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Biden Taxes: Potential Implications to Business Owners

What to Expect and How to Prepare

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Executive Summary

Capstone Partners is pleased to share its white paper on the proposed Biden administration tax policies with insights into what these provisions could mean for middle market business owners. Our featured contributor is Jeffrey Solomon, C.P.A., C.V.A., and Managing Shareholder of accounting firm Katz Nannis + Solomon.

Capstone Partners has developed a full suite of corporate finance solutions, including merger & acquisition (M&A) advisory, debt advisory, financial advisory, and equity capital financing to help privately owned businesses and private equity firms through each stage of the company's lifecycle, ranging from growth to an ultimate exit transaction. To learn more about our wide range of services, please contact us.

Background

In early 2021, President Joe Biden unveiled proposed tax increases to generate funding for the American Jobs Plan and the American Families Plans. Collectively, these bills required an additional $4 trillion dollars in tax revenue and planned to raise ~$2 trillion from corporate tax reforms over the next decade. The sizeable financial tax implications for business owners—including doubling the capital gains rate from 20% to 39.6%, increasing the corporate tax rate to 28%, and accelerating the removal of the qualified business income (QBI) deduction—created widespread concern and caused a flurry of mergers and acquisitions as owners expedited their exit timeline to lock in the current tax rate and maximize their take-home proceeds.

More recently in June, Biden agreed to a Bipartisan Infrastructure Framework, which would require $1.2 trillion over the next eight years including $579 billion in new spending—far below his original infrastructure proposal in the American Jobs Plan and excluding the Made in America Tax Plan. Due to the compromises, Senate Democrats agreed to a second, larger $3.5 trillion plan in July to focus on the missing "Human Infrastructure" components. This includes home health, childcare, Medicare, clean energy, education, and other items absent from the bipartisan bill. To pass this measure, Democrats would need to utilize a legislative process known as "reconciliation," which would allow the bill to be passed with a simple Senate majority (51 votes) rather than a three-fifths majority (60), eliminating the need for Republican support. While still a possibility, the hurdles remain high. Congress would need to first agree to a Budget Resolution and allow a Reconciliation Bill. If cleared, the Reconciliation Bill itself would still require a high level of cooperation among the fragmented Democratic party in order to pass. This multistep process will inevitably push the legislation timeline out.

So, what does this mean for business owners? This bipartisan agreement has provided little clarity on the outcome of the final tax revisions. Items missing from the proposed bipartisan bill (including the increase to the corporate tax rate) could still be pushed through in the Reconciliation Bill. Additionally, the American Families Plan, which includes capital gains increase, has yet to reach the Senate floor. As the timeline for the proposals extends, we expect the number of concessions to rise as Biden seeks to deliver on his promise to pass the plans. In any event, it is likely the current tax code will see reforms in the near term, some of which could will have significant impacts to business owner's bottom line and the valuation of their business.

Overview of Bipartisan Infrastructure Framework

The Bipartisan Infrastructure Framework is significantly smaller than the American Jobs Plan and excludes the Made in America Tax Plan– which included a 7% increase to the corporate tax rate and sought remove tax advantages included in former President Trump's 2017 Tax Cuts and Jobs Act (TCJA).

The Bipartisan Infrastructure Framework would spend $1.2 trillion over the next eight years and would focus on transformational investments in America's aging infrastructure to create U.S. jobs and build a more sustainable and competitive economy.[1] The proposed bill includes around two-thirds of the investments originally included in the American Jobs Plan including modernizing public transit, repairing railroads and bridges; reducing emissions; and replacing infrastructure for water pipelines, high-speed internet, and the electric grid.

Notably, the bipartisan deal would not use taxes levied in the Made in America Tax Plan to generate the $579 in new spending. Instead, financing sources would include: reducing the Internal Revenue Service (IRS) tax gap through improved tax compliance, repurposing unused pandemic relief funds from 2020; redirecting unused unemployment insurance funds; state-level investment in infrastructure (including allowing the use of unused toll credits); reinstating Superfund chemical and petroleum fees; using 5G spectrum auction proceeds; selling petroleum reserves; public-private partnerships; private activity bonds; direct pay bonds; and asset recycling.

In addition to providing smaller investments, the bill also omitted several physical infrastructure investments stipulated in the American Jobs Plan. The largest of these included $213 billion to create, update, and retrofit affordable housing units and $100 billion to modernize public schools. While Americans grapple with a national housing shortage and home prices have skyrocketed, the omissions reflected Republican's focus on investing in infrastructure platforms that support the movement of people, goods, and services.

Cost Breakdown

Investment Type	U.S. Dollars in Billions
Transportation	
Roads, bridges, major projects	$109
Safety	$11
Public transit	$49
Passenger and Freight Rail	$66
EV infrastructure	$7.5
Electric buses/transit	$7.5
Reconnecting communities	$1
Airports	$25
Ports & Waterways	$16
Infrastructure Financing	$20
Transportation Total	*$312*
Other Infrastructure	
Water infrastructure	$55
Broadband infrastructure	$65
Environmental remediation	$21
Power infrastructure	$73
Western Water Storage	$5
Resilience	$47
Infrastructure Total	*$266*
New Spending Total	***$579***

Source: The White House

Biden's Commitment to a "Comprehensive Agenda" Could Still Impact Taxes

The American Families Plan (including an increase to the capital gains rate) together with the "Human Infrastructure" bill hold many unknown tax implications for business owners.

The American Families Plan

The American Families Plan is still in discussion and includes $1 trillion in new spending and $800 billion in tax cuts for families and workers.[2] The plan is intended to help grow the middle class and expand economic benefits to all Americans. At the same time, the bill would generate ~$661 billion in additional taxes placed on high-income individuals and pass-through business. The initiative includes providing two years of free preschool and two years of free community college; creating a national family and medical leave program; and cutting the Child Tax Credit, Earned Income Tax Credit, and Child and Dependent Care tax Credit for lower- and middle-income workers.

Reconciliation Bill to Focus on "Human Infrastructure" of American Jobs Plan

The original American Jobs Plan (AJP) included a wide-range of investments outside of physical infrastructure. With the bipartisan bill in place, Democrats agreed in July to a second bill of $3.5 trillion that includes the omitted "Human Infrastructure" investments. This includes investments expanding caregiving for the elderly, implementing universal pre-kindergarten, free community college, and extended child tax credits.

Notably, the bipartisan bill excluded the Made in America Tax Plan—which housed the highly controversial increase to the corporate tax rate. Biden's stated intent with the plan was to return corporate tax revenue to the U.S. by removing tax advantages created by the 2017 Tax Cuts and Jobs Act. This included raising the Global Intangible Low-Tax Income (GILTI) to 21%, calculated on a country-by-country basis. These tax revisions are likely to appear again in the Human Infrastructure bill, which has yet to outline the funding source for this historic level of government spending.

*"**Still, there is more work to do** – to grow our economy, create jobs, improve living standards, reduce climate pollution, and ensure more Americans can participate fully and equally in our economy. President Biden remains committed to the comprehensive agenda laid out in the American Jobs Plan and American Families Plan."*

June 24th Statement,
The White House

Tax Proposals in the American Families Plan

Individual Income Tax
The American Families Plan (AFP) would increase the top marginal income tax rate from 37% to 39.6%. It would also seek to treat carried interest (often received by hedge funds and private equity firms) as ordinary income.

Capital Gains
The AFP would change the federal tax rate on long-term capital gains and qualified dividends, from 23.8% to 43.4%, which includes a 3.8% Net Investment Income Tax (NIIT) or Obamacare tax, for top earners. This new legislation would lead to a national average of 48% taxation when factoring in state and local capital gains taxes compared to the current average rate of 29%.

Pass-Through Business Taxes
The AFP would apply a 3.8% NIIT to all sources of income above $400,000 including pass-through business incomes.

Inheritance Tax
In addition to capital gains tax that would be levied upon death, any estates worth over an exemption of $11.7 million per person would be subject to the current estate tax of 40%.

Real Estate
The AFP would limit 1031 exchanges on real estate transactions with gains over $500,000. This is a current mechanism that allows property buyers to defer taxes by rolling their profits into their next property investment within 180 days.

Source: The White House and Tax Foundation

Potential Capital Gains Impact to Middle Market Business Owners

Thousands of business owners have expedited their exit timelines, motivated to pursue a transaction in 2021 due to the unknowns of the pending tax code and the negative impact to their after-tax profitability and business valuation.

Tax changes are coming. Regardless of how extreme the increases, one thing we know for certain is that the current economic environment is more favorable for exit opportunities than what we expect in the future. For this reason, Capstone has seen a significant increase in middle market business owners pursuing an immediate transaction to lock in the current tax code and maximize their proceeds from a sale.

While Biden's proposal (included in the American Families Plan) to double the capital gains rate to 39.6% is unlikely given bipartisan scrutiny, even a smaller increase could significantly decrease a business owner's proceeds in a liquidity event. As illustrated below, if the capital gains rate increased to 30%, a seller's net proceeds would decline 13%, if the rate increased to the proposed 39.6%, their net proceeds would drop by 26%.

To compensate for the higher tax burden, business owners would effectively need to increase the value of their company by 10%-26% in the coming year in order to make the same amount in net proceeds as in 2021. While there is some historic precedent supporting taxes being applied retroactively, it is more likely that capital gains rate will be applied at the time of its enactment rather than in April 2021, as Biden has requested.

"While the tax debate continues to play out, business owners that had planned on an exit in the next 2-5 years are expediting their timeline, with the knowledge that if the capital gains rate nearly doubles, they will need to achieve a significant increase to their enterprise value to gain the same return as in the current environment."

Todd McMahon, Head of Investment Banking
Capstone Partners

Additionally, while the proposed 7% corporate tax increase is not included in the Bipartisan Infrastructure Framework—the provision could still appear in the Reconciliation Bill. The increase to the corporate tax rate would be intended to target large corporations, however there are more than 1.4 million businesses in the U.S. with fewer than 500 employees that are structured as C-corporations, according to the U.S. Chamber of Commerce.[3] These small C-corporations, the largest share of which are in the Retail industry and still recovering from the pandemic, would be further burdened by the tax increase and could see it negatively impact their profitability, hiring power, and growth investments.

Potential Tax Impact on Sale of $100 Million C-Corporation

	23.8% (Current) Capital Gains Rate	30% Capital Gains Rate	39.6% Capital Gains Rate
Pre-Tax Sale Proceeds	$100,000,000	$100,000,000	$100,000,000
State Taxes*	-$6,000,000	-$6,000,000	-$6,000,000
Federal Taxes	-$22,372,000	-$31,772,000	-$40,702,000
After-Tax Net to Seller	**$71,628,000**	**$62,228,000**	**$53,298,000**
Percentage Change	-	-13%	-26%

**Assumes 6% average*
Source: Katz Nannis + Solomon Analysis

Q&A

Jeffrey Solomon, C.P.A. C.V.A
Katz Nannis + Solomon
Managing Shareholder

Biden included tax proposals in both his Infrastructure Plan and American Families Plan to help pay for government spending. How does the recent agreement to the bipartisan bill impact these potential tax implications?

Of course, the area all business owners are focused on right now is the increase to the ordinary tax rates in addition to the capital gains tax rates. Trying to determine the timing of these changes is foremost as well, as people are trying to determine whether to accelerate income or not into 2021.

No one is sure how the final bill will play between the Democrats and the Republicans. The IRS enforcement allotment seems to be a sticking point between both groups, and if the money is not raised there, then more taxes will likely be targeted to pay for the bill.

Overall, I would say, business owners are wary about the tax increases proposed and how they will impact the economy, their business and the valuations of their businesses.

How should business owners that are preparing to go to market navigate the uncertainty of the timing of the tax implication?

Most tax professionals still believe the ordinary tax increases will not be retroactive changes as this has rarely happened over the history of tax legislation. However, in late May, Washington insiders have said that Biden expects to use a late April 2021 date for the capital gains rate increases. This of course, will put a lot of deals we are working on closing that wanted to close before the end of the year in jeopardy. Again, at this time, it is still unclear how Congress will act on this proposal.

Could you walk us through a high-level example of the potential impact to the sale of a company before and after these proposed taxes are enacted?

Assuming rates go up 10-15% between ordinary and capital gains rates, and assuming most deals we are working on are mostly taxed at capital gains rates, this could mean less exit value for you next year versus an exit this year. So, on a $100 million exit, plan on about $10-15 million more in taxes and less for you next year.

What tax factors should owners consider when evaluating if they should seek an M&A sale immediately, at the expense of leaving more opportunity for growth on the table?

This is a hard decision for any business owner. Factoring tax increases, with the growth from the pandemic, is truly a balancing act. I tend to advise my clients with the low tax rate regime, coupled with historic all time valuation metrics, that now is a great time to transact and to probably not wait in most cases if you are thinking of doing so in the near future. The adage 'a bird in the hand is worth two in the bush' rings loudly to me right now.

How do you see the proposed tax code impacting M&A in the short and long term?

For the short term, the expectation of increases across the board is accelerating many potential transactions and their timeline into this year. Our firm, KN+S, has been working on multiple deals at any juncture for the last 12 months, and the exit values continue to be at all-time highs still.

Looking at the longer-term perspective, I think things will slow considerably as the business community begins to get their legs under them as the economy and tax increase potentially impact this fast pace we have been experiencing in M&A in the first half of 2021. In addition, I think the tax increases will slow the amount of funds available for deals in the future as both strategics now will owe more in taxes and PE firms tighten their spends from their limited partners.

How long do you expect this timeline to play out for buyers? Will the enactment of the tax code immediately cause buyers to pull back or will this take time to impact their balance sheets?

When I've seen tax increases before, and I've been doing this for many years, at some point the siphon begins to dwindle a little bit. The water starts coming out much slower because people are now paying much more in taxes and the cashflow just isn't there. The market response is usually before the enactment- you'll see people start pricing things differently and it becomes a gradual process, but it is going to happen. A lot of the timing is going to be dependent on the economy and different industry sectors a company is in.

Would location by state or industry be a factor in any of the proposed tax provisions?

I have never had more clients move to either lower income state tax regimes or zero tax regimes. I probably had 2% to 3% of my clients move to New Hampshire or another lower income tax state. These clients have decided to move themselves, their family, and to sell their Massachusetts property because of the impending tax implications. Think about it, if I'm in a 5% or 6% state tax rate and I can move over the state borders and pay 0% tax – and if I'm making a million bucks a year, that starts adding up over a couple of years.

I've also had clients now that have had two homes, one in Massachusetts and one in Florida, say, 'okay, I'm becoming a full-time Florida resident. I'm done with this.' So, there are states that people are getting fed up with during all this talk. There is talk about a "millionaires tax" in Massachusetts that is going to the voters to vote soon as well.

Many of the private equity firms we work with have found accounting firms to be so thinly staffed that they are waiting 30-45 days to get a Quality of Earnings (QoE) on the schedule, making it difficult to launch a deal before the end of 2021. What is your view on capacity at your firm and throughout the system? Knowing that deal activity is going to remain high throughout the year, how do they plan to address the bandwidth gap?

Yes, all service providers are slammed right now. We at KN+S, have had to say no to some assignments over the last few months as we felt we couldn't meet some tight and aggressive deadlines. The good news is that summer is here and there should be more availability all around. Most good QofE's take 45-60 days, in my estimation at a minimum, so any group needs to factor that time into account.

While not included in the Bipartisan Infrastructure Framework, if the corporate tax rate increases from 21% to 28%, it is still below the 35% rate that was in place prior to the Tax Cuts and Jobs Act of 2017. How does the current environment differ from the previous high tax environment?

The Fed has been able to keep inflation in check while pumping the economy with investments. When taxes increase, most business owners are expecting a slowdown to the growth and investments we have benefitted from over the last few years. Washington is saying that increases to the corporate tax rates would benefit middle to lower income families. The economy is still chugging and emerging from COVID, but I think these needed tax increases will be felt in the business community for sure.

Jeffrey D. Solomon, C.P.A., C.V.A. is the Managing Shareholder of KN+S. Jeff's passion is helping clients grow through informed, innovative, and intelligent business and personal decision making. He loves working with young technology companies and entrepreneurs, but has a soft spot for family-owned businesses, as well. Having started his career at a "Big 4" in audit, he now spends the majority of his time in tax and consulting. Jeff has sat on the board of SBANE and the MIT Enterprise Forum, and was the former Chairperson of the MSCPA. He is a graduate of UMass Amherst and is a Certified Valuation Analyst. Jeff wants his clients to succeed and loves to contribute his expertise as a valued advisor along the way. Find out more at www.knscpa.com.

How Business Owners Can Prepare for a Faster, Smoother Liquidity Event

A successful liquidity event often requires significant preparation to drive an optimal outcome and includes a knowledgeable team of experts to create more transparency into the value of your business, tax efficiency, and a robust post-close wealth planning process. Advanced preparation and collaborating with experienced CPAs, investment bankers, and private wealth advisors is key to saving time, money, and limiting emotional stress.

1. Organize your Deal Team

There are many key players that you will want to assemble to optimize your sale process including an attorney, accountant, and investment banker. These individuals will help to navigate the complex sale process and will advocate for you and your business to ensure you receive fair market value and avoid legal issues associated with a sale. As a full-service investment bank with deep sector knowledge, Capstone Partners can assist with:

- Determining the valuation of your business
- Preparing key documents used in the M&A process including a cash flow analysis and marketing materials
- Bringing the right buyers, whether financial or strategic, to the table to drive competition and to achieve a premium purchase price
- Negotiating a successful close and optimizing post-close considerations

2. Create a Tax Plan

Given the complexities and fluidity of the current tax environment, meeting an experienced tax advisor is extremely important. Work with a knowledgeable CPA to review your company's projected income and to complete a tax exposure exercise to give yourself insight into the potential tax scenarios and the impact they could have to your business value and to your net proceeds following a sale. Additionally, finding the right tax advisor can ensure that you are maximizing your deductions, avoiding penalties, and creating the best tax scenario in the case of a merger or acquisition.

3. Prepare your Financials

This step should include getting your financials audited to ensure that a potential buyer can see a true and fair reflection of your performance. A Quality of Earnings (QoE) can also add transparency by analyzing your policies around revenue recognition, expense accrual, cost allocation, and inventory tracking. All these steps take significant time and careful review. Having this paperwork reviewed and prepared in advance can significantly speed up a buyer's due diligence process and reduce the chance of the deal falling through at the eleventh hour.

4. Organize Corporate Documents

To go one step beyond physical document preparation, you can set up a secure online data room, a collection of essential corporate documents used in an M&A sale process. During a transaction process, the data room will be a key portal for sharing confidential information with authorized bidders and their legal counsel.

4. Talk with a Wealth Advisor

A wealth advisor will help you think through the legacy of your business and reduce the emotional strain that such a significant financial process can create. This should include conversations about estate planning and pre-planning for the owners and their families. Also, by gifting to certain types of trusts earlier rather than later, you can save a family member millions of dollars.

6. Prepare Your Management Team

In addition to the external deal team, you'll want to gather your close-knit team of internal employees to assist with meeting with investment banks and choosing the best fit, responding to due diligence requests during the M&A process (often the Chief Financial Officer), participating in management meetings with potential buyers, and serving as a trusted council during the liquidity process.

Endnotes

1. The White House, "FACT SHEET: President Biden Announces Support for the Bipartisan Infrastructure Framework," https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/24/fact-sheet-president-biden-announces-support-for-the-bipartisan-infrastructure-framework/, accessed June 30, 2021.
2. The White House, "Fact Sheet: The American Jobs Plan," https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-American," accessed June 18, 2021
3. The White House, "Fact Sheet: The American Families Plan," https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/, accessed June 18, 2021.
4. U.S. Chamber of Commerce, "Small Business Would Be Hit Hard by Corporate Tax Increase," https://www.uschamber.com/series/above-the-fold/small-business-would-be-hit-hard-corporate-tax-increase, accessed June 22, 2021.

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About Capstone Partners

Capstone Partners is one of the largest and most active independently-owned investment banking firms in the United States. Over the past 20 years, thousands of business owners, investors, and creditors have trusted us to help guide their strategic decisions and maximize financial outcomes at every stage of the corporate lifecycle. For more information, please visit www.capstonepartners.com.

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