Robert H. Perry & Associates, Incorporated

Notebook of Ideas for
Divestitures
of Security Guard Companies

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Will "Taxmageddon" Make 2012 the Year of the Seller?

The year 2012 promises a lot more questions than answers for owners of closely-held security companies. Over the past several months almost all of the calls to our office resulted in long discussions about what may happen if the new health care bill does not get repealed and the new tax proposals take affect. This was termed "Taxmageddon" in describing the affect it would have on our Nation's pocketbook in the February 18 issue of the Washington Post.

Here are some of the Tax proposals affecting the sale of a business that have owners worried:

- **The expiration of the Bush tax cuts automatically raises the capital gains tax rate to 20%.**
  Historically, the top tax rate on long-term capital gains has been below 30% for the past 30 years. It was as high as 35% in 1978; then had several revisions in the later years—reducing it to 20% in 1981, back to 28% in 1987, 20% in 1997 and thanks to President Bush's Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the long term capital gains tax rate fell back to 15%. However, these Bush tax cuts, which were to expire on January 01, 2011 were extended to December 31, 2012; at which time, if not extended again, will bring the long-term capital gains rates back to 20%.

  When the financial impact of the unprecedented national debt level and the cost of the war on terrorism is considered, it is very likely that Congress will try to raise the rates even higher than the 20%—a rate in the 25% range would still be at, or lower than, many of the historical levels.

- **3.8% tax on investment income.**
  In order to help fund the New Health care Bill, high earner taxpayers will pay 3.8% tax on investment income, such as "Capital Gains", dividends and other investment income. This is in addition to any other taxes the taxpayer may owe.

- **Minimum tax of 30% - the "Buffett Rule"**
  The February 14th issue of the Wall Street Journal outlined President Obama's plan to impose higher taxes on the rich. To quote from the article...."Mr. Obama, suggested eventually replacing the AMT [Alternative Minimum Tax] with a long-term plan named after billionaire investor Warren Buffett. The so-called Buffett Rule would require those who earn more than $1 million [which would be the case for most owners who sell their business] to pay a tax rate of at least 30% and prevent them from claiming deductions to push their tax rates down".

- **Elimination of the Subchapter "S" status for large corporations**
  Many closely-held corporations are set up as "Subchapter S" status; which means the corporation does not pay Federal income tax, rather the individual shareholders pay their share of personal tax on the earnings of the corporation. One of the changes being considered in rewriting the U.S. tax code is limiting the size to qualify for "S" status to $10 million of revenue. It's not clear how this change would affect existing corporations that have elected "S" status and exceed the $10 million threshold, but it's certainly something that a company's tax advisors need to keep their eye on as owners of these potentially "disqualified" corporations approach a sale transaction. If these "non qualifying companies" get re-classified to "C" corporations, it may mean that the proceeds from a sale get double taxed (as it is now when a "C" corporation sells its assets rather than its stock).

  We wrote a more detailed explanation of this in our special e-mail only Tax Alert Issue, which can be viewed in the publications section of our website (www.roberthperry.com).

What the Tax Increases Would Mean to Owners Selling After 2012

With all the uncertainties surrounding the economy, owners are starting to ask themselves: If I don't sell now, will my company be worth less as more sellers, who are concerned about the possible tax increases, come on the market? Should I take the "wait and see" approach and bet against any of these higher operating costs and tax increase proposals from happening? Do I sell now when the company may be worth more and the taxes on a sale are less?

Unfortunately, no one knows the answers to these very important questions; therefore many owners of closely-held security companies are at a dilemma as to what to do.

If some or all of the tax increases take effect, the illustrations below show what the tax increases mean to the owners' "take home pay" in a sale. Note that we show two example companies with different revenues and obvious different selling prices as a way to point out that the percent increase stays the same regardless of the selling price.

Example 1: Assume the seller has a $12 million gross revenue company and the buyer, after going through its Internal Rate of Return (IRR) computation, makes an offer of $4,500,000 (4.5 times gross monthly revenue). Further assume that the $4,500,000 qualifies for long term capital gains rates:

	Present	If rate increases to the following:		
	15%	(1) 20%	(2) 23.8%	(3) 30%
Gain to be taxed	$4,500,000	$4,500,000	$4,500,000	$4,500,000
Federal Tax	675,000	900,000	1,071,000	1,350,000
Proceeds to seller before state taxes	3,825,000	3,600,000	3,429,000	3,150,000
Decrease in seller's proceeds		$225,000	$396,000	$675,000
% decrease in seller's proceeds		**5.90%**	**10.40%**	**17.60%**

(1) Health care bill is repealed, but Bush tax cuts expire
(2) Health care bill is not repealed, resulting in 3.8% tax on unearned income and Bush tax cuts expire
(3) Congress passes 30% minimum tax on high earnings individuals

Example 2: Assume the same fact as above, except the company has $50 million in revenue - resulting in an $18,750,000 gain that qualifies for long term capital gains rates:

	Present 15%	If rate increases to the following: (1) 20%	(2) 23.8%	(3) 30%
Gain to be taxed	$18,750,000	$18,750,000	$18,750,000	$18,750,000
Federal Tax	2,812,500	3,750,000	4,462,500	5,625,000
Proceeds to seller before state taxes	15,937,500	15,000,000	14,287,500	13,125,000
Decrease in seller's proceeds		$937,500	$1,650,000	$2,812,500
% decrease in seller's proceeds		5.90%	10.40%	17.60%

(1) Health care bill is repealed, but Bush tax cuts expire
(2) Health care bill is not repealed, resulting in 3.8% tax on unearned income and Bush tax cuts expire
(3) Congress passes 30% minimum tax on high earnings individuals

How Much a Company Would Have to Increase in Value in Later Years in Order to Produce the Same After Tax Results as a Sale in 2012

Increases in taxes do not equate to an increase in multiples the buyers will pay for a company. Therefore in order for a seller to get more for a business in a period of rising taxes, the business has to be worth more. The business has to become more profitable on the same revenue, or the revenue has to increase substantially; and given the already shrinking margins and the anticipated increase in operating costs (i.e. new health care bill, unemployment taxes, etc.) none of these seem likely to happen in the near future for private security companies.

Below are two examples showing how much a company would have to grow or increase in value in order to net the owner the same as a sale in 2012. Note that in the illustrations, it is assumed that as the company grows, the margin, at the site level, as a percent of annual revenue, stays the same (i.e. the owner is not selling at lesser margins as a way to increase total revenue).

Example 3: Amount the $12 million company in Example 1 would have to grow (at the same or better margins) in order to net the owners the same in after tax proceeds as a sale in 2012:

Assumed Rate	Revenue Needed	% Increase Needed
15.0% (present tax rate)	$12,000,000	
20.0%	12,750,750	6.25%
23.8%	13,385,827	11.55%
30.0%	14,571,429	21.43%

Example 4: Amount the $50 million company in Example 2 would have to grow (at the same or better margins) in order to net the owners the same in after tax proceeds as a sale in 2012:

Assumed Rate	Revenue Needed	% Increase Needed
15.0% (present tax rate)	$50,000,000	
20.0%	53,125,000	6.25%
23.8%	55,575,000	11.55%
30.0%	60,714,286	21.43%

Advice to Owners

We still have confidence in our great Nation, which has proven resilient over time that our economy will get strong again. In the meantime, the taxes on selling a business will forever be going up and down as politicians see taxes as a way to "fix" the sluggish economy or give it a "jump-start".

Some advisors say the decision on whether or not to sell a business should not be driven by the tax rates, but we only partly agree with this theory. Every owner's financial situation and time line for selling his business is different. If an owner still enjoys running the company and the company is growing and is profitable; then unless the owner already has plans to sell in the next 5 years or so, he shouldn't be swayed into selling just because the taxes on a sale may rise dramatically in the next few years. By the time this owner gets ready to sell, the tax rates may in fact be seller favorable again.

However, for some owners, the business represents a substantial portion of the net assets the owner needs for retirement and this owner can't afford to gamble it away in this uncertain economy. If an owner is concerned about the company losing value because of higher operating costs and the loss of revenue, and does not have time to wait for the economy to improve and the next wave of seller favorable taxes to come around, then this owner should talk with his tax advisor about what to expect in a sale in 2012. The buyers are presently paying very attractive multiples and the tax rates are seller favorable - but who knows how long this will last?

Written by Robert Perry

Special Note Regarding Tax Advice: Our firm is not qualified to offer tax advice nor are we offering such advice in this article. The tax computations on the sale of a business are very complex, the outcome of which is affected by, among other things, the type of corporate entity, the allocation of purchase price, tax loss carrybacks and carryforwards, etc. We strongly advise owners thinking about selling their company to seek competent tax counsel before starting the sale process.

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We initiate and manage transactions for sellers of private security companies. Established in 1977, we have represented over 150 sellers located in the United States, Canada, Western Europe, South America, the Caribbean, and the Middle East.

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