You Don't Need a Weatherman…

What Will Higher Tax Rates Mean for Your Business?

By Benjamin Gordon

In 1965, Bob Dylan wrote, "You don't need a weatherman to know which way the wind blows." The line, considered the most memorable line in his "Subterranean Homesick Blues," also inspired the name for a radical leftist group.

Today, the Weathermen's Bill Ayers may not be in the White House, but there is no question which way the wind blows. With the support of Congress, President Obama has announced plans to let the Bush tax cuts expire on December 31, 2010. Taxes are slated to increase in several key areas, including ordinary income and capital gains.

As the year draws to an end, an increasing number of our clients have been asking the same question: "What do these tax hikes mean for my business?"

Exhibit 1: Bob Dylan, Poet and Policymaker?

Taxes: Only One Way to Go

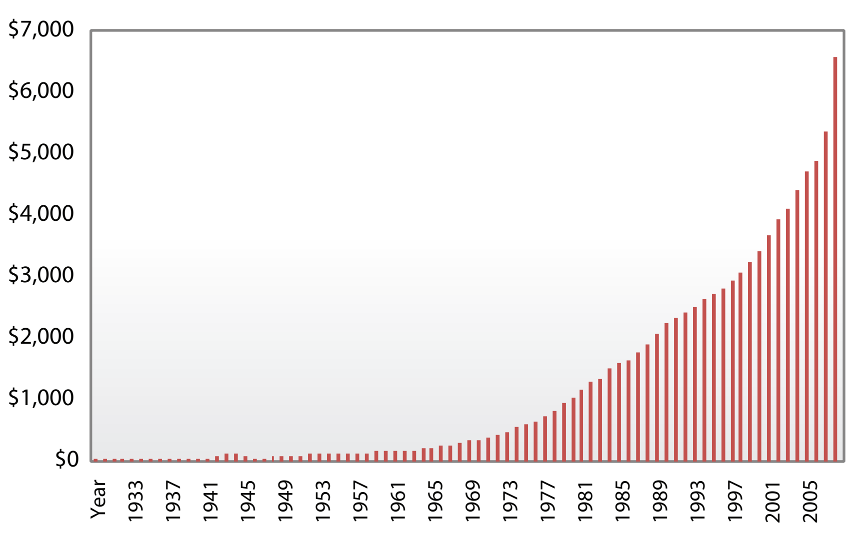
First, it should be noted that Congress may continue to change tax levels, so you should consult your tax professional for specific tax guidance.

That said, there is little doubt that taxes are slated for a major increase. The Bush tax cuts set the top level of ordinary income taxes at 35%, and capital gains at 15%. When they expire at the end of 2010, ordinary income levels should rise to 40%, unless Congress passes different tax legislation. Capital gains taxes are scheduled to expand to 20%. And a proposed health care surcharge tax could boost both sets of taxes by 6%, to 46% and 26%, respectively.

That's not all. Congressman Charles Rangel (D-NY) has proposed a 4% surcharge on incomes over $200,000. There is talk of repealing the wage cap on social security, which is currently at 6.2% but capped at $102,000. In aggregate, rates could ultimately go much higher.

Some have asked whether we think these tax changes are cyclical. While it is true that historically governments tend to alternative between left-leaning and right-learning policies, historically government expenditures have only gone up. As Exhibit 2 shows, total government spending has increased consistently since the New Deal, and has grown at the rate of 10% since 1930.

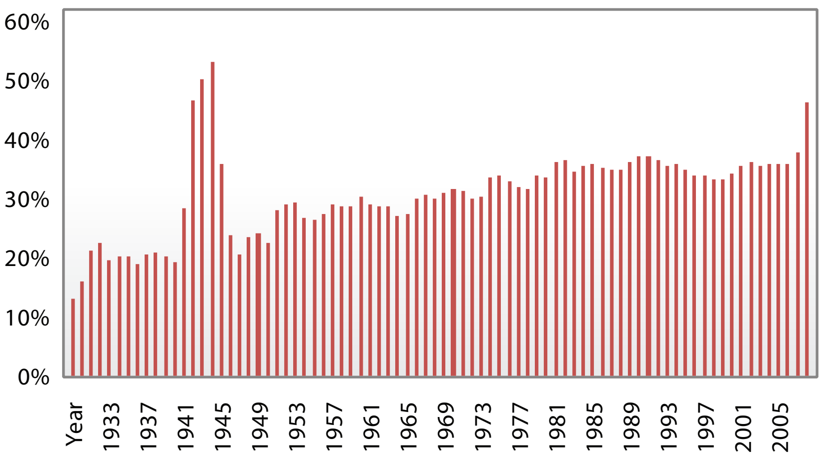
Exhibit 2: Total US Government Spending, in Billions of Dollars



Source: USGovernmentSpending.com

What about GDP? Didn't the US economy expand during that timeframe? Yes, but government spending grew faster. As a percentage of GDP, government spending has continued to grow consistently, from 13% of GDP in 1930 all the way up to 46% today. With the exception of the World War II period, government spending has continued its steady march upward, both in dollar terms and as a percentage of the total economy. See Exhibit 3 for the details.

Exhibit 3: Total US Government Spending, as a Percentage of GDP



Source: USGovernmentSpending.com

What about the future? Sadly, as the national debt continues to skyrocket, future tax obligations are likely to follow. Furthermore, entitlement spending is ballooning. The Social Security trust fund is currently projected to run out of assets in 2037. Medicare’s hospital fund is forecast to go bankrupt in 2017. By 2050, the Social Security Administration’s own intermediate assumptions project that elderly entitlements will consume 32.3% of all payroll. Social Security and Medicare Part A, meanwhile, are slated to require 21.7% of all payroll.

In sum, we are likely to witness decades of ever-increasing taxes required to fund these generational liabilities.

The Outlook: Higher Taxes in 2011, but Opportunities in 2010

When it comes to taxes, most owners are more focused on the short-term implications. What will the big 2011 increases mean?

Many of our private owner clients are talking with us about liquidity strategies in advance of the 2011 tax increases. Given the major tax hikes pending, many owners are comparing the prospect of high future income tax rates (46%+) to low current capital gain rates (15%). The conclusion for many is to consider a range of options, including a liquidity event in 2010.

Here’s how the math works.

First, assume that you own a company, generating $5 million in operating profit, which you pay yourself at the end of each year. You founded the company with a nominal cost basis, and built it up to the current levels. Then, let’s say your long-term growth rate is the same as that of the overall economy, which is 3%. Next, let’s model a sale at an average multiple of 5 times operating profit. Lastly, let’s apply an annual discount rate of 20% for our forecast, given the normal uncertainties of the future for small to mid-sized companies in the current economy.

Under these assumptions, what would happen?

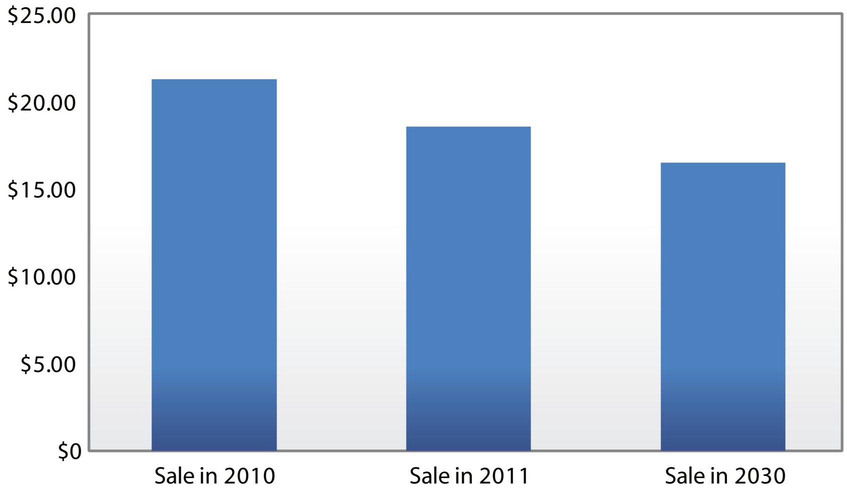
In 2010, you would pay the federal government $1.8 million in income taxes. In 2011, your tax bill could increase by 35%, to $2.4 million.

Let’s say you saw these numbers, thought about your options, and decided to explore a sale. If you decided to sell your company in 2010, you would reap $25 million. Your capital gains tax bill to the federal government would be $3.8 million. Net of taxes, you would keep $21.3 million. However, if your deal closed in 2011, you could have to pay a capital gains tax of $6.7 million. This would be a 79% increase in your tax bill. Net of taxes, you would keep $19.1 million.

Finally, let’s say you decided not to sell at all. You could run your business for the next 20 years. At the end of that time period, you would go ahead and sell, at the same profit multiple. You would continue to take year-end dividends. However, they would be reduced by the tax bite. In addition, the discount rate (reflecting inflation, uncertainty, and other modeling assumptions) would reduce the current value of those proceeds. In the end, the present value of those 20 years of hard work would be less than the present value of the 2010 sale proceeds.

In sum, when you compare these three scenarios, with these assumptions, your present value is highest when you sell in 2010, because of the historically low capital gains levels. See exhibit 4 for the comparison. Also, if you would like to see the detailed financial model, please feel free to contact me directly, and I will be happy to share it.

Exhibit 4: Present Value of Selling in 2010, 2011, and 2030



Source: BGSA analysis

Implications for Owners

In the end, Bob Dylan was right: "You don't need a weatherman to know which way the wind blows." It's clear that taxes are going in one direction – up. Meanwhile, 2010 presents a golden opportunity to lock in low rates amidst market uncertainty.

In sum, now is a good time to assemble and consult with your team. With the right professional advisors for your tax, legal, and investment banking, you can draw on outside input for both your financial well-being and your personal peace of mind.

Benjamin Gordon is CEO of BGSA, the leading strategy-led investment banking firm for the supply chain sector. For more information, please visit BGSA's website at www.BGSA.com. You may contact Benjamin Gordon directly at Ben@BGSA.com, or (561) 932-1600 x1601.

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