certain starting in 2011- higher tax rates for individual taxpayers. Individual investors as well as sponsors of private equity funds and hedge funds would be well served to accelerate the recognition of dividends and capital gains this year to avoid the impact of higher taxes next year.